EXPLORING CHAPTER 11 REFORM: CORPORATE AND FINANCIAL INSTITUTION INSOLVENCIES; TREATMENT OF DERIVATIVES

HEARING

BEFORE THE

SUBCOMMITTEE ON
REGULATORY REFORM,
COMMERCIAL AND ANTITRUST LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

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CONTENTS

MARCH 26, 2014

EXPLORING CHAPTER 11 REFORM: CORPORATE AND FINANCIAL INSTITUTION INSOLVENCIES; TREATMENT OF DERIVATIVES

WEDNESDAY, MARCH 26, 2014

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON REGULATORY REFORM,
COMMERCIAL AND ANTITRUST LAW
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to call, at 4 p.m., in room 2141, Rayburn Office Building, the Honorable Spencer Bachus (Chairman of the Subcommittee) presiding.

Present: Representatives Bachus, Marino, Holding, Collins, Johnson, and Jeffries.

Staff present: (Majority) Daniel Flores, Subcommittee Chief Counsel; Anthony Grossi, Counsel; Jaclyn Louis, Legislative Director for Rep. Marino; Jon Nabavi, Legislative Director for Rep. Holding; Jennifer Lackey, Legislative Director for Rep. Collins; Ashley Lewis, Clerk; (Minority) Susan Jensen, Counsel; Norberto Salinas, Counsel; and Slade Bond, Counsel; and Rosalind Jackson, Professional Staff Member.

Mr. BACHUS. The Subcommittee on Regulatory Reform, Commercial and Antitrust Law hearing will come to order. Without objection, the Chair is authorized to declare recesses of the Committee at any time.

I want to welcome our witnesses. This is a little unusual to have a 4 hearing, but we have had other scheduling difficulties, so we apologize. And there may be a vote on the floor starting fairly soon, so I am going to read my opening statement as quick as I can and then recognize the Ranking Member, and then we will go to the introduction of our panelists.

And as Chairman of the Financial Services Committee, obviously I had a lot of exposure to these same issues back in 2008, 2009. And it is a very important issue, and I know there was a lot of good work done bringing us to this hearing by the panelists. And it is a real esteemed body of experts that we have here today.

An integral component of the American economy is the ability of companies to turn to chapter 11 of the Bankruptcy Code to overcome unexpected financial troubles. These companies may use Chapter 11 to restructure their debt obligations while continuing their business operations, which preserves jobs and increases the value of return to the company's creditors, suppliers, customers, and the American economy.

Meanwhile, creditors of companies rely on Chapter 11 to assess the risks associated with their investment and can depend on Chapter 11's transparent judicial process to gain a level of certainty regarding their potential recoveries from a bankrupt business. Chapter 11 has evolved since its inception and has adapted to changing to changing and emerging markets. It may be time for that again.

Thirty years ago companies did not have complex capital structures with layers of intertwined debt, nor did a robust derivatives and repurchase agreement market exist. Similarly, the participants in the Chapter 11 process have become increasingly sophisticated. Given the constantly developing law and related practices, it is important that the Committee undertake a periodic review of the application of Chapter 11 and related issues.

In part to assist Congress and this Committee's oversight of Chapter 11, the American Bankruptcy Institute has a similar collection of premiere bankruptcy judges, practitioners, professionals, and academics to discuss and debate wide-ranging issues related to Chapter 11. While their process is not complete, it will be helpful to hear from the ABI regarding their review of the issues that have played a central role in the process, and whether there is any emerging consensus on particular issues. We are grateful for the work that ABI has completed today. I look forward to their report at the end of this year.

In connection with its ongoing oversight of bankruptcy issues, the Committee recently held a hearing on whether the Bankruptcy Code could be improved to better facilitate the resolution of a financial institution's insolvency. The witnesses at that hearing unanimously agreed that the Bankruptcy Code could be enhanced and reformed to achieve this goal.

Today we will continue this discussion by further examining what types of amendments to the Bankruptcy Code and potentially Chapter 11 would assist with an efficient, successful resolution of a financial institution. The bankruptcy process has long been heralded as the primary means of resolving distress companies' insolvencies because of its established history of laws and impartial administration.

It is our responsibility to ensure that the Bankruptcy Code has all the tools necessary to address the unique issues presented by financial institutions' insolvency. Today's hearing should assist the Committee in discharging this responsibility.

An issue that could impact the ability of the Bankruptcy Code to effectively administer financial institutions' bankruptcy is the nature of existing safe harbors for certain financial contracts. These safe harbors have been expanded over time, and now apply to a wide variety of financial contracts.

One of the primary rationales for creating the safe harbors was to prevent contagion of risk in the financial market. Given the recent financial crisis, it would be beneficial to review the existing safe harbors, their effectiveness, and the effect of their continued expansion. Safe harbors have a broad impact on liquidity in the short-term financial markets. And we will be mindful of this impact as we conduct our review.

Today's witnesses collectively have decades of experience on these issues, and I look forward to hearing their testimony.

At this time, I recognize the Ranking Member, Mr. Hank Johnson of Georgia, for his opening statement.

Mr. JOHNSON. Thank you, Mr. Chairman. Before I begin, I would like to take a moment to acknowledge the tragic landslide that occurred this past weekend in Oslo, Washington—excuse me—Oso, Washington. Oso is the congressional district of Suzan DelBene, our colleague on this Subcommittee. I know that Susan cannot be with us today because she is doing everything back home to help those in need, and we empathize with her and her community. They are going through so much pain and loss. And our thoughts and prayers are with the community of Oso, the brave rescuers and search parties, and also our colleagues from the State of Washington.

Now, turning to today's hearing, I would like to thank Chairman Bachus for convening this hearing on such an important topic. This July will mark the 4th year since President Obama signed the Dodd-Frank Act into law to address the financial crisis that nearly brought this country to its knees. Though imperfect, passing the Dodd-Frank Act was a crucial step in resetting our Nation's economic course.

It addressed the root cause of the financial crisis by reigning in too big to fill financial institutions on Wall Street that caused immeasurable hardship to so many American families. It is my belief that we could have done more to create financial stability by limiting the size of the largest institutions and holding wrongdoers accountable, both civilly as we have done and also criminally as we have not done.

But opportunities remain to safeguard the public through congressional and regulatory oversight. Today, the Subcommittee is exercising its important responsibility of oversight by asking how best to perfect and strengthen the Bankruptcy Code to create soft landings instead of financial crashes.

While we may not always agree on matters before this Subcommittee, today's hearing presents an opportunity to forge a bipartisan consensus and cooperation. I hope that this cooperation will guide us to explore the strengths and weaknesses of the Bankruptcy Code in other areas, particularly consumer bankruptcy.

Perhaps no other area is as important to most Americans as the exponential growth and crippling effects of the student loan debt that many face. According to the most recent quarterly report by the Federal Reserve Bank of New York, student loan debt has tripled in the last decade, rising to over $1 trillion. In my home State of Georgia, students graduate with an average of $23,089 according to the Institute of College Access and Success.

And while more people are defaulting on student loans than any other form of debt, these loans are practically non-dischargeable. Why? Although unsecured debt is typically dischargeable in bankruptcy, the Bankruptcy Code has a specific carve-out that does not exempt student loans unless the debtor is able to demonstrate that continued repayment of the debt would pose an undue hardship on the debtor.

This standard is nearly impossible for distressed borrowers to establish. In fact, earlier this month, Reuters reported that in 2007, courts granted some form of relief to only 81 debtors out of the 170,000 student loan debtors who filed for bankruptcy protection in 1 year alone.

This ballooning problem is already affecting the housing market. David Stevens, the chief executive of the Mortgage Bankers Association echoed this concern, noting that "student debt" trumps all other consumer debt. It is going to have an extraordinarily dampening effect on young people's ability to borrow for a home, and that is going to impact the housing market and the economy at large.

The goal of bankruptcy long has been to provide debtors a financial fresh start from burdensome debt. The Supreme Court recognized this principle in the 1934 decisions *Local Loan v. Hunt*, noting that bankruptcy gives the honest, but unfortunate, debtor a new opportunity in life, and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt. This principle applies to businesses and consumers alike. As we work together to improve the Bankruptcy Code, it is imperative that we also look at consumer bankruptcy.

I again thank the Chairman for holding this hearing, and I look forward to the testimony from this distinguished panel of witnesses. And I thank you all for coming.

Mr. BACHUS. Thank you. We have 4 minutes, 54 seconds left on a floor vote. And I am thinking just to keep it in an orderly way, instead of introducing maybe two of our witnesses, I will come back, introduce the entire panel, and then we will have your opening statements, and go from there.

So I understand none of you have a time constraint as such, right? So thank you. One interesting thing, and I appreciate the Ranking Member's statement, he mentioned criminalizing some of these things or criminal cases. This Committee has formed a bipartisan group of five Republicans and five Democrats to talk about over-criminalization because we continue to add to the long list of Federal crimes. And many of them are by regulation. We pass something not intending it to be a criminal act, and yet the different departments of the government are interpreting it and turning into criminal acts.

And so, we have literally filled our prisons with hundreds of thousands of inmates, and some of them for actually violations of regulations as opposed to laws because of the interpretation, which is something we are going to be looking at in a bipartisan way. And, of course, mandatory sentencing has added to that, so we have to be kind of careful about defining something as a crime if there is no mens rea. And you and I agree on that.

Mr. JOHNSON. We do, and I think we have a discussion coming up about two types of crime. One is legal and the other illegal crime. And the legal crime tends to wear a white collar, and the illegal crime, they tend to wear blue collars. And so, when we can get to the point of rectifying the disparity in the two crimes, then we can start consolidating offenses and working on other problems in our criminal justice system.

Particularly, I am interested in the effect that the private prison industry has on our public policy.

Mr. BACHUS. I did not mean to start this. [Laughter.]

Thank you. We will recess this Committee and probably be back in about 35 or 40 minutes. Thank you.

[Recess.]

Mr. BACHUS. The hearing is reconvened, and we appreciate your patience.

Our first witness is Judge Sontchi. Judge Sontchi, actually Christopher Sontchi, is a United States bankruptcy judge from the District of Delaware and a frequent speaker in the United States and Canada on issues relating to corporate reorganizations. He was recently appointed to the Committee on Financial Contracts Derivatives and Safe Harbors of the American Bankruptcy Institution's Commission to Study the Reform of Chapter 11. In addition, he is a member of the American Bankruptcy Institute and the National Conference of Bankruptcy Judges.

In 2010 and '12, he was selected as outstanding bankruptcy judge by the magazine Turnarounds and Workouts. He recently published Valuation: A Judge's Perspective in the American Bankruptcy Institution's Law Review.

Judge Sontchi received a B.A. with distinction in political science from the University of North Carolina at Chapel Hill where he was elected to Phi Beta Kappa. He received his J.D. from the University of Chicago Law School. And I guess you have quit watching the NCAA tournaments, right?

Mr. SONTCHI. At least we won one more game than Duke.

Mr. BACHUS. That is right. Duke was out in the very first round.

Seth Grosshandler is a partner of Cleary Gottlieb Steen—is it Stein or Steen?

Mr. GROSSHANDLER. Steen.

Mr. BACHUS. Steen, and Hamilton where he has been practicing law for over 30 years. His practice focuses on financial institutions, derivative products, securities transactions, secured transactions, and structured finance. As an instrumental player in the development of the safe harbor provisions of the Bankruptcy Code, the Federal Deposit Insurance Act, and orderly liquidation authority, Mr. Grosshandler is regarded as a preeminent expert on derivatives and security transactions, and as well on the risk to counterparties of regulated financial institutions in the event of their insolvency.

During and after the financial crisis, he advised major Wall Street firms, including Bear Stearns, and Lehman Brothers, and various government agencies on market stabilization efforts. Boy, you must have been paid well. Bear Stearns and Lehman Brothers. You had your hands full.

Mr. GROSSHANDLER. They are counterparties to Bear Stearns.

Mr. BACHUS. Oh, they are counterparties. Well, they did pretty well.

Mr. GROSSHANDLER. Probably better than representing the debtors.

Mr. BACHUS. That is right. Thank you. He received his undergraduate degree from Reed College and his J.D. cum laude from Northwestern University.

Ms. Jane Vris is general counsel and partner at Millstein & Company. And I did do that right. During her legal career, including as a partner at Wachtell—is that right, Wachtell—she has advised board special committees, creditors, potential purchasers of assets from distressed companies, and equity investors and companies emerging from Chapter 11. She most recently served as a partner at Vincent & Elkins and was a founding partner of Cronin and Vris.

And she is a member of the National Bankruptcy Conference. She has been designated by Chambers USA as one of America's leading lawyers for business, named a New York Super Lawyer by New York Super Lawyers, and is included in the Guide to the World's Leading Insolvency and Restructuring Lawyers by Legal Media Group, and the International Who's Who of Insolvency and Restructuring Lawyers. It is kind of a who's who of insolvency. I am sorry. I am just joking. [Laughter.]

She received her B.A. magna cum laude from the University of Pennsylvania and her J.D. from New York University School of Law, where she served as the managing editor of the Law Review. Quite impressive.

Professor Thomas H. Jackson is with the William H. Simon School of Business at the University of Rochester. Professor Jackson holds faculty positions in the Simon School of Business and the Department of Political Science at the University of Rochester, where he also served as president from 1994 to 2005.

You know, Steve Covey in his book, I do not know if you are aware, he says the job of a college president is the most difficult job in America.

Mr. JACKSON. [Off audio.]

Mr. BACHUS. Thank you. Before he became Rochester's ninth president, Mr. Jackson was vice president and provost at the University of Virginia, where he first joined as dean of Virginia's School of Law. Previously he was professor of law at Harvard and served on the faculty at Stanford University.

He clerked for U.S. District Judge Marvin Frankel in New York from 1975 to '76, and then for Supreme Court Justice and later Chief Justice William Rehnquist from 1976 to 1977.

Professor Jackson is the author of bankruptcy and commercial law texts used in law schools across the country, and served as special master for the U.S. Supreme Court in a dispute involving every State in the country over the disposition of unclaimed dividends held by brokerage houses.

He received his B.A. from Williams College and his J.D. from Yale Law School. Welcome to you.

Professor Michelle Harner is a professor at University of Maryland Francis King Carey School of Law. She teaches courses in bankruptcy and creditors' rights, business associations, business planning, and professional responsibility at the University of Maryland School of Law.

Prior to joining the University of Maryland, Professor Harner served as Assistant Professor of Law at the University of Nebraska, and was voted professor of the year by her students during the 2006 and 2008 academic years. That is quite an honor.

Professor Harner is widely published and lectures frequently on corporate governance, financially distressed entities, and related legal issues. Professor currently is serving as the reporter to the ABI Commission to study the reform of Chapter 11. She previously was in private practice in the business restructuring insolvency bankruptcy and related transactional fields. Most recently as a partner of the Chicago office of the International Law Firm Jones Day.

Professor Harner is a member of a number of professional organizations, including the American Law Institute, American Bankruptcy Institute, the American Bar Association, and the International Association of Restructuring, Insolvency, and Bankruptcy Professors.

Professor Harner received her B.A. from Boston College and her J.D. from Moritz College of Law at Ohio State University.

All right. That is a very impressive group of witnesses. Did you want to ask them whether they had ever represented the Koch brothers?

Mr. JOHNSON. The Koch Brothers?

Mr. BACHUS. Koch Brothers, that is right.

Mr. JOHNSON. Have any of you ever represented the Koch Brothers before?

Voice. No, sir.

Mr. JOHNSON. All right.

Mr. BACHUS. We are in good shape.

Mr. JOHNSON. How about Sheldon Adelman?

Mr. BACHUS. No, we will get that out of the way. You only have one. [Laughter.]

I do not know about that. The Koch Brothers, his opening statement normally contains some reference to them, and you did not work that into the statement.

Mr. JOHNSON. Well, I did not want any of that Koch Brothers money coming into my reelection campaign. That is the situation.

Mr. BACHUS. But you got legal crimes in there, which is kind of an oxymoron, so that is a new one. Pretty good.

Each of our witnesses' written statements will be entered into the record in its entirety. I ask each of the witnesses to summarize his or her testimony. Actually, we are not going to hold you to 5 minutes. If you go 6 or 7 minutes, that is fine. This is something they tell me to read every time about quitting and everything, but we are just going to go with that.

Now, I will recognize the witnesses to their testimony. And, Judge, we will start with you.

