**STATEMENT OF**

**STEPHEN E. HESSLER**

**PARTNER, KIRKLAND & ELLIS LLP**

**BEFORE**

**THE SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL AND ANTITRUST LAW**

**THE COMMITTEE ON THE JUDICIARY**

**THE UNITED STATES HOUSE OF REPRESENTATIVES**

**JULY 15, 2014**

**HEARING ON**

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

## Overview

## Introduction

Mr. Chairman and members of the Subcommittee, thank you for inviting me to testify at today's hearing. My name is Steve Hessler, and I am a partner in the Restructuring Group of the law firm Kirkland & Ellis LLP. Although Kirkland's Restructuring Group primarily represents large and midmarket companies in insolvency matters, our practice also involves representing equity holders, creditors, investors, and other parties in a wide variety of highly complex distressed situations. I have counseled clients across a broad range of industries, including financial institutions, energy, telecommunications, gaming, hospitality and real estate, and manufacturing. My recent engagements have included some of the largest and most complicated Chapter 11 cases in history, including Calpine Corporation, Charter Communications, and, at present, Energy Future Holdings Corporation. The views expressed in my testimony, written and oral, are my own, and are not offered on behalf of my firm, any client, or other organization.

Beyond my client representations, I have lectured and published a number of articles on restructuring-related topics. I currently serve as the Co-Chairman of the Advisory Board on Administrative Claims, Critical Vendors, and Other Pressures on Liquidity for the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11. I also teach a class each fall at the University of Pennsylvania to Law School and Wharton Business School students on distressed investing.

I also have written about and critiqued at length the authority provided by Congress within Title II of the Dodd-Frank Act for the "orderly liquidation" of systemically important financial institutions.[1] Most significantly, in May 2011, along

---

[1] *See* Stephen E. Hessler & James H.M. Sprayregen, *Too Much Discretion Exacerbates 'Too Big To Fail,'* WHO'S WHO LEGAL (July 2011); James H.M. Sprayregen & Stephen E. Hessler, *Orderly Liquidation*

with my Kirkland Restructuring partner James H.M. Sprayregen, I wrote a white paper, "Too Much Discretion To Succeed: Why A Modified Bankruptcy Code Is Preferable To Title II Of The Dodd-Frank Act," that we submitted to the Federal Reserve in response to its request for comments relating to the Dodd-Frank Act's Section 216 study regarding the resolution of financial companies under the Bankruptcy Code.[2] That white paper stated:

> Title II is an inferior alternative to the well-established legal landscape of the Bankruptcy Code as applied by Bankruptcy Court judges. Based on our experience, we favor the adoption of certain relatively discrete modifications or clarifications to the existing provisions of Chapters 7 and 11 that would facilitate the orderly liquidation or reorganization of systemically-important financial companies.[3]

To that end, I am pleased to note that H.R. ____, the "Financial Institution Bankruptcy Act of 2014"—which I will refer to herein by its colloquial name, "Subchapter V"—proposes to modify Chapter 11 by incorporating in full or at least in part many of the prescriptive alternatives to Title II that I have long-favored. These include, most significantly:

- Utilize Bankruptcy Court judges as the arbiters of financial corporation cases under Chapter 11, though limited to a predetermined set of especially capable jurists who are most experienced handling cases of analogous size and complexity;

---

*Authority Under the Dodd-Frank Act: The United States Congress's Misdirected Attempt to Ban Wall Street Bailouts*, INSOL WORLD (Third Quarter 2010); James H.M. Sprayregen & Stephen E. Hessler, *Failing to Be Too Big to Fail*, THE DAILY DEAL (May 21, 2010). I also was a member of the steering committee that organized the conference "Cabining Contagion: Addressing SIFI Failure Through OLA and its Alternatives," held on October 24, 2012, at New York University Law School, and I was an invited participant in the "Financial Firm Bankruptcy Workshop," conducted by The Federal Reserve Banks of Richmond and Philadelphia, on July 25-26, 2011 in Charlotte, North Carolina.

[2] The white paper is available at http://www.federalreserve.gov/SECRS/2011/June/20110607/OP-1418/OP-1418_053111_80002_310357154312_1.pdf and a related interview is available at http://online.wsj.com/video/fatal-flaws-in-the-dodd-frank-act/7CEFEDBE-0240-4771-A463-83E32996BC92.html.

[3] *Id*. at 2.

