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FINANCIAL INSTITUTION BANKRUPTCY ACT OF 2014

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 schools of law at Stanford, Harvard, and the University of Virginia. 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 two books discussing how bankruptcy can be made more effective in terms of the resolution of SIFIs and has just posted a comprehensive proposal for a new chapter to the Bankruptcy Code (Chapter 14) to handle the resolution of SIFIs (at http://www.hoover.org/sites/default/files/rp-14-july-9-tom-jackson.pdf). And, since December 2013, I have been a member of the Federal Deposit Insurance Corporation's (FDIC) Systemic Resolution Advisory Committee. I am here today in my individual capacity, and the views I express are my own, not those of any organization with which I am affiliated.

I. Introduction: The Need for a Bill to Amend the Bankruptcy Code with Respect to Large Financial Institutions

I previously had the honor of testifying before this Subcommittee on March 26, 2014, at a hearing on "Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives." At that time, my written statement (and oral testimony) focused on ways in which bankruptcy law could and should be modified so as to make it an important player in the resolution of SIFIs and that *both* bankruptcy law *and* the Dodd-Frank Act could be made more effective as a result. Attached to that written statement was an appendix that contained a draft bill under the heading "Proposed Amendments to Facilitate the Resolution of Financial Institutions Under the Bankruptcy Code: Focused on a New Subchapter V to Chapter 11."[1] The draft bill in that appendix has many features in common with the bill under consideration today, entitled the "Financial Institution Bankruptcy Act of 2014" (the "Bill"), and thus it is no surprise that I am here today as an enthusiastic supporter of the Bill.

To see the importance of enacting amendments to the Bankruptcy Code along the lines of the Bill, it is worth dropping back to the context created by the Dodd-Frank Act and by the work done by the FDIC with respect to its "single point of entry" proposal for use in the orderly liquidation authority (OLA) under Title II of the Dodd-Frank Act. Together they show, in my view, the importance of enacting the Bill.

It starts by focusing on the provisions in the Dodd-Frank Act itself. 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), the Financial Stability Oversight Council, and the FDIC, "the plan of such company for

[1] See http://judiciary.house.gov/index.cfm/2014/3/hearing-exploring-chapter-11-reform-corporate-and-financial-institution-insolvencies-treatment-of-derivatives.

rapid and orderly resolution in the event of material financial distress or failure . . . ."[2] If the Federal Reserve Board and the FDIC jointly determine that a submitted resolution plan "is not credible or would not facilitate an orderly resolution of the company under title 11, United States 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 . . . ."[3] 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 . . . ."[4] 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. Indeed, a credible plan that would not result in the "orderly resolution of the company" under the Bankruptcy Code would, according to the literal language of Section 165(d)(4) of the Dodd-Frank Act, be rejected. It therefore goes without saying—but is worth saying nonetheless—that the effectiveness of bankruptcy law in being able to resolve SIFIs in ways that do not unnecessarily destroy value (such as by liquidating a viable going concern) is critically important to the development of approvable resolution plans under Title I.

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 government regulators find that bankruptcy is wanting.[5] That is, by its own terms,

[2] Dodd-Frank Act § 165(d)(1).
[3] Dodd-Frank Act, § 165(d)(4)
[4] Dodd-Frank Act, § 165(d)(5)(A) & (B).
[5] Dodd-Frank Act, § 203(a)(1)(F) & (a)(2)(F); § 203(b)(2) & (3).

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 under Title II of the Dodd-Frank Act, 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 addition, much thinking and work has occurred since the enactment of the Dodd-Frank Act.[8] 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

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[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] A useful discussion of whether and how well Title II of the Dodd Frank Act 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* (forthcoming, Brookings 2014).

[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

"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, 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 fiscally "sound." The bridge institution then forgives intercompany liabilities or contributes 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 following a European-like "bail in"; the major difference is that in the "bail in," the entity is directly recapitalized (hence the "one-entity"), 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 the bridge institution.[12]

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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).