TESTIMONY OF THE HONORABLE CHRISTOPHER S. SONTCHI, UNITED STATES BANKRUPTCY JUDGE FOR THE DISTRICT OF DELAWARE, WILMINGTON, DE

Judge SONTCHI. Thank you. Chairman Bachus, Ranking Member Johnson, and Members of the Committee, thank you for inviting me to testify today. My name is Christopher Sontchi. I am a bankruptcy judge in the District of Delaware, and I have presided over a number of cases and issued numerous opinions involving the safe harbors for financial contracts, derivatives, and repurchase agreements.

Most notably, I presided over the American Home Mortgage case. At the time of its filing in 2007, American Home Mortgage was the 10th largest home mortgage originator in the country, and as part of its origination and securitization business, the company was a party to numerous repurchase agreements involving billions of dollars. As you also stated, I have had the honor of serving as a Member of the Committee on Financial Contracts, Derivatives, and Safe Harbors of the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11.

Today I would like to discuss two important issues related to the safe harbors. First, I believe Congress should amend Section 546(e) of the Bankruptcy Code to significantly narrow its scope. Section 546(e) exempts from avoidance as preferences or fraudulent conveyance settlement payments. I believe Congress' intent was to insulate the securities transfer system. Security industry transferees are generally not the beneficial owners of the subject transactions, but rather are the conduits. Subjecting the conduits to avoidance actions could trigger a series of unintended and disastrous defaults in the interconnected securities markets.

As written and applied, however, the Section 546(e) safe harbor has insulated settlement payments to the ultimate beneficiaries of leveraged buyouts and other transactions, even if the securities were privately issued. Absent the safe harbors, these payments often made to directors, officers, and other insiders that led the company into bankruptcy in the first place would be potentially voidable as fraudulent or preferential transfers.

The safe harbor of Section 546(e) should protect the securities transfer system, but not settlement payments or other transfers with respect to the beneficial owners of privately placed debtor equity securities. And with regard to publicly-traded securities, Section 546(e) should only protect transfers to the beneficial owners of public securities that have acted in good faith.

I have and continue to be faced with a flurry of motions to dismiss and for summary judgment filed by insiders of bankrupt companies seeking shelter from liability through the 546(e) safe harbor.

The secret is out, and defense attorneys are seeking to take advantage of the almost too good to be true safe harbor to the fullest extent possible. And I respectfully urge Congress to act quickly to close this unintended loophole in the safe harbor for the securities transfer system.

The second subject I would like to discuss is more controversial. What is the proper scope of the safe harbor's governing mortgage repurchase agreements? I respectfully urge Congress to remove mortgages and interests in mortgages from the safe harbors relating to repurchase agreements and securities contracts.

The genesis of my request is my experience in the American Home Mortgage bankruptcy case. One of the primary arguments offered in favor of the safe harbors is that it is important for assets subject to the safe harbors to remain liquid. The argument is that without the liquidity supplied by the safe harbors, the cost of lending would increase, and in the event of default, there could be a cascading series of defaults that might spread to the repo counterparty lender and parties to other agreements with the repo counterparty.

It became quickly apparent to me during American Home that mortgages and interests in mortgages are not liquid assets. In fact, it can take several months to complete the sale of one bundle of mortgages. The reality is that the counterparties to repurchase agreements, i.e., the lenders, are not interested as much in preserving the liquidity of their investment in the mortgages originated by a debtor as they are in owning what would otherwise be property of the estate and the lender's collateral.

The business of originating mortgages requires access to a large amount of capital. Traditionally, a mortgage lender would borrow the money necessary to originate mortgage loans through a warehouse secured line of credit or loan. In the event of a bankruptcy by the mortgage lender, the mortgage loans would become property of the bankruptcy estate. The automatic stay would prevent the warehouse lender from taking control of the mortgage loans. And the warehouse lender would both have a secured claim against the estate, collateralized by those loans, and be entitled, for example, to adequate protection.

But as part of BAPCPA, Congress expanded the definition of "repurchase agreement" to include mortgages. And since then, the bulk of lending to mortgage originators has been through repurchase agreements. The repurchase agreements and warehouse secured loans are really identical in all aspects for the most part, other than in a repo the mortgage belongs to the repo counterparty lender rather than to the mortgage lender.

In the event of a default or a bankruptcy by a mortgage lender, the repo counterparty has a right to declare a default and require the mortgage lender to immediately repurchase the mortgage. And in the event the mortgage lender cannot do so, which is normal, the repo counterparty would obtain permanent ownership of the loan and be able to sell it directly to investors, a securitization trust, or keep the repo.

In my experience, that is what the repo counterparty is interested in doing. Rather than preserving liquidity by selling the mortgage, it is likely to hold the loans for later disposition, especially in a crisis such as 2007 through 2009 where the value of the mortgage was low. The safe harbors allow the repo counterparty, rather than the debtor, to hold the mortgage and obtain the upside of any increase in value. As applied to mortgages, the safe harbors allow for the repo counterparty to grab what otherwise would be its collateral, and prevent the mortgage lender debtor from maximizing the value of those loans for the benefit of the estate.

This is contrary to the treatment of secured loans in bankruptcy and turns the Code on its head. The economic reality is that a mortgage lender, such as American Home Mortgage, can be stripped of its assets in days or even hours, leaving no ongoing business, and denying its creditors in general of the value of its assets, i.e., its mortgage loans. And while these safe harbors may make sense in the context of assets that are actually liquid, such as U.S. treasuries, they do not in the context of an illiquid assets, such as mortgages.

Based on my experience, I respectfully urge Congress to consider removing mortgages and interests in mortgages from the definition of repurchase agreement, as well as the definition of securities contract. And thank you again very much for asking me to testify on these important issues. I am more than happy to answer any questions you might have.

[The prepared statement of Judge Sontchi follows:]

Testimony of Hon. Christopher S. Sontchi

United States Bankruptcy Judge for the District of Delaware

"Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies;

Treatment of Derivatives"

Before the

Subcommittee on Regulatory Reform, Commercial and Antitrust Law

The Committee on the Judiciary

United States House of Representatives

Washington, D.C.

March 26, 2014

Chairman Bachus, Ranking Member Johnson and Members of the Committee:

Thank you for inviting me to testify today. My name is Christopher Sontchi and I am a sitting United States Bankruptcy Judge for the District of Delaware. I have presided over a number of cases involving the safe harbors for financial contracts, derivatives and repurchase agreements. Most notably, I presided over the *American Home Mortgage* case. At the time of its filing in 2007, American Home Mortgage was the 10th largest home mortgage originator in the country and was in the business of originating, securitizing, selling and servicing "Alt-A" home mortgage loans, a step above the now infamous subprime market. As part of its origination and securitization business the company was a party to numerous repurchase agreements involving billions of dollars. In addition, commencing in late 2007, I presided over the case of *Delta Financial Corporation,* which was a somewhat smaller version of American Home Mortgage, albeit in the riskier subprime market. I have presided over numerous other cases and issued numerous opinions involving repurchase agreements, tri-party setoffs and swaps. Finally, I have had the honor of serving as a member of the *Committee on Financial Contracts, Derivatives and Safe Harbors* of the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11.

Today, I would like to discuss two important issues related to the "safe harbors" for derivatives, repurchase agreements and other similar contracts. The first is narrow in scope and, I think, for the most part uncontroversial. I believe Congress should consider amending section 546(e) of the Bankruptcy Code to significantly narrow its scope. As set forth more fully below, Section 546(e) exempts from avoidance as preferences or fraudulent conveyances "settlement payments" and transfers made to a class of financial institutions. I believe Congress's intent was to insulate the securities transfer system. Securities industry transferees are generally not the beneficial owners of the subject transactions but, rather, are the conduits. Subjecting these conduits in the securities transfer system to avoidance actions could trigger a series of unintended and disastrous defaults in the interconnected securities markets. As written and applied, however, the section 546(e) safe harbor has insulated from preference and fraudulent conveyance actions the ultimate beneficial recipients of a settlement payments, including insiders in private transactions. The result has been to provide officers and directors of bankrupt companies with an almost "too good to be true" defense to preference and fraudulent conveyance actions.

The second issue is broader and significantly more controversial. I believe Congress should consider scaling back the scope of the safe harbors for repurchase agreements. The original 1984 safe harbor for "repurchase agreements" or "repos" encompassed repos on U.S. government and Agency securities and other highly liquid assets. In 2005 and 2006, the definition of "repurchase agreement" and "securities contract," under which certain repos had been afforded safe harbor treatment, were expanded to include a broader range of potentially less liquid assets, including mortgage loans and interests in mortgage loans. The current safe harbors for repurchase agreements allow for "runs" on financial institutions by counterparties who are not subject to the automatic stay and, thus, are free to terminate repos and other financial contracts *en masse*. These *en masse* terminations drain a target institution of its liquidity, destroy its portfolio, and accelerate its liquidation. The end result is that it is virtually impossible to reorganize companies with significant repo exposure such as American Home Mortgage.

Section 546(e) of the Bankruptcy Code

As written and applied, the section 546(e) safe harbor has insulated settlement payments to the ultimate beneficiaries of leveraged buyouts and other transactions, even if the securities were privately issued. Absent the safe harbors, these payments – often made to the directors, officers and other company insiders that led the company into bankruptcy - would be potentially voidable as fraudulent or preferential transfers. The safe harbor of section 546(e) should protect the *securities transfer system*, if and when the financial institutions are acting as conduits for payment, regardless of whether the securities involved are public or private. This safe harbor for the securities industry is important because the initial transferee is not accorded a good faith defense under section 550, potentially exposing the securities industry to large and inappropriate liability for acting as mere intermediaries in securities transactions.

However, section 546(e) should not protect settlement payments or other transfers with respect to the beneficial owners of *privately* placed debt securities or of equity securities of a closely held entity. With regard to *publicly* traded securities, section 546(e) should only protect transfers to the beneficial owners of public securities holders that have acted in good faith.

Section 546(e) of the Bankruptcy Code provides as follows:

> Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

"Settlement payment" is defined in section 741(8) in a circular fashion as a "preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." Because of this broad and circular language, courts have interpreted it to include many kinds of transactions regardless of whether it advances the legislative intent/policy behind enactment of the safe harbor, i.e., protection of the securities transfer system. These have included transfers to insiders owning private and public securities and LBO's that would otherwise have been fraudulent transfers.

Courts have applied section 546(e) literally and shielded from avoidance transfers involving little or no impact on the functioning of the public securities market. For example, in the case of *In re Quebecor World (USA), Inc.*, 719 F.3d. 94 (2d Cir. 2013), *aff'g*, 453 B.R. 201 (Bankr. S.D.N.Y. 2011), the Second Circuit affirmed the holding of the bankruptcy court that payments made to repurchase *privately-placed notes* were both "settlement payments" and transfers made in connection with a securities contract that were protected under the safe harbor.[1] I propose narrowing the scope of section 546(e) to make it clear that the safe harbor only protects the securities transfer system and settlement payments made in connection with publicly traded securities.

Section 546(e) has also been successfully invoked to protect leveraged buyouts or LBO's. In cases involving LBO transactions, the issue is whether a payment made to the shareholders of the target company in exchange for their securities is a settlement payment entitled to protection. There is a split in authority in cases interpreting the safe harbor in the LBO context. A minority of courts have held that the safe harbor only applies to LBO's involving publicly traded securities or involving the public system of intermediaries and guarantees typical of the securities industry[2] but a majority of courts have increasingly found that the safe harbor protects the beneficial recipient even if the transaction involved private securities and regardless of the involvement of a financial intermediary.[3] My proposal supports the minority position and calls for revising the statute to specifically exclude private transactions from the safe harbor.

Section 546(e) can also impact LBO's of public companies. If the LBO leaves the firm with an unreasonably small capital or if it renders the firm insolvent, then the payments to shareholders are potentially recoverable in a subsequent bankruptcy, for the benefit of the target firm's pre-transaction creditors, if the other elements of a

[1] *See also Enron Creditors Recovery Corp.*, 651 F.3d 329 (2d Cir. 2011); and *In re Munford, Inc.*, 98 F.3d 604 (11th Cir. 1996).

[2] *In re Munford, Inc.*, 98 F.3d 604 (11th Cir. 1996); *In re MacMenamin's Grill Ltd.*, 450 B.R. 414 (S.D.N.Y. 2012); and *In re Norstan Apparel Shops, Inc.*, 367 B.R. 68 (E.D.N.Y. 2007).

[3] *In re Plassein Int'l Corp.*, 590 F.3d 252 (3d Cir. 2009); *In re QSI Holdings, Inc.*, 571 F.3d 545 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009); *In re Kaiser Steel Corporation*, 952 F.2d 1230 (10th Cir. 1991); and *AP Services LLP v. Silva*, 483 B.R. 63 (S.D.N.Y. 2012).

fraudulent transfer are in place. Section 546(e) as written, however, can immunize transfers made in connection with LBO's involving public companies, including those that render the target firm insolvent, even if the target's insiders acted in bad faith.[4] I propose that shareholders of public companies would not be automatically immunized, *per se*, by section 546(e). Rather they would only be protected if they have acted in good faith.

Again, I believe Congress's intent in implementing the safe harbor in section 546(e) was to insulate the securities transfer system. Securities industry transferees are generally not the beneficial owners of the subject transactions but, rather, are the conduits. Subjecting these conduits in the securities transfer system to avoidance actions could trigger a series of unintended and disastrous defaults in the interconnected securities markets. As written and applied, however, the section 546(e) safe harbor has insulated from preference and fraudulent conveyance actions the ultimate beneficial recipients of a settlement payments, including insiders in private transactions. The result has been to provide officers and directors of bankrupt companies with an almost "too good to be true" defense to preference and fraudulent conveyance actions.

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[4] *Compare Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488 (N.D.Ill. 1988) (With respect to fraudulent conveyance claim against insider shareholders of a public company, the court "collapsed" the LBO transaction so that insiders were considered to have received property of the debtor in the transaction but did not collapse the transaction with respect to non-insider shareholders and, therefore, dismissed the actions against the non-insiders); and *In re Hechinger Investment Co. of Delaware*, 274 B.R. 71 (D. Del. 2002). (In a fraudulent conveyance action against insider shareholders resulting from an LBO of a public company, the court concluded that the distinction between insider and non-insider status was "not one that [held] legal significance under section 546(e)" and the insider shareholders were protected by the safe harbor).

I respectfully recommend that Section 546(e) of the Bankruptcy Code be amended (1) to affirm the current statutory protections in section 546(e) to security industries participants who act as conduits in both public and private securities transactions, (2) to remove the section 546(e) protection from avoidance actions for beneficial owners of privately-issued securities, and (3) to continue to safe harbor public securities holders from avoidance actions, if the public securities holder acted in good faith.

More specifically, without providing precise statutory language, section 546(e) should be amended as follows:

> (1) If the settlement payment or transfer is made to (or a securities contract is made with) a stockbroker, bank, clearing agency such as the DTC or a similar financial institution obligated to forward what has been paid or transferred, then, to the extent that the institution received such settlement payment or transfer for the benefit of a client or customer of the transferee and is obligated to forward that payment or transfer, then the institution shall receive the benefit of the existing section 546(e).
>
> (2) The first beneficial recipient of the transfer chain in question will be deemed to have received the relevant settlement payment or transfer directly from the debtor.
>
> (3) Parties receiving payments or transfers as beneficial owners of non-public securities shall not be protected by section 546(e).
>
> (4) Parties receiving payments or transfers as beneficial owners of public securities shall be protected by section 546(e) from constructive fraudulent transfer actions, as well as preferences under section 547, provided they acted in good faith without knowledge of the avoidability of the underlying transaction.

I have and continue to be faced with a flurry of motions to dismiss and for summary judgment filed by insiders of bankrupt companies seeking shelter from liability through the section 546(e) safe harbor. The "secret" is out and defense attorneys are seeking to take advantage of the safe harbor to the fullest extent possible. I believe these changes would align the statutory language and the courts' interpretation of the statute with Congress' original intent – to insulate the securities transfer system from damaging and inappropriate litigation - while not protecting the beneficiaries of private transactions or shielding insiders of bankrupt public companies who have acted in bad faith.

I respectfully urge Congress to act quickly to close this unintended loophole in the otherwise necessary safe harbor for the securities transfer system.

The Scope of the Safe Harbors for Repurchase Agreements

The second subject I would like to discuss is more controversial: what is the proper scope of the safe harbors governing mortgage repurchase agreements?

For the reasons discussed below, I respectfully urge Congress to consider removing "mortgages" and "interests in mortgages" from the definition of repurchase agreements in section 101(47)(a)(i) as well as the definition of "securities contract" in section 741(7)(A). The effect would be to remove "mortgages" and "interests in mortgages" from the safe harbors of sections 555 and 559 (and 561 under Chapter 15).