- Make explicit the Federal Government's direct ability to commence an involuntary Chapter 11 case against a financial corporation;
- Provide standing to the primary regulators of financial corporations to raise issues within their oversight purview;
- Authorize Bankruptcy Courts to consider the public interest (in accordance with the governing terms of the primary regulator's statutory mandate) when reviewing a debtor financial corporation's reorganization decisions;
- Effectively eliminate the safe harbors from the automatic stay for counterparty rejection rights of qualified financial contracts; and
- Reiterate that core Chapter 11 provisions—such as the absolute priority rule, the debtor's exclusive right to file a plan of reorganization, and directors' and management's ongoing post-petition role with the debtor in possession—remain applicable to financial corporation cases.

My testimony is organized as follows. *First*, to contextualize the financial institution insolvency regimes at issue, I will summarize the interplay between Subchapter V and Title II, and their related but distinct imperatives. I also will make some brief general observations, from my perspective as a practitioner who frequently represents debtors, about the comparative advantages of Chapter 11 (as modified by Subchapter V) to facilitate more effectively the entirely laudable goals that underlie Title II. *Second*, I will highlight and explain my general support for—and limited reservations about—the key provisions of Subchapter V.

## I. Reorganization First Principles

Put simply, of the potential insolvency resolution regimes at issue—Chapter 11 in its current form, Chapter 11 as modified by Subchapter V, and Title II—Subchapter V is the best designed option, both structurally and philosophically, to advance the private and public policies that animate the reorganization of a systemically important financial institution. Put differently, Subchapter V is most likely to maximize estate value for the benefit of stakeholders, while safeguarding against the broader economic contagion that could result from the unmitigated failure of a major bank.

**A. Operation**

A threshold item is determining which financial institutions are subject to which insolvency resolution framework. Subchapter V largely adopts Title II's touchstone concept of "covered financial companies," which are United States-incorporated bank holding companies, or nonbank financial corporations predominantly engaged in activities that the Federal Reserve has determined are financial in nature or incidental to such financial activity. But while Title II and Subchapter V both apply to the same entities, they are mutually exclusive proceedings. One of the central tenets of the Dodd-Frank Act is that, once a Title II proceeding has been instituted, liquidation of the financial company shall proceed exclusively under Title II, and no provision of the Bankruptcy Code shall apply.[4] And, conversely, for financial companies not subject to liquidation under Title II, solely the provisions of the Bankruptcy Code or other applicable insolvency laws, but not Title II, shall govern.[5]

Importantly, a proceeding under Title II is commenced by the Federal Government—specifically, upon a determination by the Treasury Department, the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC) that the financial company is in default or danger of default on its obligations, with no viable private sector remedy, and its failure and resolution under otherwise applicable state or federal law (namely, the Bankruptcy Code) would have "serious adverse effects on financial stability

---

4 12 U.S.C. § 5382(c)(1).

5 12 U.S.C. § 5382(c)(2).

in the United States," whereas liquidation under Title II would avoid or mitigate detrimental impact on "the financial system, the cost to the general fund of the Treasury, and the potential to increase excessive risk taking on the part of creditors, counterparties, and shareholders in the financial company."[6]

In partial contrast, under Subchapter V, a case may be commenced voluntarily by the covered financial corporation—or involuntarily by the Federal Reserve Board, upon its determination that the covered financial corporation is (or will soon be) insolvent, "such that the immediate commencement of a case under this subchapter is necessary to prevent imminent substantial harm to financial stability in the United States."[7]

Accordingly:

- a conventional case under the Bankruptcy Code may be commenced (voluntarily or involuntarily) by a relatively limited universe of parties in interest (a debtor or its creditors) for the relatively limited purpose of enforcing ***their own*** respective rights and obligations;

- a proceeding under Title II is initiated by a third party (the Federal Government) for the very broad purposes of liquidating the failing financial company ***and*** protecting the financial stability of the United States ***and*** discouraging problematic economic behavior of market participants; and

- a case under Subchapter V may be filed by the debtor or the Federal Government for the also broad purposes of reorganizing the failing financial corporation ***and*** preventing imminent harm to the United States' financial stability—***but*** without explicit consideration of the concomitant effect(s) on the risk taking of nondebtor parties.

These distinctions between Title II and Subchapter V matter, because, as discussed below, Subchapter V's narrower focus, and its placement within the well-

---

[6] 12 U.S.C. § 5383(b).