[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

Thus, the important question for bankruptcy law is the effectiveness of the current Bankruptcy Code as a credible resolution mechanism for a SIFI in financial difficulty, measured today against the FDIC's SPOE proposal for how it would use Title II of the Dodd-Frank Act. While a focus on an effective recapitalization of the holding company removes some of the concerns about the current Bankruptcy Code—such as its exclusion of various operating entities a SIFI might own or control[13]—and while the current Bankruptcy Code contains many of the "bones" of a successful way to recapitalize a SIFI in accordance with the rule of law, there are several obstacles that effectively eliminate the current Bankruptcy Code as a viable alternative to the FDIC's SPOE proposal.

The essence of any "rapid recapitalization"—and this is true under the FDIC's SPOE proposal as well as under any bankruptcy alternative—is pre-identified long-term debt that is both (a) required and (b) subordinated to regular unsecured obligations. It is this debt that, consistent with known priorities, will be "left behind" (or converted to equity) in any recapitalization, whether that of a single-entity or that of two-entities. The relevant government agencies, in imposing capital requirements on SIFIs, need to ensure that some of the capital requirements are in the form of debt, not exclusively equity.[14] (Mandatory equity requirements are important because equity is

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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.

[13] Bankruptcy Code § 109(b)(2) & (3). To deal with the bankruptcy of an operating entity only, different provisions—such as those that are suggested in the July 9, 2014 proposal just posted by the Hoover Institution's Resolution Project, http://www.hoover.org/sites/default/files/rp-14-july-9—tom-jackson.pdf--might be considered. (In general, these provisions are ancillary to those in the Bill. Over areas that both cover, the Hoover proposal and the Bill are rarely out of sync.)

[14] The Board of Governors of the Federal Reserve System has stated that it will issue a proposed rule that would establish a minimum amount of long-term unsecured debt and other loss-absorbing resources. Daniel K. Tarullo, *Toward Building a More Effective Resolution Regime: Progress and*

the first "cushion." But any recapitalization requires the elimination of debt—and to eliminate debt consistent with established creditor priorities, it needs to be pre-identified as distinct from (and effectively subordinated to) other unsecured obligations. That is the only way, consistent with the rule of law embedded in the Bankruptcy Code, to "leave" that debt behind, and it is the only way the FDIC can accomplish its SPOE procedure consistent with pre-established creditor priorities.)

Thus—on the crucial assumption that such long-term debt will be both identified and required—the structural essence of a recapitalization is already 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—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.[15] 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

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Challenges, at 11, 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); Statement of Daniel K. Tarullo before the Committee on Banking, Housing and Urban Affairs, at 11-12 (Feb. 6, 2014).

[15] 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").

received by the bankruptcy estate in connection with the sale. And it, at least in rough contours, has structural features in common with the two-entity recapitalization that is envisioned under the FDIC's SPOE procedure.

That said, a Section 363 sale under the current Bankruptcy Code is a wholly inadequate competitor to a SPOE process under Title II of the Dodd-Frank Act as proposed by the FDIC. While both will require identification of long-term debt (or capital structure debt) that will be left behind—and presumably that may emerge from the current Federal Reserve Board consideration of this issue—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 whose equity is transferred from the SIFI holding company to the bridge company.

This is virtually impossible 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.[16] Importantly, even if most such contracts reside (as is usually the case) in non-

[16] 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

bankrupt operating subsidiaries of the bridge company, such creditors may have cross-default or change-of-control provisions triggered by the Chapter 11 filing of their former holding company that current bankruptcy law does nothing to mitigate. 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. In my view, these problems are, essentially, fatal to any effort to use the current Bankruptcy Code to recapitalize a SIFI—and thus will inexorably lead, contrary to the clearly-identified preference for the primacy of bankruptcy law expressed by the Dodd-Frank Act and by the FDIC itself, to the routine invocation of Title II of the Dodd-Frank Act, so as to gain access to the SPOE procedures. The Bill, as I will point out, effectively solves each of these problems.

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)),[17] 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

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, need to be rethought. See David Skeel & Thomas Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152 (2012).

[17] 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 . . . ."

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 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. Again, the Bill effectively addresses, insofar as possible,[18] each of these concerns.