The genesis of my request is my experience in the *American Home Mortgage* bankruptcy case filed in 2007. It became quickly apparent to me during that case that mortgages simply do not fit into one of the primary purposes behind protecting repurchase agreements, i.e., preservation of liquidity of investments. In fact, mortgages and interests in mortgages are not liquid assets. This is due in large part to the fact that mortgages are sold by the originators to investors or securitization trusts in bundles containing as many as thousands of mortgages as well as the unique nature of mortgages. Every mortgage is secured by a unique piece of real property and involves a buyer that has a unique credit profile and payment history. In order to address the uncertainty arising from the individual nature of mortgages, sales often include lengthy look back periods where the buyer can return some mortgages in a portfolio to the seller if there is an early default or representations regarding the loans turn out to be inaccurate. In fact, it can take several months to complete the sale of a portfolio of mortgages.[5] These are not United States government securities. The reality is that the counterparties to repurchase agreements, i.e., the lenders, are not interested as much in preserving the liquidity of their investment in the mortgages originated by a debtor as they are in owning what would otherwise be property of the estate and the lender's collateral.

The current safe harbors for repurchase agreements allow for "runs" on financial institutions such as American Home Mortgage by counterparties/lenders which are not subject to the automatic stay and, thus, are free to terminate repos and other financial contracts *en masse*. These *en masse* terminations drain a target institution of its liquidity, destroy its portfolio, and accelerate its liquidation. The end result is that it is virtually

[5] While the same argument may be applied to "mortgage related securities" and "interests in mortgage related securities" there can be no question that these agreements are much more liquid than the underlying mortgages themselves and, thus, I do not recommend their removal from the protections of the safe harbors.

impossible to reorganize companies with significant repo exposure such as American Home Mortgage.[6]

The business of originating mortgages requires access to a huge amount of capital. For example, when a new homeowner buys a house for $100,000 with 20% or $20,000 down and borrows the remainder of the purchase price through a mortgage, the mortgage company must deliver $80,000 in cash at the closing of the sale. As of the end of 2013, there were approximately $9.9 trillion in home mortgage loans outstanding, every penny of which came from a mortgage lender. [7] In most cases, the mortgage lender providing the cash at closing obtained that money from a counterparty to a repurchase agreement or through a secured loan.

Traditionally, a mortgage lender would borrow the money necessary to originate mortgage loans through a warehouse secured line of credit or loan. That warehouse loan would be for a large amount of money, say $100 million. At the closing of a mortgage loan, the cash necessary for the mortgage borrower to buy the property would come from the warehouse lender (either directly or through the mortgage lender). The amount of the balance under the warehouse loan would increase by the amount of the mortgage loan and the mortgage itself would automatically become the warehouse lender's collateral. However, the mortgage would remain property of the

[6] There is a persuasive argument to be made that the current scope of the repo safe harbors increases systematic risk for the financial system as a whole and exacerbated the financial crisis of 2007-09. Although I support that position, I am not addressing it in today's testimony. Rather, I am limiting my comments to the adverse effect that allowing the termination of repurchase agreements, notwithstanding the automatic stay, has on a company's ability to reorganize.

[7] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, MORTGAGE DEBT OUTSTANDING (March 6, 2014), http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm.

mortgage lender. When the mortgage lender later sold the mortgage loan to another financial institution or a securitization trust, the cash received from the sale would be used to pay down the warehouse secured loan (plus interest) and the mortgage loan would automatically be removed from the warehouse lender's collateral pool. In the event of a bankruptcy by the mortgage lender, the mortgage loans that had been originated but not yet sold would become property of the bankruptcy estate, the automatic stay would prevent the warehouse lender from taking control of the mortgage loans, and the warehouse lender would both have a secured claim against the estate collateralized by the mortgage loans and be entitled to adequate protection.

Starting in the late 1990's, master repurchase agreements began to replace warehouse secured loans. The prevalence of mortgage repos increased slowly until, as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Congress expanded the definition of "repurchase agreement" to include mortgages.[8] Since 2005, the bulk of lending to mortgage originators has been through repurchase agreements. Mortgage repurchase agreements are virtually identical to warehouse secured loans except for the fact that, under a repo, the mortgage belongs to the repo counterparty/lender rather than to the mortgage lender. As discussed below, this difference is of huge import.

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[8] Prior to 2005, mortgage repurchase agreements proceeded under the theory that they were protected by the safe harbors governing securities contracts. The number of repos under that theory were limited by the litigation risk that courts might not agree the safe harbors were applicable and the transaction was, in fact, a loan.

The procedure for originating mortgage loans under a master repurchase agreement and a warehouse secured loan are virtually identical. The mortgage lender and the repo counterparty/lender would enter into a master repurchase agreement for a large amount of money, say $100 million. At the closing of a mortgage loan, the cash necessary for the mortgage borrower to buy the property would come either directly from the repo counterparty or the mortgage lender. Simultaneously with the mortgage loan closing (or very shortly thereafter), the mortgage lender would sell the mortgage loan to the counterparty with an agreement that the mortgage lender would repurchase the mortgage loan within a specified period of time (usually between thirty and ninety days) for the original purchase price plus a fee. The mortgage lender would use the time of the repurchase agreement to arrange to sell the mortgage to a "permanent" investor or a securitization trust. At the time of the closing of the ultimate sale or securitization of the mortgage loan (or immediately prior), the mortgage lender would repurchase the mortgage from the repo counterparty and flip it to the buyer. As mortgage loans were sold to the repo counter party the balance of loans subject to the master repurchase agreement would increase and as they were repurchased it would decrease. I hope it is readily apparent that warehouse secured loans and repurchase agreements are virtually identical except for the ownership of the mortgage loans themselves.

Under a repurchase agreement, the mortgage loan is property of the repo counterparty. In the event of a default or bankruptcy by the mortgage lender, the repo counterparty has the right to declare a default and require the mortgage lender to immediately repurchase the mortgages (in secured creditor parlance this would be the equivalent of calling the loan). In the event the mortgage lender could not immediately repurchase the loan, the repo counterparty would obtain permanent ownership over the mortgage loans and would be able to immediately sell them directly to permanent investors, securitization trusts or any other third party willing to buy the loans. Alternatively, the repo counterparty could maintain ownership over the mortgages. In any event, the mortgage loans would not be property of the estate and the automatic stay would not be applicable. The structure discussed above and the safe harbor from the rules governing warehouse secured loans such as the automatic stay have been codified by the repo safe harbors.[9]

The ability of a repo counterparty/lender to be able to immediately sell the mortgage loans to a third party and, thus, limit its exposure to the risks inherent in the mortgage itself, i.e., liquidity, is asserted as one of the primary bases for the repo safe harbors. The argument is that without the liquidity supplied by the safe harbors the cost of lending would increase and, in the event of a default, there could be a cascading series of defaults that might spread to the repo counter party/lender and parties to other agreements with the repo counterparty.

So far, so good. But, in my experience, the repo counterparty may not be interested in having the ability to preserve liquidity by selling the mortgages but, rather, is likely to hold the loans for later disposition, especially in a crisis such as in 2007-2009 where the value of the mortgage was artificially low. Indeed, as described

[9] See Exhibit A attached hereto for a brief recitation of the relevant safe harbor provisions.

above, mortgage loans are illiquid assets and, thus, the counterparty may have no choice but to hold the loans. The safe harbors allow the repo counterparty rather than the debtor to hold the mortgage and obtain the upside of any increase in value. In the event the transaction was treated as a loan, the debtor would be able to retain ownership and control over the mortgage loans, subject to providing adequate protection, and preserve the upside for the estate as a whole. As applied to mortgages, the safe harbors allow for the repo counter party/lender to grab what otherwise would be its collateral and prevent the mortgage lender/debtor from maximizing the value of those loans for the benefit of the bankruptcy estate.

This is contrary to the treatment of secured loans in bankruptcy and turns the Bankruptcy Code on its head. The economic reality is that a mortgage lender such as American Home Mortgage can be stripped of its assets in days or even hours, leaving no ongoing business and denying its creditors in general of the value of its assets, i.e., its mortgage loans.[10] While these safe harbors make sense in the context of assets that are actually liquid such as U.S. Treasuries, they do not in the context of an illiquid asset such as mortgages.

Let me close my discussion of mortgage repurchase agreements with a real world example. In the *American Home Mortgage* case, the debtor was a party to a master repurchase agreement with Calyon Bank. At the time of the bankruptcy filing in 2007,

[10] Generally speaking, a debtor would not be able to force a lender under a warehouse secured loan or a repurchase agreement to continue funding future mortgages. 11 U.S.C. §365(c)(2). But, at the very least, the debtor would still own its portfolio. In addition, forcing a debtor and a secured lender to deal with each other often results in continued lending.

the outstanding principal amount of the mortgage loans subject to the master repurchase agreement was approximately $1 billion. Immediately prior to the bankruptcy filing, Calyon declared a default under the master repurchase agreement and took ownership of the mortgage loans. If a repo counterparty such as Calyon takes ownership of the mortgages subject to the repurchase agreement and the value of those mortgages is less than the outstanding principal balance of the loans, the counterparty, *i.e.*, Calyon, can assert an unsecured claim for the deficit. They are, in effect, an undersecured creditor asserting a claim for unsecured portion of their loan.

I conducted a trial over two related issues: (1) at what time does the court value the mortgage loans for considering whether there is a deficit and, thus, a claim; and (2) how does the court calculate the value of the loans. I ultimately issued an opinion on those issues that was affirmed by the Third Circuit.[11] I raise the issue here, however, for a different reason. It became clear in trial that Calyon never had any intention of selling the mortgage loans in the foreseeable future. Rather, its strategy was to hold the mortgages until value rebounded and in the interim its credit exposure was minimized because the mortgage borrowers, i.e., the homeowners, were continuing to make principal and interest payments.

There is nothing morally wrong with Calyon's strategy to hold on to the loans. Indeed, it makes perfectly valid economic sense. The problem is that it should have been in the debtor's purview – not Calyon's - to make the decision whether to hold the

[11] *In re American Home Mortgage Holdings, Inc.*, 411 B.R. 181 (Bankr. D. Del. 2009), *aff'd*, 637 F.3d 246 (3d Cir. 2011).

loans for the benefit of the bankruptcy estate and the debtor's creditors rather than just for Calyon. With virtually every other type of asset that serves as collateral for a secured loan control rests in the debtor. But secured creditors are not without protection. For example, they may be entitled to adequate protection. The law governing the rights of secured creditors and the balance of those rights with other considerations are well developed. The repo safe harbors remove what would otherwise be considered a secured loan from the bankruptcy estate, depriving the debtor with any control over what would otherwise be its property and the lender's collateral. The asserted reason for exempting mortgages from the rules governing virtually every other type of collateral is that those protections are necessary to preserve liquidity in the system and, more particularly, for the repo counterparty's exposure. But, that asserted basis for extraordinary treatment is fallacious because mortgage loans are not liquid, especially in times when there is likely to be a default under the loans such as in 2007-2009. There is no reason to exempt mortgage loans and interests in mortgage loans from the ordinary, well established rules governing secured lending.

I am cognizant that the application of the safe harbors to mortgages and interests in mortgages is a complicated and controversial subject and any amendment to the safe harbors should be carefully weighed. It is not my intention to address the entirety of the issues. Rather, I have attempted to pass on my conclusions as to one issue based on my experience as a bankruptcy judge overseeing several cases involving repurchase agreements governing mortgages, especially the *American Home Mortgage* case.

Based on my experience, I respectfully urge Congress to consider removing "mortgages" and "interests in mortgages" from the definition of repurchase agreements in section 101(47)(a)(i) as well as the definition of "securities contract" in section 741(7)(A).

In closing, thank you very much for inviting me to testify on these important issues. I do not envy this committee's task in addressing these complicated issues. Nonetheless, I believe there are important, discrete changes that can be quickly addressed such as amending section 546(e) to align the statutory language and the courts' interpretation of the statute with Congress's original intent – to insulate the securities transfer system from damaging and inappropriate litigation - while not protecting the beneficiaries of private transactions or shielding insiders of bankrupt public companies who have acted in bad faith. In addition, I think the committee should take a step back and reconsider the scope of the repo safe harbors, especially as they apply to mortgages. While there are a number of issues and arguments that should be considered in such an examination, I think one thing is clear – the assertion that the repo safe harbors are necessary to preserve liquidity does not apply to illiquid assets such as mortgages. They should be returned to whence they came and be subject to the normal, long-standing, well-developed law governing secured lending.

Thank you again.

Exhibit A

Since 1982, Congress has enacted a number of amendments to the Bankruptcy Code that work in concert to preserve the liquidity of the repo market by exempting repurchase agreements from significant provisions such as the automatic stay:

- Sections 555, 559 and 561, which protect the exercise of certain contractual rights to liquidate, terminate and accelerate repurchase agreements from stays, avoidance and other limitations;
- Sections 362(b)(7) and 362(o), which exempt from the automatic stay and all other Bankruptcy Code stays setoffs under repurchase agreements and the realization against collateral for repurchase agreements;
- Sections 546(f) and 548(d), which provide exemptions from preference and fraudulent transfer avoidance for settlement and margin payments; and
- Portions of sections 101 and 741, which define the key terms repurchase agreement, margin payment, settlement payment, repo participant and financial participant.

Section 559 and its exclusion of repurchase agreements from the automatic stay are of primary significance. Collier explains that "[m]ost repurchase agreements afford a non-defaulting party the right to 'close-out' or 'liquidate' the agreement upon the other party's default.[1] Furthermore, virtually all repurchase agreements contain *ipso facto* clauses which authorize repo participants to terminate "for cause" (or otherwise forfeit or modify rights) if the other party becomes bankrupt, insolvent, or fails to maintain contractually specified conditions.[2] "In almost all instances, commencement of a Bankruptcy Code case by a party ... will constitute a default triggering the availability of such rights."[3] Such clauses permit termination of the repurchase

[1] 5 COLLIER ON BANKRUPTCY ¶¶ 559.04 (Alan N. Resnick and Henry J. Sommer eds. 15th ed. rev. 2007).

[2] *Id.* at ¶¶ 559.04 and 559.LH.

[3] *Id.*

agreement simply because of the other party's distressed financial condition. Section 559 protects rights triggered by a condition of the kind specified in section 365(e)(1), i.e., *ipso facto* clauses or bankruptcy defaults.[4] Thus, "section 559 allows protected parties to act upon *ipso facto* clauses."[5]

In addition, section 555 of the Bankruptcy Code provides the tool for the non-defaulting repo participant to exercise its contractual right to close-out, terminate or accelerate a "securities contract."[6] "Such a close-out or liquidation typically entails termination or cancellation of the contract, fixing of the damages suffered by the non-defaulting party based on market conditions at the time of the liquidation, and accelerating the required payment date of the net amount of the remaining obligations and damages."[7]

Finally, as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Congress expanded the definition of "repurchase agreement" to include the transfer of "mortgage related securities (as defined in section 3 of the Securities Exchange Act of 1934), mortgage loans, [and] interests in mortgage related securities or mortgage loans."[8]

Section 101(47) of the Bankruptcy Code contains the definition of a repurchase agreement. A repurchase agreement is an agreement, including related terms, which (i)

[4] *Id.*

[5] *Id.*

[6] As defined in 11 U.S.C. § 741.

[7] 5 COLLIER ON BANKRUPTCY ¶ 555.04.

[8] 11 U.S.C. § 101(47).

provides for the transfer of one or more mortgage loans or interests in mortgage loans; (ii) against the transfer of funds by the transferee of such mortgage loans or interests in mortgage loans; (iii) with a simultaneous agreement by such transferee to transfer to the transferor thereof mortgage loans or interests mortgage loans; (iv) at a date certain not later than 1 year after such transfer or on demand; and (v) against the transfer of funds.[9] No other criteria are set forth in the statute for a contract to be considered a repurchase agreement under the Bankruptcy Code.

The definition of repurchase agreement is incorporated into section 559 of the Bankruptcy Code. As noted earlier, since 1982, Congress has enacted a number of amendments to the Bankruptcy Code to preserve the liquidity of the repo market by exempting repurchase agreements from significant provisions of the Bankruptcy Code. Section 559 and its companion statute, section 555, preserve market liquidity by providing a "safe harbor" for non-defaulting repo participants "to terminate, liquidate or accelerate . . . repurchase agreements with the bankrupt or insolvent party."[10] Indeed, the legislative history of the 2005 amendments specifically provides that:

> The reference to "repurchase and reverse repurchase transactions" is intended to eliminate any inquiry under section 555 and related provisions as to whether a repurchase or reverse repurchase transaction is a purchase and sale transaction or a secured financing. Repurchase and reverse repurchase transactions meeting certain criteria are already covered under the definition of "repurchase agreement" in the Bankruptcy Code.[11]

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[9] *Id.*

[10] H.R. Rep. 109-31, pt. 1, at 133 (2005).