[7] Section 1183(a).

established environs of Chapter 11, actually increase the likelihood that the shared aims of both statutes will be achieved.

**B. Efficacy**

Subchapter V will provide superior protection against another financial crisis. The signal weakness of Title II is that it imbues the FDIC with barely limited discretion to exercise its "orderly liquidation authority." Insofar as Title II does require that "[a]ll financial companies put into receivership under [Title II] shall be liquidated" and "[n]o taxpayer funds shall be used to prevent the liquidation of any financial company under this title,"[8] it does follow that public dollars will not be used (or at least not directly) to "bail out" a failing financial company. But lenders care primarily (if not exclusively) about being repaid; they are not concerned with whether the borrower survives or which entity, private or public, funds the repayment.

Described generally, the "moral hazard" targeted by the Dodd-Frank Act results when creditors are incentivized to make risky loans because legal and regulatory regimes effectively operate to privatize gains but socialize losses. Investors will engage in increasingly speculative behavior if they are reasonably assured they will enjoy outsize profits if an investment succeeds, but the government will shield them from outsize harms if it fails. Title II expressly authorizes the dissimilar treatment of similarly situated creditors.[9] And because any excess costs of liquidation will be funded by assessments on third-party financial companies,[10] the Dodd-Frank Act essentially authorizes regulators to

---

[8] 12 U.S.C. § 5394(a).

[9] 12 U.S.C. § 5390(b)(4).

[10] 12 U.S.C. § 5390(o)(1)(B).

pay creditors whatever amounts are deemed necessary to stabilize the economy, according to the economic (and political) priorities of the prevailing Administration.

The hallmark of an optimal resolution regime for distressed financial firms must be clear and established rules, administered by an impartial tribunal. To that end, Subchapter V is a financial company-specific supplement to the existing corporate reorganization provisions of Chapter 11 of the Bankruptcy Code. Thus Subchapter V builds upon the decades of practice and precedent that have refined the Code and that otherwise provide a well-tested, and demonstrably successful, reorganization framework for major corporations, including systemically important financial institutions. So understood, Subchapter V is an appropriately modest and viable construct, as opposed to Title II, which replaces wholesale any application at all of the Bankruptcy Code.

## II. Subchapter V—Key Provisions

The following testimony explains my general support for, and limited reservations about, key provisions of Subchapter V.

### A. Bankruptcy Court Judges

Among the most significant benefits of Subchapter V is its mandate that financial corporation Chapter 11 cases will be administered by Bankruptcy Court judges—as opposed to Title II, which utilizes politically sensitive regulators to decide issues that should be ruled upon by neutral arbiters. Although Subchapter V largely (but not entirely) maintains the Chapter 11 status quo in this respect, these provisions are a critical comparative advantage to Title II.

The United States Code establishes that bankruptcy cases are filed in the applicable Federal District Court, which may then "refer" the cases to the Bankruptcy

Court in that judicial district.[11] As a matter of course, every Federal District Court has a standing order that all bankruptcy cases filed therein are automatically referred to that jurisdiction's Bankruptcy Courts (except for certain limited issues or in certain limited circumstances).

While this construct generally works exceptionally well, I do support Subchapter V's provisions that assign covered financial corporation Chapter 11 cases to a predetermined panel of not fewer than ten Bankruptcy Court judges "who have significant experience with cases under title 11 in which a financial institution or a company with assets or liabilities exceeding $1,000,000,000 is a debtor."[12] Ensuring Subchapter V cases are heard by a defined subset of jurists who are most knowledgeable about how to administer a financial corporation reorganization under the Bankruptcy Code is a reasonable and justified accommodation to the exigent circumstances at issue in cases of this distinct size and nature.

Likewise, as to appellate review, Subchapter V provides that "the Chief Justice of the United States shall designate not fewer that 3 judges of the court of appeals in each circuit to serve on an appellate panel to be available to hear" covered financial corporation case appeals.[13] This also is a departure from the status quo, which involves Federal District Courts serving as the initial appellate bodies to review Bankruptcy Court decisions. However, given that Chapter 11 litigants already have the right to seek direct appeal of Bankruptcy Court rulings to the relevant Court of Appeals,[14] and given the

---

[11] 28 U.S.C. § 157.

[12] Section 298(b)(1).

[13] Section 298(a).