II. The Essential Changes to the Bankruptcy Code—and How the Bill Effectively Would Implement Them

From this recitation, it is clear that the Bankruptcy Code needs tweaking—sometimes subtle, detailed, and complicated, but tweaking nonetheless—to permit it to be, in the vast majority of cases, a viable resolution mechanism of a SIFI, fully competitive with—and in some respects, superior to—the FDIC's SPOE proposal for Title II of the Dodd Frank Act.[19]

[18] Cross-border issues are complex, and require agreements among countries that are outside the jurisdiction of either the FDIC or the Bill. Fortunately, there are solid signs that such international cooperation may be feasible.

[19] 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 Bill appropriately addresses issues of effective resolution, rather than using ineffective resolution mechanisms as a means to force smaller financial institutions. The latter should be addressed on its own merits, not as a behind-the-scenes objection to continue ineffective bankruptcy resolution procedures.

What are these changes? Given the necessarily intricate details of the Bill itself, let me discuss what I think, at a conceptual level, the needed changes are, and along the way provide references to provisions in the Bill that would accomplish these conceptual changes in a concrete and effective way.[20] The heart-and-soul of necessary changes center on a provision—Section 1185 of the new subsection V of Chapter 11 of the Bankruptcy Code proposed by the Bill—that substantially sharpens the nature and focus of a sale of assets under Section 363 of the Bankruptcy Code. This provision contemplates[21] a rapid transfer to and, in effect, recapitalization of, a bridge company[22] (effectively within 48 hours after the commencement of the case)[23] by a SIFI holding company (the debtor—the "covered financial corporation"), after which the bridge company can recapitalize, where necessary, its operating subsidiaries.[24] 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 hopefully will be perceived as solvent by market-participants, including liquidity providers,[25]

[20] I have found a few places where I think cross-references may need to be changed in the Bill I have been referencing in preparing this statement and a few places where I think consideration of modestly-changed or different provisions would be useful. To the extent other statements submitted for this hearing do not make relevant suggestions along those lines, I will be happy to supply modest thoughts in this direction. For present purposes, however, I want to focus on why I believe this Bill is a major advance in addressing the issues I've already flagged.
[21] A bankruptcy case is commenced under subchapter V of Chapter 11 either under Section 301 of the Bankruptcy Code (by the debtor) or by the Federal Reserve Board under Section 303, upon the Federal Reserve Board's certification that (a) the institution is under defined financial stress and (b) the commencement of a bankruptcy case and a transfer to a bridge company is necessary to prevent imminent substantial harm to financial stability in the United States. Bill, Sec. 3, § 1183.
[22] Bill, Sec. 3, § 1185.
[23] Bill, Sec. 3, § 1185 doesn't specify when a transfer can occur (after the first 24 hours), but other provisions provide essential stays only for the first 48 hours, unless a transfer is approved. Bill, Sec. 3, §§ 1187(a)(3), 1188(a).
[24] The institutions that can use these new bankruptcy procedures are effectively those that can be placed into OLA under Title II of the Dodd-Frank Act. See Bill, Sec. 2(a).
[25] Recognizing that this liquidity is not a part of bankruptcy law, and thus not within the jurisdiction of this Subcommittee, I will not here enter into the debate over whether market-based liquidity to the bridge company, backed by existing Board lender-of-last-resort access under Federal Reserve Act

because it will be (effectively) recapitalized, as compared to the original SIFI, by leaving behind in the bankruptcy proceeding previously-identified long-term unsecured 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 an interest in a trust[26] 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).

Many of the remaining provisions that would need to be adopted as well—and are all contained in the Bill—are 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.

§ 13(3)'s "program or facility with broad-based eligibility," in the event of a broader liquidity freeze, are sufficient. Without greater access to government liquidity—under the stringent standards set forth in John Bovenzi, Randall Guynn & Thomas Jackson, *Too Big to Fail: The Path to a Solution* (Bipartisan Policy Center, Failure Resolution Task Force May 2013)—however, I can envision cases where the government may commence an OLA proceeding under Title II of the Dodd-Frank Act, in preference to bankruptcy, for the primary purpose of gaining liquidity access via the Orderly Liquidation Fund, Dodd-Frank Act § 210(n).

[26] Bill, Sec. 3, § 1186.