[11] *Id.* at 130.

Mr. BACHUS. Thank you.
Mr. Grosshandler?

TESTIMONY OF SETH GROSSHANDLER, PARTNER, CLEARY GOTTLIEB STEEN & HAMILTON LLP, NEW YORK, NY

Mr. GROSSHANDLER. Thank you, Chairman Bachus. Thank you for having me here. You have my written testimony. I am not going to repeat what is in there. The only reference to the written testimony I want to make is to thank my colleagues Knox McIlwain and Timmy Coldorovo who put it together in such short order.

I was the co-chair with Judge Peck of the Lehman bankruptcy of the ABI Safe Harbors Committee that Judge Sontchi was on as well. And we started that a few years ago, and we were given by the ABI commissioners several pages of topics to cover. We could not get to them all. This is a very, very complicated topic, the safe harbors, the treatment of financial contracts in bankruptcy.

Part of that has to do with there are lots of different players involved, and you may have different answers depending on who the players are, so you have systemically important financial institutions. You have hedge funds. You have industrial companies. You have individuals on the debtor side. It may depend on who the creditor is. Is the creditor a securities clearing agency, like DTC, or is it a non-dealer party? And there are different policy considerations depending on who you are talking about on the debtor and on the creditor side.

Although we had many disagreements among the committee members, there were several things we agreed on. First of all, really complicated. Could not get it all done in the time we had. And then, the safe harbors do derogate from the general principles of the Bankruptcy Code, and that needs to be justified, right? And the justification, and different people on the committee disagreed as to what was and was not justified under these standards. But I think that the basic standards were agreed to, which is the safe harbors, if they promote stability and liquidity, that those are things that might justify derogating from the usual rules of the Bankruptcy Code.

I think people generally agreed that the derivatives, creditors, and repo creditors, at least some of them, maybe not the whole loan repo creditors. I disagree with Judge Sontchi on that, but we can talk about that if you would like. But that some of the risks they face are different from other creditors under the Bankruptcy Code, and, therefore, at least some of the safe harbors were justified under those standards.

The safe harbors also underpin very important markets. The derivatives market, the repo market, they might not cease to exist if you got rid of the safe harbors, but they would certainly shrink a lot. And is that good or bad depends on a lot of things.

And one of the problems with just getting rid of the safe harbors is it is a very blunt instrument because it would basically mean everybody is not safe harbored as opposed to, for instance, regulatory change. So if you look at short-term funding transactions, like repos, the Federal Reserve Board is all over it, in terms of greater liquidity requirements, capital requirements, that sort of thing, to give a disincentive to over reliance on those kinds of transactions, whereas just getting rid of a safe harbor under the Bankruptcy Code, again, would be a very blunt instrument.

I think an interesting example is insurance insolvency, not the subject of this Committee. It is State law. Insurance insolvency is governed by State law.

Little known to most people because why would they be focusing on this, but in the past 5 years, at least 10 States have enacted new safe harbors for insurance company insolvency for derivatives and repos. We are up to about 20, 22 now. But the bulk of that has happened since the financial crisis. Why? It is the insurance companies, the users of those products that wanted the safe harbors to have access to those markets because Wall Street was unwilling to give them access or limited access because of the risk. So this is not only about protecting Wall Street. It is also end users like insurance companies who want the safe harbors.

All that being said, there are clearly issues with everybody liquidating all at once. You want to avoid that if you can. In Lehman, I think that that actually helped prevent more contagion. If all the creditors had been stayed from exercising their rights, there would have been a lot of problems. But the liquidations caused their own problems, of course.

So I think mechanisms that achieve continuity—Chapter 14, the Federal Deposit Insurance Act, single point of entry—all of these designed to avoid close out and are very, very good things. The key to them working from a creditor perspective is that there is somebody who is creditworthy who is able to continue the performance, and that is not only balance sheet creditworthiness. It is liquidity, liquidity to be able to perform.

And then the final thing I would say is to the extent that Congress believes that changes to the fundamental safe harbor provisions are necessary, we need to be very careful. It is really complicated. There are a lot of international aspects to this. There are safe harbors around the world, capital implications for financial institutions.

And the final thing is on the committee we dealt with a number of issues, the really hard issues like the scope of the repo exemption. There was a lot of division. There were several other issues that we picked first because it was so-called low hanging fruit where there was actually a lot of agreement about changes that would make the safe harbors better for America. Thank you.

[The prepared statement of Mr. Grosshandler follows:]

STATEMENT OF

SETH GROSSHANDLER

BEFORE

SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL AND ANTITRUST LAW

COMMITTEE OF THE JUDICIARY

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

MARCH 26, 2014

EXPLORING CHAPTER 11 REFORM: CORPORATE AND FINANCIAL INSTITUTION INSOLVENCIES; TREATMENT OF DERIVATIVES

Chairman Bachus, and members of the committee:

Thank you for inviting me to testify today. I am Seth Grosshandler, a partner at Cleary Gottlieb Steen & Hamilton LLP in New York City. I am co-chair of the Financial Contracts, Derivatives and Safe Harbors Advisory Committee to the American Bankruptcy Institute's Commission on the Reform of Chapter 11 and a member of the Legal Advisory Panel advising the Financial Stability Board on resolution questions. I represented the Securities Industry and Financial Markets Association in connection with the financial contract netting provisions of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (for bank insolvency) and the Bankruptcy Code amendments of 2005 and 2006. I previously testified with respect to the 2005 Bankruptcy Code amendments before the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee in 1999.

A large portion of my practice is dedicated to working on resolution plans for large financial institutions required under Section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which has allowed me to spend considerable time thinking about the resolvability of financial institutions. I have also been actively engaged with both market participants and regulators in the development and implementation of innovative approaches to financial company insolvency, such as "bail-ins" and single-point-of-entry resolution strategies. I also dedicate a substantial part of my practice to cleared and uncleared over-the-counter derivatives and other financial contracts, ensuring that close-out and other rights are protected in the event of an insolvency. I appear before you today in my individual capacity. The views I express are entirely my own, and not those of Cleary Gottlieb Steen & Hamilton LLP or any client or organization with which I am affiliated.

This experience has led me to the conclusion that the Bankruptcy Code safe harbors[1] serve a vital role in promoting systemic stability and resilience, have significantly increased the availability to end-users of derivatives and repurchase agreements and the liquidity of these transactions and related assets, have reduced the cost of transactions to end-users and have decreased the cost of financing to issuers of assets. The safe harbors protect counterparties under a wide variety of financial contracts, including contracts for the purchase or sale of securities and commodities, derivatives contracts, such as swaps and forwards, and repurchase agreements on securities and mortgage loans (collectively, "Safe Harbored Contracts").[2] These contracts are used both by major financial market participants, such as dealers, banks, mutual funds, hedge funds and pension funds, and by businesses in the "real economy." The benefits of the safe harbors accrue not only to users of Safe Harbored Contracts, but to issuers of assets and borrowers under loans financed by Safe Harbored Contracts. In particular, the safe harbor for repurchase agreements on residential mortgage-backed securities and whole loan mortgages serves to reduce the cost of mortgage financing to homeowners.

The risks related to Safe Harbored Contracts, which are secured by (or reference) financial assets and commodities, the value of which can change rapidly, are fundamentally different from the risks related to other contracts; the protections afforded by the safe harbors are aimed at reducing the risks unique to Safe Harbored Contracts. These protections are especially important to central counterparties, who facilitate and reduce risk in markets for Safe Harbored Contracts by interposing themselves between parties to such contracts (acting as the "buyer" to the "seller," and the "seller" to the "buyer"). By protecting counterparties' rights to terminate their Safe

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[1] *See* 11 U.S.C. §§ 362(b)(6), (7), (17), (27), 362(o), 546(e)-(j), 548(d)(2), 553(a)(2)(B)(ii), (a)(3)(c), (b)(1), 555, 556, 559, 560, 561, 562, 753 and 767 (2012).

[2] *See* 11 U.S.C. §§ 101(25) (forward contract), (38A) (master netting agreement), (47)(repurchase agreement), (53B) (swap agreement), 741 (securities contract), 761(4) (commodity contract) (2012).

Harbored Contracts, net amounts owing between the parties, and to exercise rights against related collateral, the Bankruptcy Code safe harbors serve as a firewall, ensuring that the failure of one party does not expose its counterparties to excessive, unquantifiable and therefore un-hedgeable risks. This firewall has been effective in allowing major market participants, such as Lehman Brothers, MF Global and Enron, to exit the market without causing cascades of failures throughout the financial system as a result of Safe Harbored Contracts. Of course, the Lehman bankruptcy did create risks in the financial system, but they, by and large, were not related to Safe Harbored Contracts, and the risks to counterparties and the financial system would have been far greater without the safe harbors.

One of the tangible effects of the safe harbors under "business as usual" conditions, that is, prior to a bankruptcy, is the increase of the liquidity of Safe Harbored Contracts, which reduces both the cost of these transactions and the costs to the issuers of the assets underlying the transactions—the securities or commodities being bought or sold, the mortgages and credit card receivables being financed, the risks being hedged. These benefits flow directly from the certainty provided to market participants that, in the event of the failure of their counterparty, they will be able to realize the value of their bargained-for security, crystalize their loss and hedge the risk related to their counterparty's failure.

It should be noted, however, that, in the context of systemically important financial institutions, immediate close-out may not be the ideal approach. While risks to the financial system would be far greater if counterparties could not immediately close out, the wide-spread and immediate liquidation of contracts and collateral following the failure of a major financial institution can negatively affect markets for less liquid assets. Indeed, this dynamic was present for certain parts of Lehman's book of Safe Harbored Contracts and increased losses to the

Lehman estate. Instead, an approach that provides for the continuity of Safe Harbored Contracts would be preferable in the case of a failed systemically important financial institution, as it would avoid immediate close-outs. I discuss possible approaches at the end of this testimony. However, the risks associated with counterparty contagion that the safe harbors mitigate are far more detrimental to the financial system than the effects of widespread close-outs. Therefore, even if mechanisms for promoting the continuity of Safe Harbored Contracts upon the failure of a systemically important financial institution cannot be achieved, the current safe harbors should be preserved.

Safe Harbors Reduce Systemic Risk by Protecting Against Contagion

Systemic risk can manifest itself in a variety of ways. One example is the risk that the failure of one financial institution could cause a chain reaction of failures in the financial system because of the high degree of interconnectedness within the system. Interconnectedness is inherent in financial markets and the business models of many financial market participants, especially dealers or "market makers." Because there are always at least two parties to any Safe Harbored Contract, major financial market participants are by definition interconnected to one another and, generally, to non-financial companies as well. Similarly, many of the Safe Harbored Contracts that market participants enter into are related or connected to other of their own Safe Harbored Contracts. For example, dealers and other major market participants generally seek to hedge market exposure. Thus, if they are exposed to a risk under one Safe Harbored Contract they will attempt to hedge that risk under a matching and offsetting Safe Harbored Contract (or on a portfolio basis), creating a web of interconnected financial contracts.

While interconnections can be reduced (and industry and regulators have indeed been taking steps to reduce interconnections), they cannot be eliminated. When considering how to address systemic risk, the question therefore becomes how the risks associated with such interconnections are handled during the insolvency of one of the parties to a transaction. While the safe harbors do not address all aspects of systemic risk, they have proven to be very effective in containing the risk of contagion by allowing counterparties to terminate volatile financial contracts with the debtor quickly, thus limiting their exposure to possibly catastrophic losses from the failure of the debtor. This is the very reason why Congress enacted the safe harbors in the first place.[3]

The effectiveness of the safe harbors in containing contagion was demonstrated during the bankruptcy of Lehman Brothers. None of Lehman Brothers' counterparties (many financial institutions among them) failed because of losses under Safe Harbored Contracts with Lehman.[4] Almost all counterparties exercised their safe harbored rights to terminate, net and exercise rights against collateral, with only approximately 3% of Lehman's derivatives book remaining outstanding after three months following its bankruptcy petition.[5] If these counterparties were not

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[3] *See e.g.*, Bankruptcy Law and Repurchase Agreements: Hearing on H.R. 2852 and H.R. 3418 Before the Subcomm. on Monopolies and Commercial Law of the H. Comm. on the Judiciary, 98th Cong. 19 (1984) (statement of Hon. Walter E. Fauntroy) ("The great fear is that a chain reaction would result because of the complex interrelation of many transactions and firms, putting at risk hundreds of billions of dollars and threatening the solvency of many institutions."); H.R. REP. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583 (stating that the 1982 safe harbor amendments "are necessary to prevent the insolvency of one commodity or security firm from spreading to other firms and possible [sic] threatening the collapse of the affected market"); Bankruptcy Reform Act of 1978: Hearing on S. 2266 and H.R. 8200 Before the Subcomm. on Improvements in Judicial Machinery of the H. Comm. on the Judiciary, 95th Cong. 524 (1978) (statement of Stuart D. Root, Esq.) (stating that the absence of close-out rights for futures commission merchants would have "a potential domino effect"), *available at* http://www.archive.org/stream/bankruptcyreform1978unit/bankruptcyreform1978unit_djvu.txt.

[4] Kimberly Ann Summe, *Lessons Learned from the Lehman Bankruptcy, in* ENDING GOVERNMENT BAILOUTS AS WE KNOW THEM 59, 77 (2010), *available at* http://media.hoover.org/sites/default/files/documents/Ending_Government_Bailouts_as_We_Know_Them_59.pdf.

[5] *Id.* at 79.

protected by the safe harbors, these positions would have been indefinitely frozen, causing potentially catastrophic capital and liquidity implications for counterparties in addition to any losses under the contracts. While subsequent failures (and near-failures) occurred during the financial crisis, they had other causes—mainly losses caused by outsized exposures to the subprime mortgage market and the seizure of the inter-bank credit market. The effects of these dynamics were exacerbated by the political uncertainty caused by letting Lehman fail, while shoring up other institutions, which led to or exacerbated runs on not just broker-dealers, but on insured depository institutions (the first time runs had occurred since the Great Depression).

The effectiveness of the safe harbors in containing contagion was evident in the insolvencies of other financial companies, such as the failures of MF Global in 2011 and Enron in 2001. MF Global was a leading broker in a variety of U.S. and European commodities markets, but was able to exit the market safely and without disrupting financial markets.[6] Enron was a party to one out of every three gas transactions and one out of every five electricity transactions in the United States.[7] Despite this massive and unrivaled market presence, no other major financial institution failed as a result of Enron's bankruptcy.

Repealing or Substantially Narrowing the Safe Harbors Would Have Significant Negative Effects on Counterparties and Markets Related to Safe Harbored Contracts

The safe harbors are not a silver bullet against all systemic risk, but repealing them or substantially narrowing them would eliminate the most effective tool for addressing the risk of

[6] Jack Farchy, *MF Global's Demise Felt by Commodities Exchanges*, FT.COM (Nov. 1, 2011), http://www.ft.com/intl/cms/s/0/418fa2f2-046c-11e1-ac2a-00144feabdc0.html?siteedition=uk#axzz2wiK4MXNO.

[7] Committee on Governmental Affairs Members and Staff, Committee Staff Investigation of the Federal Energy Regulatory Commission's Oversight of Enron Corp. 19 (2002), *available at* http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/enron/111202fercmemo.pdf.

contagion. This would decrease the resilience of financial markets and increase the risks to financial market participants, thereby increasing systemic risk.

Absent safe-harbor protection, counterparties would be subject to the Bankruptcy Code's automatic stay and assumption/rejection powers, which would subject Safe Harbored Contract counterparties to a variety of risks. Unlike other contracts, the value of Safe Harbored Contacts typically can change rapidly based on the fluctuating value of the underlying assets or collateral, prevailing market conditions and other factors. The inability of counterparties to terminate such contracts and foreclose on collateral exposes them to risks that cannot be hedged effectively. If the debtor is given the right to assume or reject Safe Harbored Contracts in bankruptcy, this effectively gives the debtor an indefinite option to perform or terminate the contract, making it impossible to effectively hedge the related risks in an adequate manner. It could also potentially give the debtor the right to "cherry pick" between contracts, exacerbating losses to creditors. Although the Bankruptcy Code provides protections to secured creditors, the mechanisms are not timely enough and are too cumbersome to obtain to effectively protect counterparties under volatile Safe Harbored Contracts, especially on a large scale, such as during the failure of a systemically important financial institution.