[14] 28 U.S.C. § 158(d)(2).

highly time-sensitive ruling requirements imposed by Subchapter V (discussed below), this is a justified amendment to current practice.

### B. Enhanced Government Role

#### 1. Ability to Commence Involuntary Case

As noted above, Subchapter V amends the Bankruptcy Code to allow the Federal Reserve to file an involuntary petition, thus commencing a Chapter 11 case without the debtor financial corporation's consent. Given that regulators already have myriad methods of effectively requiring that a financial company commence a voluntary case under the Bankruptcy Code, making this ability explicit—and, importantly, subject to a determination by the Bankruptcy Court that the Federal Reserve has shown by a preponderance of the evidence that doing so "is necessary to prevent imminent substantial harm to financial stability in the United States"—should help motivate financial corporations to confront their problems early and diligently pursue responsible restructuring options.[15]

#### 2. Standing & Consideration of the Public Interest

The Bankruptcy Code does not presently provide an expansive grant of standing to the Federal Government to participate in Chapter 11 cases. Section 1109(b) states "[a] party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter."[16] The Code does include a limited right to be heard to the Securities and

[15] Section 1183(a)(2)(A)(iv).

[16] 11 U.S.C. § 1109(b).

Exchange Commission,[17] but otherwise, unless the Federal Government has a claim against or equity interest in the debtor, regulatory bodies generally do not have standing to appear, in their capacity as regulators, and advance their public interest mandates in financial corporation cases under Chapter 11.

Subchapter V addresses this shortcoming by providing that the Federal Reserve and FDIC "may raise and may appear and be heard on any issue in any case or proceeding under" Subchapter V.[18] A helpful further modification would be to expressly authorize the Bankruptcy Court to consider the "public interest" in reviewing a financial corporation debtor's proposed actions in Subchapter V cases. There is precedent for doing so, as the Bankruptcy Code already includes the "public interest" as an applicable factor in the Bankruptcy Court's review of most of the debtor's key restructuring decisions in railroad cases.[19] This is an apt parallel, in light of the integral importance of the railroads to the American economy at the time those provisions were enacted. Today, the orderly resolution of systemically important financial companies, as with the railroads in prior generations, is likewise vital to protecting the public interest.

### C. Automatic Stay Safe Harbors for Qualified Financial Contracts

The Bankruptcy Code currently provides that counterparties to qualified financial contracts (such as repurchase or swap agreements) are not subject to the automatic stay

---

17 Section 1109(a) states "[t]he Securities and Exchange Commission may raise and may appear and be heard on any issue in a case under this chapter, but the Securities and Exchange Commission may not appeal from any judgment, order, or decree entered in the case." 11 U.S.C. § 1109(a).

18 Section 1184.

19 Section 1165 requires that "[i]n applying sections 1166, 1167, 1169, 1170, 1171, 1172, 1173, and 1174 of this title, the court and trustee shall consider the public interest in addition to the interests of the debtor, creditors, and equity security holders." 11 U.S.C. § 1165. Those sections involve, for instance, the ability to change wages or working conditions established by collective bargaining agreement, lease rejection or abandonment of a railroad line, and confirmation of a reorganization plan or liquidation.

imposed by section 362 that otherwise bars conventional contract counterparties from relying on an *ipso facto* clause in an agreement to terminate the contract and exercise rights to enforce any security interests in the debtor's collateral.[20] Put simply, when a debtor files for bankruptcy, most contract counterparties are stayed from terminating their agreement with the debtor and/or engaging in self-help remedies against estate assets,[21] but these pro-debtor protections do not apply to qualified financial contract counterparties.[22] As a result, a Chapter 11 filing by a financial corporation with significant qualified financial contracts could be marked by chaos at the outset as counterparties, unimpeded by the automatic stay, proceed to terminate these contracts and enforce their rights in the debtor's assets.

Subchapter V addresses this issue by subjecting qualified financial contracts to the automatic stay—albeit only for 48 hours.[23] I have previously criticized Title II for imposing a similarly brief stay, only until 5:00 p.m. (eastern time) on the business day following the date of the FDIC's appointment as receiver, or after the counterparty receives notice the qualified financial contract has been transferred to a bridge financial company.[24] My concerns primarily were twofold. *First*, this was a problematic grant of discretion to the FDIC to pick winners and losers, through its determination of which counterparties would have their qualified financial contracts transferred to a solvent

---

[20] 11 U.S.C. § 362. An *ipso facto* clause typically provides, among other things, that the commencement of a voluntary or involuntary case under the Bankruptcy Code is an automatic breach of contract.

