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# Testimony of Professor Lubben before U.S. House Judiciary Committee Subcommittee on Regulatory Reform, Commercial and Antitrust Law regarding Financial Institution Bankruptcy Act of 2014

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Chair Bachus and Distinguished Members of this Subcommittee:

I hold the Harvey Washington Wiley Chair in Corporate Governance & Business Ethics at Seton Hall University School of Law in Newark, N.J. I have been at Seton Hall since entering academia in 2002, and I teach Bankruptcy, Corporate Finance, and Financial Institutions at the Law School. I also write the *In Debt* column for the New York Times' *DealBook*, and I write about corporate bankruptcy for *Credit Slips*.

Before entering academia, I was an associate for several years with the law firm of Skadden, Arps, Slate, Meagher & Flom in New York and Los Angeles, where I specialized in corporate reorganization and debt restructuring. But my comments today only reflect my own opinions, and not those of any current or former employer or client.

I was asked by minority staff to comment on a draft bill entitled the "Financial Institution Bankruptcy Act of 2014."

As an initial matter, I commend the draft bill as an important and promising first step. As a general matter, resolution of financial institutions must take into account the wide range of contexts in which the institution might encounter financial distress.

Some financial institutions might well be resolved under the extant Bankruptcy Code. But for many institutions, traditional chapter 11 lacks the needed speed. In addition, the so-called "safe harbors," which exempt derivatives from vital parts of the Code, make a filing extremely unattractive.

Moreover, save for the SEC – which has a role in chapter 11 cases for historical reasons – most regulators do not clearly have a way into a bankruptcy case. And no regulator has the ability to commence a bankruptcy proceeding in the face of objections from a financial institution's board.

Despite these problems, Dodd-Frank reflects Congress' strong preference for use of the Bankruptcy Code whenever possible. A modified version of chapter 11, like that proposed in the present bill, represents an important step in realizing this preference.

I also appreciate that the proposal utilizes the experienced bankruptcy judges to conduct the proceedings. One of the key benefits of the American approach to corporate restructuring is the use of experienced, specialized judges.

There are ways in which the bill could be improved, however, and I will address those in the remainder of my comments. In particular, I will highlight three big-picture concerns I have with the draft before turning to a series of smaller, more discrete issues.

First, I have my doubts about the utility of the "special trustee." Under the legislation, such a trustee may be appointed to hold the shares of the bridge company, until the shares are distributed under the debtor's plan. Once appointed, the trustee is largely immune from any oversight by the debtor or the bankruptcy court, but the trustee does have some reporting requirements.

The key question is why have this trustee at all?

Is there any good reason the debtor could not hold the sale consideration, as it typically does in chapter 11 following a 363 sale? And even if we could imagine that in some cases the debtor should not be trusted with this responsibility, is there any reason to think that the traditional remedy for a mistrusted debtor – appointment of a trustee – would not suffice?

Indeed, given the posture of a case under subchapter V, it should be expected that such a trustee will be appointed save for when old management has already been replaced.

The special trustee provisions add unneeded complexity and uncertainty, and thus cost, to a case under subchapter V.

The real goal of the special trustee provisions seems to be to take managerial power of the operating subsidiaries away from the debtor-in-possession. That could seemingly be achieved by directly appointing a manager of the bridge company – the Federal Reserve or some other appropriate regulator should be vested with this power. The regulator could compensate the manager and then be provided with a priority claim in the debtor's bankruptcy case to reimburse the expense.

There is no real need for the debtor's sole asset to be placed into a complex trust arrangement, with equally complex reporting requirements, to achieve these ends. At heart, the special trustee concept seems to confuse the debtor's ownership of the shares of the bridge company with the ongoing operations of the bridge company and its subsidiaries.

Next, I would urge the Subcommittee to give further thought to the fate of the debtor after the sale of its assets to the bridge company.

Understandably, the bill focuses primarily on the successful movement of the debtor's assets – the equity in its operating subsidiaries – to the bridge company. But what happens next?