For example, a party who is owed 100 by the debtor at the time of the debtor's insolvency, and who has 105 in collateral, would be protected from risk if it could immediately terminate the contract, realize on 100 of the collateral and return the remaining 5 of collateral. However, if the counterparty is unable to terminate, and the value of the contract changes such that the debtor owes the counterparty 120 and additional collateral is not posted, the counterparty is exposed to a loss of 15. Similarly, if the value of the collateral were to decrease to 80, and the debtor did not post additional collateral, the counterparty would be exposed to a loss of 20. Further, the increased loss for the counterparty would result in a larger claim against the estate, which would potentially reduce recoveries for other creditors of the estate.

The inability to exercise close-out rights is particularly problematic where a counterparty has entered into back-to-back or related transactions. For example, a dealer or market maker generally will have entered into one or more offsetting transactions to eliminate its financial exposure and lock in a spread; the receipt of a payment under one contract offsets the obligation to make payments under the related contracts. A debtor's failure to post margin or make other payments required under the contract puts an immediate liquidity pressure on the counterparty. This liquidity pressure creates an immediate risk for counterparties, over and above any ultimate loss that may be realized on the contract. It is therefore critical for the non-defaulting party to close out contracts with the debtor, liquidate the collateral and use the proceeds to replace the position with a solvent, creditworthy counterparty. These risks do not exist nearly to the same extent for other creditors in bankruptcy. For example, the value of a loan secured by plant, property or equipment is not likely to change rapidly after the filing for bankruptcy.

These risks are particularly acute with respect to central counterparties, which interpose themselves between parties to Safe Harbored Contracts. Central counterparties reduce risk to the system and to clearing members by reducing net exposures and by maintaining collateral and other loss-absorbing mechanisms that prevent losses from being propagated through the financial system. Central counterparties therefore serve a role similar to that of the safe harbors—as a mechanism for containing contagion. But central counterparties can serve this risk-reducing function only if they can quickly close out Safe Harbored Contracts to contain and manage their own risk—otherwise, central counterparties become a vector for systemic risk.

One of the primary effects of the certainty and protections afforded by the safe harbors is to increase the liquidity of markets for Safe Harbored Contracts, which reduces the costs of both the safe harbored transactions and the costs to the issuers of the assets underlying such transactions. The history of the repurchase agreement market and the related safe harbor demonstrates well this dynamic. In the early 1980s, the securities dealers underwriting the issuances of U.S. Government debt (the so-called "primary dealers") financed their purchases of Treasuries by entering into repurchase agreements on the purchased securities with other market participants in reliance on the "securities contract" safe harbor. In 1982, the Lombard-Wall bankruptcy case threw a shadow over the safe-harbor protection for repurchase agreements by holding that they were to be treated as secured loans rather than purchases and sales of securities and were thus subject to the automatic stay.[8] The uncertainty that the case created had a substantial effect on the repurchase agreement market—the volume of repurchase agreement transactions dropped and the cost rose.[9] As a result, there was a measurable increase in the U.S. Treasury's borrowing costs and the cost of financing the U.S. debt. Concerned that the lack of a robust and liquid repurchase agreement market would impair the U.S. Government securities market, Congress created the safe harbor for repurchase agreements in 1984.[10]

[8] *Lombard-Wall Inc. v. Columbus Bank & Trust Co.*, No. 82 B11556 (Bankr. S.D.N.Y., Sept. 16, 1982) (bench decision). Courts in later decisions rule to the contrary. *See e.g.*, *In re Residential Resources*, 98 B.R. 2 (Bankr. D. Ariz. 1989).

[9] Bankruptcy Law and Repurchase Agreements: Hearing on H.R. 2852 and H.R. 3418 Before the Subcomm. on Monopolies and Commercial Law of the H. Comm. on the Judiciary, 98th Cong. 19 (1984) (statement of Hon. Walter E. Fauntroy) (acknowledging the "major impact" the ruling had on the repurchase agreement market and the resulting increase in repurchase agreement interest rates); Bankruptcy Law and Repurchase Agreements: Hearing on H.R. 2852 and H.R. 3418 Before the Subcomm. on Monopolies and Commercial Law of the H. Comm. on the Judiciary, 98th Cong. 48 (1984) (statement of Peter D. Sternlight, Executive Vice President of the Federal Reserve Bank of New York) (stating that, in the aftermath of the Lombard-Wall case, some repurchase agreement participants withdrew from the market and repurchase agreement financing costs were negatively affected).

[10] *Id.* at 18-19.

Lombard-Wall's effect on the repurchase agreement market demonstrates what would be the result for other Safe Harbored Contracts were their safe-harbor treatment eliminated or scaled back: the price of such transactions would increase, liquidity would decrease and the markets for such contracts would undoubtedly shrink. In my experience, financial market participants simply would not enter into certain Safe Harbored Contracts without the protection afforded by the safe harbors, meaning that markets for those contracts could virtually disappear. Because of the direct and dramatic effect that eliminating or substantially narrowing the safe harbors would have on markets for Safe Harbored Contracts, a decision to proceed with such revisions equates to a determination that these markets do not provide value to the financial system or the broader economy and thus can be curtailed or eliminated.

The benefits of the safe harbors are also evidenced by the fact that many states have very recently—since the financial crisis—incorporated safe-harbor protections into their laws governing the insolvency of insurance companies. Rather than being subject to the Bankruptcy Code or other federal insolvency law, insurance companies are subject to state "rehabilitation" regimes, many of which did not originally contain safe harbors for financial contracts. As of 2013, at least 21 states had added safe-harbor protections to their insurer insolvency laws, and most of these safe harbors have been added since 2008. My understanding is that the drive to enact these reforms came from the insurers themselves (rather than from the banks and dealers) in an effort to gain broader and more cost-effective access to markets for Safe Harbored Contracts, such as repurchase agreements and swaps.

Elimination of the safe harbors could also affect the funding profile and stability of financial companies, including systemically important financial institutions. In the absence of safe harbors, the preference of parties providing funding would likely be for very short-term transactions in order to reduce the likelihood of being trapped in term transactions upon a counterparty's failure. Further, all counterparties—secured and unsecured, short term and long term—would be more likely to stop engaging in new transactions (i.e., to "run") at the first sign of weakness, making entities less stable and resilient. The safe harbors, therefore, provide counterparties the comfort necessary to engage in longer-term transactions and to continue to engage in transactions with a financial company notwithstanding signs of weakness.

Last but not least, the United States is not alone in providing safe-harbor protections for financial contracts. Since the financial crisis, numerous international bodies have considered the issue of systemic risk and financial company insolvency. The resounding consensus has been in favor of broad safe harbors for the termination of financial contracts, netting of amounts owing and realization on related collateral if such contracts cannot be transferred to a creditworthy successor within one or two days. This approach was enshrined in the Financial Stability Board's "Key Attributes of Effective Resolution Regimes for Financial Institutions," which was endorsed by the Group of Twenty Finance Ministers and Central Bank Governors (the G20) and serves as the global standard for financial company insolvency regimes in the developed world.[11] This approach was based on the financial contract safe harbors under the bank insolvency provisions of the Federal Deposit Insurance Act and the Orderly Liquidation Authority provisions of the Dodd-Frank Act, which served as models for the "Key Attributes." Both the Basel Committee on Banking Supervision and the International Monetary Fund, among others, support this approach.

Outside the sphere of financial company insolvency, there has been broad international support for safe harbors as effective means of protecting financial markets and cabining

[11] Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (2011), *available at* https://www.financialstabilityboard.org/publications/r_111104cc.pdf.

contagion. According to data from the International Swaps and Derivatives Association, Inc., as of 2010, there were thirty-seven jurisdictions allowing a non-defaulting party the right to terminate and net obligations under derivatives contracts in the event of insolvency.[12] Any action by the United States to scale back on the safe harbors would be at odds with the international trend towards providing robust safe harbor protections. More importantly, it would put U.S. firms at a significant competitive disadvantage.

More Targeted Measures Should be Pursued

Some have criticized the safe harbors and argued for their repeal, citing among other things the creation of skewed incentives and potentials for distortions in asset markets. These criticisms are particularly prevalent in academic circles. To the extent any such criticisms are justified, and that they outweigh the safe harbors' unquestionable benefits to the stability of financial markets, such risks should be addressed directly, through targeted means, and not by the blunt instrument of repealing or narrowing of the safe harbors.

Take for example the criticism that the safe harbor for repurchase agreements has created an incentive for large financial institutions to rely excessively on short-term repurchase agreements rather than on other forms of funding.[13] The banking and securities regulators are uniquely positioned to address any such issues. In fact, regulators have already taken steps to reduce reliance on short-term funding through tougher capital and liquidity requirements,[14] and

[12] David Mengle, The Importance of Close-Out Netting, ISDA Research Note, No. 1 (2010), *available at* http://www.isda.org/researchnotes/pdf/Netting-ISDAResearchNotes-1-2010.pdf.

[13] Mark J. Roe, Statement to the Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the Committee on the Judiciary of the House, The Bankruptcy Code and Financial Institution Insolvencies (Dec. 3, 2013), *available at* http://judiciary.house.gov/_files/hearings/113th/12032013_2/Roe%20Testimony.pdf.

[14] *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and

plan further action.[15] These rules address specific concerns about the funding profile of major financial institutions without increasing risks to counterparties that would arise if the safe harbors were instead narrowed or eliminated.

Consider also the criticism that the wide-spread close-out that can occur upon the failure of a systemically important financial institution can have negative effects on markets for less liquid collateral. Rather than eliminating the transactions in question, by narrowing or eliminating safe-harbor protection, I would encourage the committee to explore mechanisms that provide for the continuity of such transactions and that avoid close-outs. A case in point is the Federal Deposit Insurance Act's treatment of Safe Harbored Contracts, which facilitates the transfer of a failed bank's portfolio of Safe Harbored Contracts to a creditworthy successor—a successor that is solvent from a capital perspective and that has the liquidity to meet its obligations. Similar concepts exist under the Securities Investor Protection Act, which facilitates the transfer of a failed broker-dealer's "customer" property and transactions to a successor broker-dealer, and Subchapter IV of Chapter 7 of the Bankruptcy Code and the Commodity Futures Trading Commission's Part 190 Rules thereunder, which similarly facilitate the transfer of a failed commodity broker's "customer" property and transactions to a successor commodity broker. Indeed, the recent "Chapter 14" bill proposed just such a mechanism in the context of special bankruptcy proceedings designed to allow financial institutions to restructure rather than

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Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,018 (Oct. 11, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-10-11/pdf/2013-21653.pdf; Liquidity Coverage Ratio, 78 Fed. Reg. 71,818 (Nov. 29, 2013) (Proposed Rule), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-11-29/pdf/2013-27082.pdf.

[15] *See* Daniel K. Tarullo, Speech at the Americans for Financial Reform and Economic Policy Institute Conference (Nov. 22, 2013) (indicating the need to address short-term wholesale funding through regulation and outlining possible regulatory approaches) , *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20131122a.htm.

liquidate.[16] Such approaches may ultimately prove the most effective at reducing the systemic risks associated with the failure of a major financial institution.

Finally, as noted at the beginning of my testimony, there are many aspects to systemic risks. Some have argued that because the Dodd-Frank Act and related regulatory efforts are aimed at reducing systemic risk, that there is no longer any justification for the safe harbors and that they should therefore be repealed. At best, this argument fails to distinguish among the various aspects of systemic risk. As I have described, the safe harbors are aimed at preventing failures from cascading throughout the financial system—one form of systemic risk. But as the 2008 financial crisis demonstrated, there are many other forms of systemic risk. The Dodd-Frank Act reforms are largely aimed at reducing other forms of systemic risk.[17] The fact that other aspects of systemic risk are being addressed through other regulatory means does not mean that the safe harbors are no longer justified or that they are no longer needed as a bulwark against cascading failures. To the contrary, the multiple aspects of systemic risk require that we deploy a variety of defenses.

Conclusion

In conclusion, the safe harbors should not be narrowed or repealed because they serve an important role in preventing the spread of financial contagion throughout financial markets. The certainty that these protections provide has created robust and liquid markets for Safe Harbored

[16] Taxpayer Protection and Responsible Resolution Act, S. 1861, 113th Cong. (2013).

[17] While the "single-counterparty credit limit" requirement of Section 165 of the Dodd-Frank Act is aimed at reducing interconnectedness, it would of course not eliminate it. The safe harbors would still be necessary to address counterparty contagion risk under the remaining interconnections. Further, while the Orderly Liquidation Authority provisions of the Dodd-Frank Act do address contagion risk, the Dodd-Frank Act provides that the Bankruptcy Code remains the preferred means of addressing financial company failures. Accordingly, it cannot be said to address contagion risk other than in the extreme cases in which it was designed to be used.

Contracts. This is not to say that the safe harbors cannot be improved upon. The Financial Contracts, Derivatives and Safe Harbors Advisory Committee, which I co-chaired with Judge James Peck, recommended to the American Bankruptcy Institute's Commission on the Reform of Chapter 11 a variety of potential improvements to the safe harbors. Other work is under way to develop mechanisms for providing continuity for financial contracts during the failure of a major financial institution and other improvements to the way the Bankruptcy Code addresses the failure of financial institutions. I encourage the subcommittee to consider these approaches when considering potential reforms to the Bankruptcy Code.

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Mr. BACHUS. Thank you.
Ms. Vris?

TESTIMONY OF JANE LEE VRIS, PARTNER AND GENERAL COUNSEL, MILLSTEIN & CO., WASHINGTON, DC

Ms. VRIS. Thank you. Thank you, Chairman Bachus——

Mr. BACHUS. Maybe pull that mike a little closer. It will actually put less of a strain on——

Ms. VRIS. There we go. Is that better?

Mr. BACHUS. Yes, there you go.

Ms. VRIS. Okay, great. Thank you, and thank you, Ranking Member Johnson, as well for this opportunity to speak on behalf of the National Bankruptcy Conference. I am the chair of the Capital Markets Committee there, and I am submitting for our testimony today position papers and proposed changes to the Bankruptcy Code that the conference has previously prepared. And these topics cover both safe harbors for, let us call them, the qualified financial contracts. By that I mean the derivatives, the swaps, the repos that you have been hearing about, as well as some form of bankruptcy proposal for treatment of SIFIs, the systemically important financial institutions.

So in a sense, I sort of appropriately sit in the middle here because I am dealing both with the QFCs and safe harbors, as well as the Chapter 14 topic that I think you are going to be hearing more about.

I will start with the SIFIs. We recognize in the conference that SIFIs face extraordinary challenges in bankruptcy. Ordinarily the mission in bankruptcy, and I think the Bankruptcy Code does a good job of this, is to preserve asset value for the benefit of all of the constituents. The automatic stay is a key component of that protection. It protects the debtor's assets from actions of creditors that would otherwise allow them to get at the assets, favor the first to act creditors, and leave less value behind for the other creditors.

When a SIFI files, we are concerned that to some extent the reverse happens, that the filing itself can trigger a loss of asset value to the detriment of all parties concerned. I think it is important to think for a moment what we mean when we say "when a SIFI files." By that I mean a parent holding company whose assets are the equity in operating subsidiaries, institutions like banks, insurance companies, broker dealers. So it is the parent that we are focusing on when we talk about bankruptcy solutions, including, I think you will hear, for Chapter 14 type solutions.

The parent when it files has its assets protected by the automatic stay, but the operating subsidiaries do not have the benefit of the same protection. First, many of them are not eligible to file. Insurance companies, banks, they cannot file for bankruptcy under any chapter. Some subsidiaries can file, but only liquidation, and one conducted by a trustee, which is not really conducive to maximizing asset value for anybody.

So for these reasons when the parent files, the regulated subsidiaries may be seized by their regulators, both here in the U.S. and abroad. Even if they are not seized, parties who have deposits with the banks are likely to demand their deposits back, a lack of confidence in the SIFI. And parties who may previously have been extending short-term financing are likely to stop extending that financing to those enterprises. All of this increases the need for liquidity at the subsidiaries at the same time that liquidity is no longer available to those subsidiaries. In these circumstances, value dissipates quickly.