[21] 11 U.S.C. § 365(e)(1).

[22] *See, e.g.*, 11 U.S.C. §§ 555, 556, 559, 560, and 561.

[23] Section 1187(a)(3)(A)(i).

[24] 12 U.S.C. § (c)(10)(B)(i)(I).

bridge company (thus presumably maintaining the full economic benefits of the agreement), and which contracts will remain with the insolvent debtor (thus presumably providing those counterparties with only the liquidation value of their claims). And, *second*, it seems highly unrealistic that, within one full business day of its appointment, the FDIC would be sufficiently prepared to make informed transfer determinations (much less effectuate those determinations) for a major financial company's entire book of qualified financial contracts.

Subchapter V partly solves the first point regarding discretion. Section 1185(a) provides that the trustee (*i.e.*, the debtor in possession) or the Federal Reserve may request the transfer of estate property to a bridge company, including qualified financial contracts to be assumed, and this request is subject to Bankruptcy Court approval. Ideally Subchapter V would further be clarified to specify the actual decisionmaking authority as to which qualified financial contracts are transferred and assumed remains with the debtor. But because the debtor is at least coequally involved in those determinations, and because those determinations must be authorized by the Bankruptcy Court, the unchecked regulatory discretion in Title II is not present here.

Subchapter V does not, however, directly resolve the second issue regarding whether it is commercially viable essentially to require a debtor to make transfer and assumption decisions almost immediately upon a filing. In my experience, even with months to prepare for the petition date, the first 48 hours (at least) after the commencement of a major Chapter 11 case are already an incredibly hectic period for management and their advisors, and to add to that burden that a financial corporation debtor must review its entire portfolio of qualified financial contracts, and determine for each one whether assumption or rejection is in the best interests of the debtor's estate, does not seem commercially pragmatic.[25] That said, since passage of the Dodd-Frank Act in 2010, financial corporations have had four years to draft and revise their "living wills," and perhaps the enactment of Subchapter V, which also would reinforce the need to make qualified financial contract assumption decisions nearly immediately, would further prompt the relevant managers to plan responsibly for potential insolvency contingencies.[26]

---

[25] For example, when Congress amended the Bankruptcy Code to impose a maximum time limit of 210 days for a debtor to determine whether to assume commercial leases, 11 U.S.C. § 365(d)(4)(B), restructuring experts widely believe this limitation made it prohibitively difficult for retail debtors to revise their business plans and make informed lease assumption and rejection decisions quickly enough—and the result was a spate of retail debtor liquidations.

[26] Although my default position is these safe harbors should not exist at all, I acknowledge it may be possible there are some types of financial products that are specially deserving of a safe harbor—with the following caveats.

*First*, because an exemption from the automatic stay is an extraordinary right, it should be limited to a very narrow class of qualified financial contracts for which an inability to terminate promptly, at the counterparty's election, would pose a demonstrated credible threat of severe harm to the counterparty, as balanced against the harm that termination would inflict upon the debtor (and the public interest).

*Second*, to disincentivize qualified financial contract drafters from responding to this reform by structuring all manner of non-deserving contracts in the guise of exempt agreements, the safe harbor should only become available 60 days after the petition date. *Cf.* 11 U.S.C. § 1110 (providing the automatic stay under section 362 expires 60 days after the petition date for creditors with a security interest in certain aircraft vessels and equipment, unless the debtor within that period obtains court authority to assume and cure any defaults under the agreement).

Qualified financial contract counterparties, like secured lenders upon the advent of the Bankruptcy Code a few decades ago, will protest that eliminating the safe harbors will decimate their markets. But these highly sophisticated parties, just as they learned to draft all manner of commercial transactions as qualified financial contracts (so as not to be subject to the automatic stay), can be expected to adapt their documentation and other practices accordingly, and the resulting benefit (restoring a Chapter 11 filing as a viable option for financial corporations with major qualified financial contracts exposure) will outweigh the detriment (subjecting qualified financial contract counterparties to the same treatment under the Bankruptcy Code as other secured creditors).

Lastly, it bears reiterating that, like all parties in interest, any counterparty that hypothetically could demonstrate an inability to terminate its qualified financial contract immediately after the petition date would pose a credible threat of material harm to the counterparty, as balanced against the injury that termination would inflict upon the debtor, already has the right under section 362 to petition the court to lift the stay immediately. 11 U.S.C. § 362(d).