The bill intimates that a plan will follow, and thus distribute the shares of the bridge company to creditors. But how will that plan be drafted and votes solicited thereon? The bankruptcy process is not self-sufficient, and drafting and negotiating even a liquidation plan requires the work of compensated professionals.

The debtor might be compelled to transfer less than all of the group's operating cash to the bridge company, thus retaining some ability to fund its own liquidation process. The trick, of course, will be to balance the debtor and the bridge company's competing claims to the cash.

Perhaps the debtor could borrow against the value of the bridge company to fund its case, which provides another argument for the debtor, and not the special trustee, to have control over the shares. And proposed section 1185 would seem to prevent such financing in any event.

This may seem a bit picayune, but the debtor's creditors might rightly argue that leaving them to recover their claims in an unfunded liquidation proceeding is little different from direct appropriation of their claims. At the very least there should be a mechanism for converting the case from subchapter V to a traditional chapter 7 liquidation. Indeed, the Subcommittee might well consider if conversion to chapter 7 is not the likely outcome in every case under the terms of the bill as currently drafted.

Moreover, the debtor's professionals, or the bankruptcy trustee, will need access to the debtor's historical financial records if any sensible distribution to creditors is to happen. The management of the bridge company should have some express obligation to accommodate such needs. Otherwise the post-transfer windup of the debtor again becomes an impossibility.

In short, without a viable mechanism to get the bridge company shares into the hands of creditors, the bill is apt to create a morass of litigation that will linger for years after the financial institution's failure.

I similarly urge the Subcommittee to consider what might happen if a subchapter V proceeding failed. Specifically, what happens when the transfer of the operating companies to a bridge and the "bail in" of those companies by the bridge entity fail to halt a run on the operating companies?

Could the bridge company itself be placed into an OLA receivership under title II of Dodd-Frank? Does the bankruptcy court have any ability to convert a subchapter V proceeding into some other type of insolvency proceeding?

Likewise, does the bankruptcy court have any ability to block regulatory actions that might undermine the subchapter V process? For example, what if a state regulator takes action against an operating subsidiary that undermines the viability of the financial institution as a going concern?

Presumably any such power would not extend to foreign regulators – which highlights the reality that solving the "too big to fail" problem is as much about the structure of financial institutions as it is about the specifics of any insolvency process.

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I conclude with a series of more specific, technical comments on the bill:

1. At present the bill provides a role for the Federal Reserve and the FDIC. As noted, the SEC is given a general role in chapter 11, and presumably that would also apply in a subchapter V proceeding. What about the CFTC, state banking and insurance regulators, and the OCC? Alternatively, if the intent is to streamline the process, then it should be made clear that the SEC's role under section 1109 does not extend to this subchapter.

2. Is there any reason to limit the definition of "capital structure debt" to unsecured debt? The current definition could encourage the issuance of bonds secured by the debtor's equity in its subsidiaries, as such bonds might be treated differently in a subchapter V proceeding.

3. The bill is vague as to whether the bridge company would be chartered under state or federal law. While state corporate law is familiar, given the duties of the bridge company's management to mitigate systemic risks, a special federal charter might more appropriately address the fiduciary duties of management.

4. The bill should include express statements that (a) termination rights do not exist against the bridge company and its successors unless they themselves default and (b) that the transfer of assets to the bridge is entirely free and clear of all claims, no matter how contingent or uncertain, including claims arising under state successor liability doctrines.

5. I also suggest further consideration of the proposal to appoint ten bankruptcy judges, each with "big case" experience, per circuit to the pool of judges that might handle cases under the new subchapter V. In particular, I doubt this will always be workable. For example, the Tenth Circuit has just over twenty bankruptcy judges in total. It is not clear that half of those judges have substantial experience with large chapter 11 debtors. Moreover, outside of the Second Circuit, it is not obvious that any other circuit would need anything close to ten bankruptcy judges "at the ready."

I appreciate the opportunity to appear before the Subcommittee today to share my views and look forward to any questions.