We think that the safe harbors for QFCs to some degree contributes to this dynamic. Even at the parent level the counterparties are not bound by the automatic stay. They may seize collateral, as you heard from the judge. They may sell the collateral, and they may terminate contracts. Not only at the parent level, but because the parent often guarantees these qualified financial contracts on behalf of its subsidiaries, when the parent files, because it is a guarantor, that can trigger the rights of the counterparties down at the subsidiaries to also terminate contracts, grab collateral. So as a consequence, when the parent files, there is a ripple effect throughout the entire enterprise that can cause assets to dissipate and also increase the need for the liquidity.

We have thought about the ways in which the Bankruptcy Code could be modified to help a SIFI when it files. We support some limited modifications to the safe harbors. We think that would be beneficial. But we do not support the wholesale revocation of those safe harbors. We do recognize the single point of entry, and I think you will hear more about this, framework for a bankruptcy solution for SIFIs. Its chief component is allowing assets to be moved rapidly away from the parent, and to allow new management, and with the help and the input of regulators, to make fundamental decisions about how best to stabilize those subsidiaries away from the battleground that bankruptcy can sometimes be and that the parent will be under.

However, even for the single point of entry solution to work, we think there must be a temporary stay of the safe harbors for the qualified financial contracts. And we also believe that the entire enterprise will need access to liquidity of some sort. And so, we think while the Chapter 14 single point of entry is a very positive development in the thinking about how to resolve SIFIs in bankruptcy and the Bankruptcy Code can be amended to incorporate that, we think it also requires some changes to the safe harbors and requires some access to liquidity.

On behalf of the National Bankruptcy Conference, again I want to thank you for allowing us to present this testimony today.

[The prepared statement of Ms. Vris follows:]

STATEMENT

of

JANE LEE VRIS[1]

On behalf of the

NATIONAL BANKRUPTCY CONFERENCE

Before the

SUBCOMMITTEE ON REGULATORY REFORM,
COMMERCIAL AND ANTITRUST LAW

Of the

COMMITTEE ON THE JUDICIARY

U.S. HOUSE OF REPRESENTATIVES WASHINGTON, D.C.

MARCH 26, 2014

EXPLORING CHAPTER 11 REFORM: CORPORATE AND FINANCIAL INSTITUTION INSOLVENCIES; TREATMENT OF DERIVATIVES

[1] Chair of the Capital Markets Committee, National Bankruptcy Conference. Partner and General Counsel, Millstein & Co., L.P. The views expressed in this testimony are expressed solely on behalf of the National Bankruptcy Conference and do not necessarily represent the views of Ms. Vris or of Millstein & Co., L.P. or any of its members or clients.

The National Bankruptcy Conference (the "Conference") appreciates the opportunity to participate in this hearing. The Conference is a voluntary, non- profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws.

The Conference has recognized that a failing systemically important financial institution (SIFI) faces extraordinary challenges when it becomes a debtor under the Bankruptcy Code. In the bankruptcy circumstances considered unique to a SIFI, the debtor is a parent holding company whose chief assets are equity in regulated banks and broker dealers with operations both here and, in the case of global SIFIs (G-SIFIs), internationally. When the parent files, its regulated subsidiaries are likely to be seized by domestic and foreign regulators; depositors may demand their deposits and short term financing throughout the corporate family ceases to roll over, both increasing the need for liquidity and eliminating ready access to it; and remaining assets are sold, some rapidly. In these circumstances, value and liquidity throughout the entire corporate group dissipate quickly to the detriment of all constituents, and the resulting instability and "fire sale" of assets may threaten market confidence in other SIFIs and the assets they hold.

Contributing to this dynamic, a group of provisions in the Bankruptcy Code referred to as safe harbor provisions permit (generally) counterparties to short-term repo financings, swaps and other derivatives to terminate agreements, set off obligations and seize collateral. Ordinarily, once a company becomes a debtor, the automatic stay under the Bankruptcy Code prevents parties from taking any of these actions, preserving asset value for the benefit of all creditors ratably in accordance with legal priorities. However, actions by counterparties to derivatives, or Qualified

Financial Contracts (QFCs) (a term used elsewhere but not in the Bankruptcy Code), are to a meaningful degree exempt from the automatic stay. This freedom to act is firmly embedded in international forms for global transactions of this nature. In addition to being a party to derivatives itself, the parent holding company for the SIFI may have also guaranteed its subsidiaries' derivative obligations. As a consequence, a bankruptcy filing by the parent SIFI who is also a guarantor typically triggers a default under each of its subsidiaries' derivative obligations, permitting the counterparty to demand cash collateral from the subsidiary or even to terminate the derivative prematurely, generating termination obligations for the subsidiary. With access to capital constrained by the parent filing, these new demands can cause a subsidiary which is otherwise financially sound to buckle. It is only a matter of time before the failure of the guarantor parent assures either the seizure (for the regulated banking entities) or filing (for the other entities) of most if not all of its subsidiaries.

The Conference has considered ways in which the Bankruptcy Code could be modified to avoid the meltdown described above without unduly interfering with the global derivatives market.[2] I have attached to my opening statement three resources reflecting the views of the Conference on these issues. The first is a letter from the Conference in January this year submitted to Senators Cornyn and Tommey in response to S. 1861 entitled the "Taxpayer Protection and Responsible Resolution Act ("TPRRA"). The letter recommended modifications to the TPRRA, some technical and some substantive, and identified in more detail than here the challenges a SIFI faces. The other is testimony I presented on behalf of the Conference to the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 in May of last year. The testimony summarized

[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") has created a mechanism for resolution of SIFIs outside of bankruptcy and created other measures designed to minimize the impact of a failed SIFI on the financial system generally. Notably, though, it did not alter the Bankruptcy Code for SIFIs.

prior recommendations the Conference had given the House Judiciary Committee to amend the safe harbor provisions in the Bankruptcy Code. For reference, I have also included the Conference's 2010 letter to Representative Conyers in his capacity as Chairman of the Committee on the Judiciary with a more detailed description of the recommended amendments to the safe harbor provisions. These attachments constitute the Conference's testimony today.

I also present a few observations summarized from the attached materials. First, SIFIs need liquidity to function, and a bankruptcy filing disrupts the ability of a SIFI to pump liquidity throughout its enterprise. Second, even the threat of a bankruptcy filing pulls liquidity and the ability to replace it rapidly away from a SIFI. Third, a bankruptcy filing can trigger the need for even more liquidity throughout the SIFI under its QFCs as counterparties act on their legal remedies largely free from the constraints of the automatic stay.

As stated in the Conference's 2014 letter to Senators Cornyn and Toomey in response to TPRRA (on page 2):

> The NBC generally supports the idea that resolution of [SIFIs] should be done in a manner that (i) maximizes value for stakeholders, (ii) minimizes systemic disruption and moral hazard, yet (iii) protects taxpayers from loss. We accordingly support the growing global consensus that financial firms should be required to maintain a sufficient stack of loss absorbing, contractually or structurally subordinated equity and debt that can be utilized to quickly recapitalize the enterprise . . . .

The Conference has not proposed a single set of modifications to the Bankruptcy Code to address all of these issues. It has recognized the single point of entry (SPOE) approach, which has been proposed both for out of court and bankruptcy resolutions, as a framework which can insulate the operating entities in the SIFI from the shock created by the parent bankruptcy filing.[3] The

[3] Fellow Conferee Donald S. Bernstein testified in his individual capacity before this Subcommittee on December 3, 2013 and in his testimony gave a detailed and excellent description of the SPOE approach. I would refer this

Bankruptcy Code can be effectively amended to permit a SIFI debtor (or regulators on its behalf) to transfer all of the equity it holds in its operating subsidiaries to a newly formed subsidiary, allowing new management to decide how best to handle the operating subsidiaries while allowing the parent to realize and distribute any equity value which might remain after stabilizing and resolving the situation at the operating subsidiaries, utilizing familiar and tested bankruptcy precepts. This SPOE structure assumes there will be coordination with regulators, both domestic and, for G-SIFIs, foreign. In fact, much of that coordination should occur before the bankruptcy filing. The modifications to the Bankruptcy Code to permit the SPOE transaction are not intended to – and cannot -- replace the need for communication with and the cooperation of relevant regulators.

To be effective and to permit the immediate and orderly transfer of assets which is core to the SPOE approach, any SPOE regime must include at least a temporary stay from counterparty actions under QFCs at the parent and subsidiary level. Even with the SPOE approach, though, the Conference considers some ability to access new capital for liquidity essential. The Conference believes that without this, regulators and the market generally will lack the confidence needed to preserve at least a minimal sense of calm without which all parties -- regulators, counterparties and other market participants – will race to seize assets and withdraw liquidity at all levels of the SIFI.

Once again, on behalf of the National Bankruptcy Conference I would like to thank the Chair and the rest of this Subcommittee for inviting the Conference to testify here today and for permitting us to submit our prior work as part of this testimony.

Subcommittee to his testimony rather than attempt my own description here.

Attachments to Testimony of Jane Lee Vris

On behalf of the

National Bankruptcy Conference

Worldwide Web References

1. Letter from National Bankruptcy Conference dated January 29, 2014 to Senators Cornyn and Toomey regarding R. 1861 – Taxpayer Protection and Responsible Resolution Act

http://www.nationalbankruptcyconference.org/images/NBC%20Ltr%20re%20s%201861%20(Ch%2014).pdf

2. Statement of Jane Lee Vris on behalf of the National Bankruptcy Conference before the ABI Commission to Study Reform of Chapter 11, May 15, 2013

   [Not available without credentials through worldwide web.]

3. Letter from National Bankruptcy Conference dated March 15, 2010 to Representative Conyers regarding Proposed Amendments to the Bankruptcy Code Concerning Exemptions for Financial Contracts

http://www.nationalbankruptcyconference.org/images/National%20Bankruptcy%20Conference-%20Proposed%20Amendments%20to%20the%20Bankruptcy%20Code%20Concerning%20Exemptions%20for%20Financial%20Contracts_3-15-2010.pdf

Letter from National Bankruptcy Conference dated January 29, 2014 to Senators Cornyn and Toomey regarding R. 1861 – Taxpayer Protection and Responsible Resolution Act

NATIONAL BANKRUPTCY CONFERENCE
A Voluntary Organization Composed of Persons Interested in the Improvement of the Bankruptcy Code and Its Administration

January 29, 2014

Hon. John Cornyn	Hon. Pat Toomey
United States Senate	United States Senate
Washington, DC 20510	Washington, DC 20510

Re: S. 1861 – Taxpayer Protection and Responsible Resolution Act

Dear Senators Cornyn and Toomey:

The National Bankruptcy Conference (NBC) is a voluntary, non-partisan, not-for-profit organization composed of about 60 of the nation's leading bankruptcy judges, professors and practitioners. It has provided advice to Congress on bankruptcy legislation for over 75 years. I enclose a Fact Sheet, which provides further information about the NBC.

The NBC has reviewed S. 1861, the "Taxpayer Protection and Responsible Resolution Act" ("TPRRA"), which you introduced last month. We have considered both the substance of the bill and the technical and drafting issues. Our substantive comments follow immediately below. In addition, consistent with our mission of providing technical assistance to Congress in this very technical area of the law, and without regard to our substantive comments, we have reviewed the legislation for technical and drafting issues that might prevent the bill from achieving its policy objectives. Following the substantive comments is our report on technical and drafting issues and our suggested solutions. We hope this report is helpful in your deliberations.

Background

TPRRA creates a new chapter 14 of the Bankruptcy Code available only for "covered financial corporations", which are bank holding companies or financial institutions. The chapter 14 debtor is likely to be a parent entity with its operations and regulated activities conducted through subsidiaries or affiliates. The chief departure under TPRRA from general bankruptcy concepts is to permit an expedited transfer of potentially all the assets of the debtor at the beginning of the case, to be administered outside of the confines of the debtor's case and away from the jurisdiction of the court. This is accomplished through the rapid transfer of select assets and liabilities to a new bridge holding company, a "bridgeco," whose equity interests are held in trust for the chapter 14 estate and administered by a special trustee approved by the court. A temporary stay prevents the occurrence of certain destabilizing actions during the transfer process. The expectation is that the chapter 14 debtor in possession will thereafter complete a plan process using the same provisions as under a chapter 11 case, culminating in a plan to distribute any proceeds realized by the special trustee from the equity of the bridgeco to the creditors of the parent company whose debts have not been assumed by the bridgeco as part of the asset transfer.

The bridgeco mechanism attempts to set the stage for and enable what is now commonly referred to as the Single Point of Entry strategy for resolution of SIFIs. The TPRRA does not contain any special liquidity facility and repeals title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, including the potential credit support guaranty facility and the ability of U.S. regulators to take over the resolution process if necessary to gain the cooperation of foreign regulators. The NBC has not studied the repeal of title II and thus takes no position on the repeal, focusing instead on the portions of TPRRA that contain the proposed chapter 14 provisions.

General Observations

At the outset we note that the NBC has not previously reviewed the TPRRA or any of the proposals on which it is based, so our comments and questions about the bill are necessarily preliminary and general given the limited time we have had for review. Based on our preliminary review, several members expressed serious reservations about whether the approach under TPRRA would work for SIFIs, raising as it does novel and difficult issues. We have provided a preliminary discussion of some of the most important issues below. We will continue to study the bill after submission of this initial letter and hope to provide more detailed drafting comments in the future.

The NBC generally supports the idea that resolution of covered financial corporations[1] should be done in a manner that (i) maximizes value for stakeholders, (ii) minimizes systemic disruption and moral hazard, yet (iii) protects taxpayers from loss. We accordingly support the growing global consensus that financial firms should be required to maintain a sufficient stack of loss absorbing, contractually or structurally subordinated equity and debt that can be utilized to quickly recapitalize the enterprise, as well as assets (such as intercompany loans) that can be contributed to the capital of distressed operating subsidiaries in connection with any such recapitalization. In contrast to the unitary bank model employed in some other countries, the bank holding company structure in the United States facilitates this approach by separating significant amounts of long-term unsecured debt from deposit and account-holding regulated entities, thereby adding an additional layer of loss absorbency at the holding company level.

[1] "Covered financial corporation" is the terminology used in the TPRRA, section 3(a), adding a new section 101(9A) to the Bankruptcy Code. The entity does not have to be a SIFI, since any bank holding company can qualify for chapter 14. Some of our concerns here, particularly with respect to the need for liquidity and global coordination, are aimed primarily at SIFIs and G-SIFIs. We recognize that a limited number of smaller bank holding companies holding only US assets have been able to restructure on an expedited basis under chapter 11, and if anything, chapter 14 as proposed would potentially make such restructurings easier.

The proposed chapter 14 takes advantage of the bank holding company structure to recapitalize the covered financial corporation by permitting the rapid transfer of select assets—equity in subsidiaries and other assets held at the parent holding company—to the bridgeco, leaving significant (if not most) liabilities of the parent behind. We believe that to be successful, any such recapitalization needs to be announced and accomplished with remarkable speed to stabilize the recapitalized firm and minimize any liquidity "run" or asset fire-sales. The TPRRA addresses this by including expedited procedures to create the bridgeco. (Our detailed comments below suggest ways in which the procedures can be further expedited.) We also believe the temporary stay prohibiting the exercise of rights by counterparties to qualified financial contracts ("QFCs") has the potential to substantially reduce the short-term liquidity and collateral needs of the covered financial corporation and avoid wholesale termination of QFCs on terms disadvantageous to the covered financial corporation, aiding in its near-term stability and ability to recapitalize. Given the interconnectivity of exposure between covered financial corporations which are SIFIs through QFCs, the temporary stay may also significantly reduce the risk of contagion.

Stabilizing and permanently restructuring any financial institution, though, will require some form of immediate liquidity source and/or credit support which the TPRRA does not provide. Despite the speed of the recapitalization proposed under TPRRA, we believe, even under the best of circumstances, it will take a period of time for the market to assimilate information about the financial restructuring of the covered financial corporation before the institution's full access to market liquidity returns.[2] Without some degree of certainty that the bridgeco has sufficient liquidity on its own taking into account the specific assets and liabilities assumed and discarded, that funding will be available at the time of filing, or failing both, without advance planning, communication and coordination among the debtor, the Federal Reserve Board, and regulators worldwide, the commencement of a chapter 14 case may cause ring-fencing by regulators worldwide, flight of short-term capital and value erosion. In severe cases, these events could cause the very sort of run on the regulated subsidiary entities that the Single Point of Entry strategy seeks to avoid.