### D. Other Core Provisions

Beyond Subchapter V's key amendments, also notable are certain core provisions of Chapter 11 that Subchapter V quite importantly does ***not*** modify.

#### 1. Absolute Priority Rule

Stated generally, the Bankruptcy Code requires debtors to adhere to the so-called "absolute priority rule," which generally provides that claims with rights of a similar legal nature be placed in the same class and that no class of junior creditors may receive any recovery unless and until each class of senior creditors receives payment in full (but no more than that) of its claims.[27]

In stark contrast, Title II expressly provides that similarly situated creditors may receive dissimilar treatment, without regard for seniority. Specifically, the FDIC "may take any action" that "does not comply" with the absolute priority rule, if it determines that doing so is necessary to maximize value and minimize loss, provided that similarly situated creditors receive "not less than" they would have in a Chapter 7 or state law liquidation.[28] But so long as that minimum threshold is satisfied for legally coequal claimants, the FDIC may favor certain creditors over others.

That Subchapter V does not disturb the primacy of the absolute priority rule, which is among the most fundamental principles of Chapter 11, is critical to ensuring the traditionally fair and equitable treatment of creditors in these otherwise atypical financial corporation cases.

---

[27] *See* 11 U.S.C. § 1129.

[28] 12 U.S.C. § 5390(b)(4)(B).

### 2. Plan Exclusivity

Subchapter V also does not amend a debtor's exclusive right to file a reorganization plan under section 1121.[29] In other words, the Federal Reserve and FDIC, like all parties in interest, have standing to file a motion to terminate exclusivity for "cause" (including for the reason that allowing the financial corporation's regulator to propose a plan furthers the public interest). But the Federal Reserve and FDIC appropriately remain required to first obtain Bankruptcy Court permission before usurping a Chapter 11 debtor's prerogatives on these critical restructuring decisions.

### 3. Directors & Management

Chapter 11 applies the concept of a "debtor in possession" retaining the ability to manage its businesses post-petition—not to shield executives from the consequences of their stewardship, but to ensure that decisionmakers of distressed corporations are not disincentivized from pursuing the difficult but necessary restructuring decisions that may involve or lead to a Chapter 11 filing.[30]

Title II, on the other hand, directs that "management responsible for the condition of the financial company will not be retained" and the FDIC and other agencies "will take all steps necessary and appropriate" to ensure that management "bear losses consistent with their responsibility" for the failure of the covered financial company.[31] More specifically, the FDIC may recover from any culpable current or former senior executive or director "any compensation" received within two years of the FDIC appointment

[29] 11 U.S.C. § 1121. Subchapter V does otherwise require that "[t]he special trustee shall distribute the assets held in trust ***in accordance with the plan*** on the effective date of the plan." Section 1186(c) (emphasis added).

[30] 11 U.S.C. §§ 1107, 1108.

[31] 12 U.S.C. § 5384(a).

date.[32] The FDIC also may seek to ban directors or executives from participating in the "affairs of any financial company," for a period of no less than two years, for violating any laws or breaching their fiduciary duties.[33]

To be sure, if the leadership of a Chapter 11 debtor (including a covered financial corporation) has acted in a manner that justifies its removal, the Bankruptcy Code already provides ample tools for doing so.[34] But the reality of most restructurings is that the knowledge, expertise, and commitment of existing directors and officers is indispensable to effectuating a debtor's soft landing into and orderly passage through Chapter 11. To that end, Subchapter V exercises admirable restraint in not reflexively vilifying (much less disqualifying) directors and management.[35]

### E. Reservations

While I am overall very supportive of Subchapter V, there are certain issues about which I have reservations. An exploration of all points that I believe should be studied in greater detail is beyond the limited scope of my testimony, but I do want to preview the following high-level thoughts.

#### 1. SPOE

Although not expressly defined as such in Subchapter V, a central feature of the legislation is the "single point of entry" (or SPOE) approach that allows the debtor to

---

32 12 U.S.C. § 5390(s).

33 12 U.S.C. § 5393(c)(1).

34 *See* 11 U.S.C. §§ 1104, 1105, 1106.