First, there are provisions applicable to debts, executory contracts, and unexpired leases, including qualified financial contracts.[27] Conceptually, the goal of these provisions is 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 affiliates (such as 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 affiliates), [28] 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 affiliates, since the ownership of the bridge company will be different than the ownership of the debtor (the SIFI holding company) prior to the bankruptcy filing.[29] 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

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[27] Bill, Sec. 3, § 1187 (debts, executory contracts, and unexpired leases); § 1188 (qualified financial contracts and affiliate contracts).

[28] Bill, Sec. 3, § 1187(a)(1)(B), 1188(e) & (f). While § 1188(f) affects 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 either of the commerce clause or 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.)

[29] Bill, Sec. 3, §§ 1187(b)(2) & (c)(1), 1188(e) & (f). This includes offsets and netting out under qualified financial contracts, § 1188(a)(2).

"purpose" of Section 363, bankruptcy law currently 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.[30] But, if there is going to be a two-entity 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—and the Bill does.[31] Second, Section 365 doesn't deal with change-of-control provisions; amendments need to add that and extend it to debt agreements as well—and, again, the Bill has provisions that accomplish that.[32]

With respect to qualified financial contracts, there should be provisions in addition to those just mentioned. Thus, the Bill provides that 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.[33] 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, the Bill appropriately has a requirement that the debtor (the covered financial corporation) and its affiliates shall continue to perform payment and delivery obligations.[34] Conversely, because the counterparty may not

[30] See David Skeel & Thomas Jackson, *supra* note 16.
[31] Bill, Sec. 3, § 1187.
[32] Bill, Sec. 3, § 1187(b)(2) & (c)(1).
[33] Bill, Sec. 3, § 1188(a).
[34] Bill, Sec. 3, § 1188(b)(1).

know for sure what the outcome will be during this interregnum, the Bill also has a provision that the counterparty may promptly "cure" any unperformed payment or delivery obligations after the transfer.[35]

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 government to terminate or modify them based on an "ipso facto" clause or a transfer to a bridge company—and the Bill includes such a provision.[36]

III. Conclusion

The Bill—as noted by the references to its provisions above—effectively accomplishes all of the changes necessary to make the Bankruptcy Code a viable alternative to the proposed SPOE procedure under Title II of the Dodd-Frank Act. It might be enough to note that the Bill would thus accomplish the original desire of the Dodd-Frank Act to have bankruptcy be the preferred mechanism (and the focus of effective resolution plans), and deserves enactment for that reason alone.

But there are reasons why, for the vast majority of cases, the Bill provides not just a "parallel" mechanism to accomplish a SPOE-like procedure outside of Title II, but a *superior* mechanism. First, the new company formed in the Section 1185 transfer of the Bill is neither (a) subject to the jurisdiction of a bankruptcy court[37] nor (b) subject to "control" by a

[35] Bill, Sec. 3, § 1188(b)(2).
[36] Bill, Sec. 3, § 1189.
[37] See Bill, Sec. 3, § 1186(d).

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.[38] 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 distributed to the creditors and old equity interests "left behind"), whereas the FDIC's SPOE proposal relies on expert valuations for those distributions.[39] Third, because of language in the Dodd-Frank Act,[40] 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).[41] In the bankruptcy process, the Board of Directors, and management, of the newly-created bridge-company would be identified with the input both of the SIFI's primary regulators as well as the beneficiaries of

[38] 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."). Compare this with comparable provisions in the Bill, Sec. 3, § 1185(b)(3), where the trustee provides notice to the bankruptcy court in connection with similar actions.

[39] 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.").

[40] 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).

[41] 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").

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.[42] 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.[43] Fifth, Title II treats the bridge company created in an OLA under Title II as a government entity, exempt from taxes;[44] I think that provision is a serious mistake, preferring the bridge company to its non-protected 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-step recapitalization. The Bill does not make this mistake. Sixth, 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 as provided by the Bill, 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. As I hope I have made clear, I view this Bill to be an important substantive contribution to the

[42] Bill, Sec. 3, § 1185(d)(3).
[43] 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.").
[44] 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 or hereafter imposed by the United States, by any territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority.").

process of effective resolution of troubled SIFIs that began with the financial turmoil of 2008 that led to the enactment of the Dodd-Frank Act in 2010. It is an honor to appear before you today as you begin consideration of this welcome Bill. I would of course be delighted to answer any questions you may have about my testimony.