The TPRRA needs to provide for an additional source of backstop interim liquidity for those covered financial corporations which will file without sufficient liquidity to prevent flight of short-term capital and stabilize the institution, particularly if there is a risk of contagion. The backstop can be limited to fully secured commitments or advances similar to the discount window currently available to banks. At a minimum, consideration should be given to incorporating provisions similar to section 364 to

[2] The regulated banks held by the bridgeco will have access to the discount window and their deposits will be supported by deposit insurance, both of which should prevent and/or fund any run on its liquidity resources. However, covered financial corporations that are diversified financial firms will have broker dealers, insurers, and other operating subsidiaries which lack access to any credit support other than through the public markets.

permit priming liens in the bridgeco's assets and first-out provisions for any new credit support provided to bridgeco, although we question whether even this will be sufficient to entice the public markets in the early stages of the recapitalization. In any event, all of the NBC's comments below must be understood in the context of our overriding concern that a successful recapitalization which achieves all of the goals stated at the outset of this memorandum cannot be achieved in all cases without some provision for potentially significant credit and collateral support.

Section-by-Section Comments

TPRRA Sec. 3(c). *Who May be a debtor:* The court should have the power to authorize the conversion of a case under chapter 14 to a case under chapter 7 once the transfer of assets to the bridgeco has occurred pursuant to section 1406. Section 1112 should be modified to permit conversion from chapter 14 to chapter 7. Chapter 7 will be necessary in those instances when a chapter 14 debtor is not able to satisfy the requirements for confirmation of a plan, for example, when the administrative expenses cannot be paid in full in cash.

TPRRA Sec. 3(b). *Applicability of chapters*: Rather than create a full plan process in chapter 14 or create the bridgeco mechanism within existing chapter 11, TPRRA adds a new section 103(m), which incorporates the chapter 11 plan process into chapter 14. Given this approach, section 1401 should be expanded in a manner similar to section 901 after a thorough review of provisions in the other chapters of the Bankruptcy Code to be sure their omission or inclusion is intentional.

Bankruptcy Code Sec. 1401. *Inapplicability of other sections*: See above.

Bankruptcy Code Sec. 1402. *Definition of "capital structure debt"*: The definition creates a category of liabilities that are not permitted to be transferred over to the bridgeco. It is critical to the success of a chapter 14 recapitalization that many liabilities presumptively do not get assumed by the bridgeco. But great care should be taken with this definition. Liabilities transferred over to bridgeco will presumably receive much better recoveries than those left behind. The potential preferential treatment of certain obligations and liabilities violates the fundamental bankruptcy policy of equality of distribution and should occur only in furtherance of the chapter 14 goals. We considered whether to approach the exercise by restricting the types of debts that bridgeco could assume rather than defining the liabilities that must remain with the chapter 14 debtor, but determined that the Bankruptcy Code should give the Federal Reserve Board and the special trustee flexibility in creating the optimum bridgeco. In any event, the NBC is concerned that debt can be too easily structured to avoid characterization as capital structure debt if the definition is based on the original maturity date and suggests that the following concept would not be as easily manipulated: all unsecured debt for borrowed money for which the debtor is the primary obligator.

Bankruptcy Code Sec. 1403. *Commencement of case*: The successful recapitalization under chapter 14 requires speed and certainty. After the fact challenges to either the appropriateness of the filing or the creation of the trust will undermine the very maintenance or restoration of market confidence and prompt access to sources of liquidity the bridgeco mechanism is designed to achieve. It is critical that the statute be unambiguous, standards clear and opportunity to undo non-existent. Similarly, we anticipate that before the chapter 14 petition is filed, most if not all of the planning for the creation of the bridgeco will have occurred by the Federal Reserve Board and the debtor in coordination with other relevant regulators, sources of funding and, in some cases, potential buyers. A meaningful judicial review process of even one day could jeopardize the process, and the NBC is concerned that the proposed one-day judicial process would not be meaningful in any event given the import of the findings the court is required to make.

We therefore propose here and in other places that certain actions would require Federal Reserve Board approval in lieu of a notice and hearing before a court. We would remove the requirement of a court determination in section 1403(a)(2)(B) and require that for any petition to be accepted, the Federal Reserve Board must make the finding and certification described in section 1403(a)(2)(A). Removing the judicial approval construct would also mean removing the appeal process. To the extent it is considered either necessary or desirable to limit the type of filing that is not subject to judicial review further, we would still recommend removing the judicial approval construct under section 1403(a)(2)(B) so long as the covered financial company has not objected to the Board's action within some very limited period of time. We also recommend that in the event the debtor has either filed the petition or consented to the petition at the time it is filed, the members of the board of directors and management involved in that decision should be able to make it free from any threat of recrimination or penalty from the constituents at the chapter 14 entity. The filing triggers an immediate transfer of potentially all the assets of the chapter 14 entity for a recapitalization process that will be largely without judicial review and will not be undertaken solely for the benefit of the chapter 14 constituents. It is easy to imagine that the constituents' representatives will challenge the decision-making process that results in the extraordinary transfer of assets without legally required approvals under constituent documents, exchange rules and state laws requiring shareholder approval and the like. We would therefore recommend that the statute include some form of safe harbor or exculpation protecting members of the debtor's board of directors and management for participating in the decision-making process, albeit a narrowly crafted one.

Bankruptcy Code Sec. 1404. *Regulator*: None.

Bankruptcy Code Sec. 1405. *Special trustee and bridge company.* As a preliminary observation, we believe the TPRRA anticipates that either the chapter 14 debtor will have created an intermediary entity which can act as the bridgeco shortly before the filing or one will be created simultaneously with the filing. In either event, the section should more clearly distinguish between (1) the new holding company to which the assets and certain liabilities of the chapter 14 debtor are transferred, (2) the trust, which holds the equity of the new holding company, and (3) the equity of the subsidiaries held, after the transfer, by the new holding company. Section 1405(a)(1) appropriately requires that the entity should not be a preexisting company which has liabilities and assets prior to the filing. For additional clarification, some consideration should be given to insulating this new bridgeco from preexisting liabilities that attach by operation of law on a joint and/or several basis (for example, certain tax liabilities). Ideally, the provision should also contemplate the transfer of lower-tiered equity interests in a multi-tiered enterprise, while skipping the assets and liabilities of intermediate funding entities, so that bridgeco can recapitalize not only by the conversion of the parent debt to equity but also by similar recapitalization of mezzanine type financing, for example, trust preferred securities, although this additional type of selection requires more detailed analysis.

Management of bridgeco and guardianship of the bridgeco interests will be significant factors in the effort to restore or maintain market confidence. In addition, similar to our comment with respect to section 1403, the designation of the special trustee and management of bridgeco must be rapid and certain. To the extent the Federal Reserve Board has appointed a person (or entity) to act as special trustee at the time the request to create the trust is filed, that appointment should be final, absent subsequent gross negligence, fraud, or similar misconduct. Likewise, the Federal Reserve Board's consent to the designation of senior management at bridgeco should be required, again with the expectation that these individuals will have been selected prior to the actual filing. Once the trust has been established and the selected assets and liabilities transferred, the powers of the special trustee would include the power to replace and appoint new senior management without further court approval. At the chapter 14 case level, we believe that once the bridgeco order has been entered, the mandatory appointment of a trustee rather than the continued control of prior management as a debtor in possession under section 1107 is appropriate. (This should not preclude any party in interest from seeking the appointment of a trustee sooner, and some consideration should be given to an expedited request process if the Federal Reserve Board wants a trustee at the chapter 14 debtor immediately upon filing.) The chapter 14 debtor is not an operating entity after the transfer, and there is no particular expertise existing management has for the negotiation of the allocation of value among the chapter 14 constituents or administration of the claims allowance process. Removal of existing management from the chapter 14 process should add to the perception of fairness in the overall process.

Section 1405(b)(3) requires the special trustee to provide notice to the parties in interest in the chapter 14 of certain corporate actions, including significant actions affecting the assets and liabilities of the bridgeco. Nothing further is provided for, leaving open the possibility that creditors and even equity interest holders in the parent can object in court but equally leaving open the possibility that there is no recourse beyond the ability to voice an objection. The special trustee will require extraordinary skills in executing its fiduciary duties under extreme stress and time constraints. It may seem beyond dispute that there is little a special trustee could do which would harm the chapter 14 constituents beyond the filing itself, but experience has taught us that it is a rare bankruptcy case in which valuation and strategy disputes do not exist. We would recommend that rather than such an open-ended process creating uncertainty both as to the finality of actions taken by the special trustee and the special trustee's potential legal exposure for taking those actions, the statute permit (but not require) the special trustee to specify any actions it intends to take in furtherance of the recapitalization of bridgeco and its subsidiaries and, so long as the Federal Reserve Board does not object to any of those actions, to allow the bridgeco order to reference such actions and immunize the special trustee and the bridgeco's directors and officers from any liability to the chapter 14 parties-in-interest for taking those actions.

The disclosure statement is a crucial element of the plan proposal process; informed consent is essential. There are known difficulties in gathering and understanding information when a debtor loses access to its books and records. Here, a significant portion of the debtor's books and records may be transferred to the bridgeco and no longer in the control of the chapter 14 entity. The standard for the chapter 14 trustee's access to that information in the current proposal seems unnecessarily high. We recommend that in lieu of "necessary" in section 1405(b)(2)(B), the special trustee should make the information available if "necessary or advisable".

Bankruptcy Code Section 1406: *Special transfer of property of the estate.* This section, authorizing transfers of assets into the trust, should make clear that once assets have been transferred into the trust, they are no longer part of the chapter 14 estate by adding a new sentence following the first sentence of section 1406(a): "Property ceases to be property of the estate once the court has ordered the transfer and the transfer has occurred." (Conforming clarifications may also be required to sections 1407 and 1408.) Section 1406(c)(3) should be deleted: the bridgeco will not be a deposit holding entity under any circumstances. To the extent that this provision refers to deposits which the chapter 14 entity itself holds as depositor at any of its subsidiaries, there should be no absolute requirement that all such deposits go over to the bridgeco. Once the bridgeco has been created and assets have gone over, the chapter 14 estate will have no access to cash flow. Conceivably, it might be able to get new (probably expensive) financing, but to the extent it has sufficient cash to fund its chapter 14 administrative expenses and fees, it should be allowed to retain at least some cash for that purpose.

Section 1406(c)(4) requires the court to find by a preponderance of the evidence that the Federal Reserve Board has certified as to adequate assurance of future performance of contacts, leases and liabilities assumed by the bridgeco. We are not certain that this requirement adds anything beyond the certification by the Federal Reserve Board itself, and in any event, believe that the Federal Reserve Board certification should be sufficient. We would therefore recommend substituting a requirement that the Federal Reserve Board provide the certification in a filing with the court for the current section 1406(c)(4). Further, as with our earlier comments on sections 1403 and 1405, we believe that the Federal Reserve Board's consent should also be required. While there is no time period prescribed for the judicial review in this section, the temporary stays in section 1407 and 1408 create a practical 48-hour limit for the review process. We believe it will be far more valuable for the statute to encourage an active dialogue between the Federal Reserve Board and the prospective debtor (whether as a continuation of the living will dialogue or otherwise) and to that end, the specifics of bridgeco should be in hand and approved by the Federal Reserve Board by the time the filing is made with the court.

We believe that the TPRRA should specifically address the treatment of liens in assets which are transferred to the bridgeco. Section 363(k) provides for credit bidding, but we do not expect that the transfer to bridgeco will occur in any sort of auction process. One possibility would be for the liens to transfer with the assets on a nonrecourse basis; there could also be a mechanism for bridgeco essentially to purchase the collateral by giving the secured creditor cash equal to the value of the lien (although this would have to be accomplished in a manner that did not interfere with the expedited transfer at the beginning of the case). As a practical matter, there may not be much of any secured debt at the chapter 14 entity, but to the extent there is, the transfer process currently leaves the treatment of liens uncertain.

Bankruptcy Code Section 1407. *Automatic stay; assumed debt*: See below.

Bankruptcy Code Section 1408. *Treatment of qualified financial contracts and affiliate contracts*: Both this section and section 1407 create special stay provisions and are addressed together here. These special stay provisions go beyond established bankruptcy concepts by staying actions against nondebtors and their assets which would otherwise occur because of the condition of the chapter 14 debtor and the transfer to the bridgeco. They also significantly curtail actions by counterparties under QFCs, which normally are protected by a variety of safe harbor provisions under the Bankruptcy Code, safe harbors which include, importantly, special carveouts from the automatic stay under section 362. Both of these new special stay provisions are in our view appropriately limited in duration and scope; they are necessary to give the Single Point of Entry approach to recapitalization a brief moment in time to freeze the effect of the chapter 14 filing until the bridgeco is up and running and has assumed the liabilities, contracts and leases it wants in order to recapitalize.

The transfer provisions are similar to, but not identical to, section 365. Significantly, the bridgeco has the power to assume notwithstanding any state or contractual restrictions, but not the power to assign in a subsequent transaction. We considered whether these special provisions should extend to a subsequent transfer, and concluded that on balance, because of the indeterminate duration of the bridgeco and the myriad of potential transactions it may engage in during that time, it was better not to give special treatment to subsequent transfers.[3]

[3] Sections 1407 and 1408 identify assumptions, assumptions and assignments, and assignment in various places. We believe the intent in each case is in connection with the transfer to bridgeco and not a subsequent transfer. It is possible that a more consistent use of the different terminology is required. As time permits, we recommend a thorough review of this terminology to avoid confusion later.

We note that in a number of places, these special provisions preclude the termination or modification of rights or obligations during the period in which the special stay provisions are in effect. We believe particularly in light of the fact that debt instruments are included in these special provisions, that the sections should specifically reference acceleration (that is, eliminate or stay any acceleration) and any other modification that occurs automatically upon the occurrence of one the specified events. For example, most debt instruments provide for automatic acceleration of debt upon the debtor's (and sometimes, any of its significant affiliate's) bankruptcy filing. There is no need for this automatic acceleration for debt that is assumed by the bridgeco within the prescribed time limits, and unwinding it may be more than a matter of simply reinstating the debt. Likewise, some securitizations have "flip" or "extinction" clauses which purport to change contractual entitlements to waterfalls upon a bankruptcy filing. These should also not be triggered automatically upon the filing. In other words, the concepts termination and modification should clearly include any alteration in the contractual or legal status quo that occurs because of the events specified, and for the periods specified, in the applicable subsections of sections 1407 and 1408.

The NBC does not have substantive comments on any of the sections following section 1408.

Technical and Drafting Comments

As a general comment, the NBC believes it would be preferable to include the provisions on covered financial corporations in a new subchapter V of chapter 11, instead of adding a new chapter 14. Most of the provisions of chapter 11 are applicable to such cases, fewer Bankruptcy Code sections would have to be amended, and it would cause less confusion if the new provisions on covered financial corporations were placed in a new subchapter of chapter 11.

Other comments relate to specific provisions. References are to the new provisions of titles 11 and 28, rather than the bill sections.

§ 103(*l*) – As proposed ("Chapter 14 of this title applies only in a case under this title concerning a covered financial corporation"), this subsection suggests that chapter 14 would apply if a covered financial institution files a chapter 7 or chapter 11 petition (even though section 109 would not make it eligible for such a filing). To make it clearer, we suggest: "Chapter 14 of this title applies only in a case under such chapter." That also conforms to the style of section 103 (see 103(i) and (j)).

§ 103(m) – The new section 103(m) is fine, but if it is added to the Code it will conflict with section 103(g). Therefore, section 103(g) should be amended as follows: "Except as provided in <u>sections 103(m) and</u> ~~section~~ 901 of this title,..."

§ 109(i) – To conform to the style used in other subsections of section 109 (see section 109(d), (e) and (f)), change section 109(i) to: "Only a covered financial corporation may be a debtor in a case under chapter 14 of this title."

§ 1401 – Change to read: "Sections 321(c) and 322(b) of this title do not apply in a case under this title."

§ 1402(2) – Change to read ".... under section 1405(a) of this title."

§ 1402(4) – First, the list of sections referenced in this provision should include section 561. Also, the referenced sections do not define "contractual right." Therefore, change section 1402(4) to the following: "The term 'qualified financial contract' means any contract ~~as defined~~ of the kind described in section 555, 556, 559, ~~or~~ 560, or 561 of this title."

§ 1402(5) – Change to "The term 'qualified financial contract' means any contract of a kind ~~specified~~ defined in paragraph (25) ..." Note that the sections cited do contain definitions. Also, add "of this title" after "section 761).