35 The only incremental requirements that Subchapter V appears to establish on this front are: the bridge company that is the recipient of a transfer of estate assets shall obtain court approval of its governing documents, including the initial directors and senior officers of the corporation—and that the trust agreement governing the trust (that holds the equity of the bridge company) shall provide that the special trustee (appointed to administer the trust) shall provide notice to the Bankruptcy Court of any change in a director or senior officer of the bridge company. Sections 1185(d)(3); 1186(b)(3)(A).

effect a quick separation of “good” assets from “bad” assets, via transfer of the good assets to a bridge financial company whose equity is held by a trust that is managed by a special trustee for the benefit of creditors—with liquidation of the bad assets in the bankruptcy process, also for the benefit of creditors—with both the transfer and liquidation subject to Bankruptcy Court approval.[36]

My preliminary view is the SPOE construct merits very careful consideration and perhaps further modification. While the contemplated transfer in many respects mirrors the lightning fast “melting ice cube” section 363 assets sales that already are occurring under Chapter 11—including, most relevantly, in the sale of most of Lehman’s operations to Barclays within less than a week of its petition date—there are a number of provisions of Subchapter V that codify and seemingly accelerate these practices. These include, most prominently:

- The transfer of a financial corporation’s assets to a bridge company shall occur not less than 24 hours after the commencement of the Subchapter V case;[37]
- Notice of the proposed transfer shall be provided only to a limited group of creditors, including the holders of the 20 largest secured claims, the 20 largest unsecured claims, and the counterparties to any qualified financial contracts to be assumed by the bridge company;[38] and
- After the transfer of good assets has occurred, the special trustee shall be subject only to applicable nonbrankuptcy law, and the actions and conduct of the special trustee shall not be subject to court approval.[39]

---

36 Sections 1185, 1186, 1187, 1188, 1189, 1191.

37 Section 1185(a).

38 Section 1185(b).

39 Section 1186(d).

That said, there also are a number of safeguards that Subchapter V establishes around SPOE, including:

- The provisions of existing section 363 apply to the transfer of good assets to the bridge company[40]—a critical protection, in my view;
- The bridge company must obtain Bankruptcy Court approval of its governing documents;[41]
- The Bankruptcy Court must approve the trust agreement governing the trust;[42] and
- Perhaps most importantly, the distribution of the trust assets (including, presumably, the equity in the bridge company) shall be done in accordance with otherwise applicable Chapter 11 plan of reorganization confirmation requirements and protections.[43]

### 2. Commencement Procedures

Secondarily, I believe there are a handful of remaining issues, surrounding certain of the procedures and deadlines for commencing a Subchapter V case, that also deserve additional study.

Described summarily, Subchapter V provides that, upon the Federal Reserve filing an involuntary proceeding, the Bankruptcy Court shall hold a hearing on whether to uphold the filing within 12 hours, without notice to or attendance by any creditors, with transcripts that shall remain sealed for at least three months.[44] The Bankruptcy Court must issue its ruling on the Federal Reserve's involuntary petition within 14 hours of the petition being filed—and, upon the Bankruptcy Court's ruling, the covered financial

[40] Section 1185(a).

[41] Section 1185(d)(3).

[42] Section 1186(a)(2)(A).

[43] Section 1186(c).

[44] Section 1183(b)(1)-(2).

corporation shall file any appeal within one hour.[45] The appellate panel shall hear the appeal within 12 hours, and shall issue its ruling within 14 hours, of the Bankruptcy Court's decision.[46] The decision of the appellate panel shall be final and not further appealable.[47]

To state the obvious, these are highly compressed time periods, with atypical sealing requirements, and limited judicial review. These provisions depart from standard Bankruptcy Code principles of due process and transparency, and thus my threshold reaction is greater flexibility and openness may be advisable. That said, I am also quite aware that the drafters of Subchapter V are grappling with widespread, expert views that the good assets of a financial corporation cannot withstand the prolonged public scrutiny inherent in normal Chapter 11 cases. So these extraordinary elements may justifiably be needed due to the unique time and awareness sensitivities of a Chapter 11 case of a covered financial corporation, and thus I look forward to further careful consideration of these important issues.

## Conclusion

It is a privilege to appear before you today. I thank the Subcommittee for allowing me to share my views. And I welcome the opportunity to answer any questions about my testimony.

---

[45] Section 1183(b)(4); 1183(c)(1).

[46] Section 1183(b)(4); 1183(c)(2).

[47] Section 1183(c)(3).