§ 1402 – The use of the word "trustee" used in sections 1405, 1406 and elsewhere is confusing. Chapter 11 uses that term to mean a person appointed or elected under section 1104. Although section 1107 generally gives the debtor in possession the rights and powers of a trustee, it is unclear whether "trustee" in chapter 14 is meant to include a DIP when a trustee has not been appointed. For example, see section 1405(a), which says "On request of the trustee or the Board, the court may order the trustee to appoint ..." Is it intended that a DIP can make that request if there is no trustee? Does the court order the DIP to appoint the special trustee? To make it clear, we suggest that a definition of "trustee" be included in section 1402. If it is intended that "trustee" mean a DIP if there is no trustee, section 1402 can define "trustee" to mean "a person that has been appointed or elected under section 1104 of this title, and that has been qualified under section 322 of this title, to serve as trustee in the case or, in the absence of such person, the debtor in possession."

§ 1403(a)(2) – The way the proposed provision is organized, a Board petition certifying circumstance (IV) requires a duplicate certification of imminent financial harm to financial stability in the US (see 1403(a)(2)(A)(i)(IV) and (a)(2)(ii), which are both required). We suggest that (IV) be changed by ending it after "sufficiently soon", thereby deleting "such that the immediate commencement of a case .... financial stability in the United States." An alternative fix would be to move the provision that is now 1403(a)(2)(A)(ii) to follow (a)(2)(A)(i)(III) and then have what is now (a)(2)(A)(IV) as an alternative basis for a Board petition.

§ 1403(a)(2)(B) – This refers to the "bankruptcy court" making a determination that the requirements for commencing the case have been satisfied. Is it intended that 28 USC § 157 does not apply? Does the bankruptcy court's authority to make this determination depend on a reference under section 157(a)? Can a district judge withdraw the reference under section 157(d)? If not, perhaps section 1403(a)(2)(B) should start with "Notwithstanding section 157 of title 28." If it is not intended that section 157 be displaced, it may be better to say "court," instead of "bankruptcy court." This also applies in other places where "bankruptcy court" is used. Similarly, section 1403(c)(1) and (2) refer to the "district court" hearing an appeal. If a district judge withdraws the reference and there is an appeal, it should go to the court of appeals.

§ 1403(b)(1) – As proposed, the hearing must be within 12 hours after a certification under section (a)(2)(A), but there is nothing that prevents the certification from being made (signed) before the petition is filed. To avoid the 12-hour period from expiring prepetition, change "makes a certification under subsection (a)(2)(A)" to "files a petition under subsection (a)(2)." The certification must be in the petition. In addition, on lines 19-20, will the wording "with notice only to" create a potential problem if someone else (other than the listed entities) gets actual notice? Would the court proceeding then not be a "hearing described in this subsection"? It may help to insert "given by the Board" between "notice" and "only". This also seems like an indirect way to prohibit notice to other parties (which is apparently the intent). Perhaps change section 1403(b)(2) to directly prohibit such notice ("Only the Board and the entities listed in paragraph (1) may receive notice, attend, or participate in a hearing…").

§ 1403(b)(2) – Change the last sentence as follows: "Transcripts of such hearings shall be sealed until the ~~end of~~ the case is closed." The "end of the case" is ambiguous and not consistent with Code style.

§ 1403(c) – First, the provision is silent about further appeals to the court of appeals. If the intent is to limit appeals to the district court level, an exception should be provided to make the relevant provisions of title 28 (§§158, 1291, 1292) inapplicable. If an appeal to the court of appeals is contemplated, providing for an expedited appeal should be considered. Second, (c)(1) says that a covered financial corporation may file an appeal, but it is silent on whether the Board may file an appeal if the bankruptcy judge dismisses the case because it finds that the Board has failed to meet its burden to prove that the requirements for the filing have been satisfied? The negative inference is that the Board does not have the right to appeal, but it is not clear? Are they to be treated as the SEC is under section 1109(a)? This should be clarified. It could be clarified by amending proposed section 1404(a). Third, section 1403(c)(2) is missing language specifying within 12 hours of *what* shall the district court review the determination. Should it be "within 12 hours of such determination?

§ 1403(d)(2) – Though this may be a substantive comment, it has been suggested that "bankruptcy court shall immediately order" should be changed to "bankruptcy court shall promptly order" to give the court some leeway if it is impractical to issue the order exactly when the time to appeal has expired or when the district court affirms.

§ 1403(d)(2)(B)(i) – Change it to read "the period for appeal … has ~~passed~~ expired without an appeal."

§ 1404 – The provisions regarding the Board's and the FDIC's standing are unclear. Does "case or proceeding under this title" mean only a proceeding that arises under title 11, or does it have a broader meaning (any proceeding arising under title 11, or arising in or related to a case under title 11)? The "in connection with" phrase is also unclear in section 1404(b). Also, the authority should be limited to chapter 14 cases (similar to the limitation in section 1109 to "a case under this chapter"). We believe it would be clearer if changed to: "The Federal Deposit Insurance Corporation may raise and may appear and be heard on any issue ~~in any case or proceeding under this title in connection with~~ involving a transfer under section 1406 <u>in a case under this chapter or in any proceeding within such a case</u>." Similar changes should be considered for section 1404(a).

§ 1405(a)(2) – It is unclear as to which "estate" this paragraph is referencing. It probably should be changed to "… are property of the estate <u>of a debtor under this chapter</u>" or something similar. We make the same comments with respect to sections 1405(b)(1), 1406, 1408(f)(1), 1408(f)(3), and 1409(a).

§ 1405(b)(1) – The special trustee is supposed to be paid "from the assets of the trust and not from property of the estate," but under (a) the assets of the trust are the equity securities of the bridge company and those equity securities are property of the estate (and to be held by the special trustee for the sole benefit of the estate, so the estate continues to hold the beneficial interest of the equity securities). Which assets of the trust would not be property of the estate and, therefore, could be used to pay the special trustee? Consider clarifying this paragraph.

§ 1406(b)(8) – Change to "the United States trustee <u>or bankruptcy administrator</u>."

§ 1406(c)(3) – The proposed transfer must provide for "the transfer of any accounts of depositors of the debtor…" Since the debtor is the bank holding company, not the bank, how can the debtor transfer deposit accounts (which are not property of the estate in the holding company's bankruptcy case)?

§ 1406(c)(4) – Change "leased" to "lease" on lime 14 (typo).

§ 1407(a)(1) – Change as follows: "… any debt, contract, lease, or agreement <u>of the kind</u> described in paragraph (2) …." This conforms to the phrasing in section 1407(c)(1) and in (c)(2) on page 20, lines 11-12, and page 21, lines 9-10.

§ 1407(a)(1)(B)(iv)(III) – on page 18, lines 1-2, delete "of the bridge company" because the phrase repeats in (a)(a) on line 3.

§ 1408(a) – The list of sections referenced at the beginning of section 1408(a) probably should include section 362(o). Consider changing the subsection as follows: "Notwithstanding sections 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), <u>362(o),</u> 555, …."

§ 1408(c)(1)—We believe the intent is to nullify certain provisions in a debt, contract, lease, or agreement <u>once it has been assumed by bridgeco</u>, and we recommend that this clarification be made. (This would be similar to the language in section 1408(d) which does specify that the relevant agreement must have been assumed and assigned to the bridgeco.)

§ 1408(e) – We question whether the reference to section 1407(b) was intended to be a reference to section 1407(a)(1).

28 U.S.C. § 298(b)(1) – The phrase "bankruptcy judges who are experts in cases under title 11 in which a financial institution is a debtor" may be either too high a standard or too unclear? Does taking a course on such cases (perhaps one to be offered by the Federal Judicial Center) make a judge an expert? Does one become an "expert" only by presiding over at least one such case? Assuming it does, are there as many as 10 bankruptcy judges sitting at the same time that have presided over such cases? Should the standard be made clearer and also lowered a bit so that judges who have never presided over a financial institution case, but have completed an FJC course of study or another reputable course of study designed for such cases, and/or have backgrounds in private practice involving financial institutions, be eligible (which would result in a greater pool and in more geographic diversity among the judges)?

28 U.S.C. § 298(f)(1) – The reference to "bridge company formed under section 1405" (page 30, lines 18-19) should be changed because the bridge company is not "formed" under section 1405. We assume it is formed under state law (such as a Delaware corporation). The phrase "formed under section 1405" should be deleted. Since "bridge company" is defined in section 1402, the sentence in section 298(f)(1) should work well without that phrase.

Conclusion

We hope these comments are useful in your deliberations. We conclude by noting that this is important legislation, one that is deserving of far more attention and study than we have been able to give it in the time allotted. To the extent the legislative time table permits, the NBC would welcome the opportunity to continue its analysis and submit further recommendations.

With best regards.

Sincerely,

Richard Levin

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cc. Tonnie Wybensinger (by email)
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Statement of Jane Lee Vris on behalf of the National Bankruptcy Conference before the ABI Commission to Study Reform of Chapter 11, May 15, 2013

Statement Before American Bankruptcy Institute Commission to Study the Reform of Chapter 11
May 15, 2013

My name is Jane Vris, and I am here today in my capacity as a conferee in the National Bankruptcy Conference and chair of the Conference's Committee on Capital Markets and the Uniform Commercial Code. Our topic today is the treatment of certain financial contracts under the Bankruptcy Code, call them "Qualified Financial Contracts" or QFCs, and I have been invited to share with you the recommendations and conclusions reached by the NBC's Capital Markets Committee after reviewing QFCs under the Bankruptcy Code.

As a preliminary matter, I note that the Capital Markets Committee did not undertake the comprehensive review of QFCs that you are now engaged in, and I salute you for committing to this brave project. The Committee has recognized over the years the extraordinary breadth, as well as importance, of the exemptions and safe harbors afforded QFCs and has addressed certain aspects of those exemptions and safe harbors with specific legislative recommendations. As I sit here today and share these recommendations, I do so with the understanding that on topics as complex and significant as these, the chapter 11 process will be well-served by as much collaboration among bankruptcy professionals – judges, practitioners and professors alike – as possible, and it is therefore a pleasure to be here today with you, a varied and accomplished group of professions, to share the Capital Markets Committee's work.

The Committee has recognized the reasons for the special treatment of QFCs and over the years has consistently affirmed the need for some level of protection for QFCs. It has appreciated that any proposed changes to the safe harbors should neither create uncertainty in the market about the availability of the safe harbor, nor remove the protection from transactions that implicate systemic risk.

However, it has also continuously expressed concern that the safe harbor provisions in their various forms over the years have sheltered transactions which do not pose the type of systemic risk that warrants special treatment. In particular, it has focused on three areas of concern and proposed legislation for each: (1) limiting the protection for securities settlement payments once they have gone to the beneficial holders; (2) protecting the estate's operating assets from the safe harbors exemptions to the automatic stay to avoid frustrating the ability to reorganize; and (3) not protecting forward and commodity contracts entered into purely for commercial supply rather than financial purposes. In addressing each of these, the Committee kept its recommendations as specific and targeted as possible.

Settlement payments under 546

Ten years ago, the Committee studied the origins and use of the safe harbor under section 546(e) and concluded then that the section went further than necessary to achieve its original purpose. Congress created the safe harbor in reaction to a ruling in the Ira Haupt case.

A slight digression by way of an interesting history note, one that is useful to remember as you review the safe harbor provisions – the Haupt opinion.[1] Ira Haupt & Co. was a commodities broker which had the misfortune of having as its customer a company run by "a master swindler", in the word of the court. The customer had gone long on salad oil, too long, and collapsed from the effort of meeting variation margin calls as the prices for salad oil dropped. (At one point, it was the buyer for 90% of the salad oil futures contract market.) It filed under old chapter XI. As Ira Haupt made calls on its customer, the clearing association for the New York Produce Exchange in turn required Haupt to post more collateral. Although Haupt had collected collateral from its customer and could have survived (with help from the exchange, which shut down trading in oil futures to avoid further declines), it too

[1] *Seligson v. New York Produce Exchange (In re Ira Haupt & Co., L.P.)*, 394 F. Supp. 125 (S.D.N.Y. 1975).

collapsed with the discovery that the collateral posted by its client consisted of forged warehouse receipts.

The trustee (for the historians here, Charlie Seligson) sued the New York Produce Exchange, its clearing association, directors and officers, and some of the members (big names in commodities: Bunge and Continental Grain). The suit alleged, among other things, that the transfers Haupt made to the clearing association for variation margin payments were fraudulent transfers, payments made by Haupt without receiving fair consideration in return at a time when it was insolvent. The clearing association moved for summary judgment, and the court denied it.

Congress enacted the first safe harbor, former Section 764(c), to overrule the Haupt case. The provision prohibited avoidance of margins or deposits to a commodity broker or forward contract merchant and settlement payments by a clearing organization. The same protection moved to section 546 (then as section 546(d), and since renumbered as section 546(e)) in 1982, when Congress expanded it to the securities exchanges and brokers. By protecting parties participating in the commodities clearance and settlement system (and by subsequent amendment, the securities system as well), Congress wanted to avoid the failure of one participant in the system from spreading to other participants, threatening the entire market – a systemic risk.

After studying the various types of payments protected by the safe harbor in the years since it was first enacted, the Capital Markets Committee found that payments received by beneficial holders of securities, in other words, payments going beyond those made to market system participants, were being sheltered under section 546(e). The Committee concluded that avoidance recoveries from the ultimate recipients of certain transfers on securities, the beneficial owners, would not create the systemic risk the safe harbor was intended to avoid. As an unwarranted limitation on the trustee's power to recovery assets for all creditors, the Committee recommended that actions against beneficial holders for recovery of redemption payments, principal payments, dividend payments, interest payments or other distributions on or in respect of securities be taken out of the safe harbor provision of section 546(e).

The Committee has periodically revisited section 546(e) (and now its analogues in sections 546 (f) and (g)) and the continuing developments in the case law. Over the years, more, not fewer, types of payments have benefitted from the safe harbor. The Committee has maintained its recommendation, adopted by the Conference, that payments of any kind on securities once received by (or for) ultimate beneficial holders should not be exempt from avoidance actions. It has also expanded its recommendation, more in the nature of a technical amendment, to exclude from the safe harbor actual fraudulent conveyance actions under state law to mirror the exclusion under the federal cause of action in the Bankruptcy Code.

Protecting operating assets

Following the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[2] (the "2005 Amendments"), the Committee recognized the growing potential that ordinary loans could be structured, and in fact were being structured, as repurchase or reverse repurchase agreements. The Committee noted that the home mortgage industry relied increasingly on repurchase and reverse repurchase agreements to finance the securitization pipeline, replacing the former warehouse lines for whole loans. The 2005 Amendments explicitly included agreements for the repurchase of mortgage loans, interests in mortgage loans, and mortgage-related securities in the definition of "repurchase agreement" (as well as securities and obligations of Fannie Mae and Freddie Mac). What had previously been ordinary commercial loans known as warehouse lines became protected QFCs. The 2005 Amendments also added security agreements for these repurchase

[2] Pub. L. No. 109-8, 119 Stat. 23 (April 20, 2005).

obligations. As a result, lenders could structure ordinary financings as repurchase agreements secured by a security interest in substantially all of the assets of the borrower, and foreclose on the collateral during the bankruptcy without relief from the automatic stay. This risk is not limited to repurchase agreements; the 2005 Amendments significantly expanded the definition of swaps, the protection for which includes the ability to enforce security agreements, and added a new category of protected transactions, master netting agreements, also with security agreements. (Just to complete the picture, commodity, forward and security contracts also include security agreements, enabling certain counterparties to foreclose, set off or take other enforcement actions notwithstanding the automatic stay.)

The Committee explored different ways of addressing its concern and ultimately proposed that the exemptions from the automatic stay should be limited to "financial collateral", such as cash, U.S. Treasuries and money-market instruments and should not include assets typically used in the operations of a debtor that is not a financial services company In this way, the Committee concluded that the operating assets of a typical non-financial services company business debtor necessary for reorganization - e.g., inventory, trade receivables and equipment and other fixed assets - would remain in the estate without creating any systemic risk of failure in the financial markets.

Supply contracts with end-users

The final area of concern which the Committee addressed was the protection given to ordinary course supply contracts to end-users. The Committee followed developments in the case law, which does not currently appear to distinguish the "end-user", that is, a counterparty that contracts for the future delivery of a commodity either expecting to take physical delivery at the end of the contract or hedging for physical delivery it will need, from the market participant. Stated differently, the Committee was of the view that the failure of a debtor to pay for commodities used in its business was not likely to create the type of systemic risk the safe harbors were designed to prevent, at least so long as that end-user was not itself a financial participant.

The Committee treaded very carefully. It sought some way of distinguishing transactions which threatened the commodity contract system from those that did not. Yet, it also recognized that even if commodity contracts did not pose a systemic risk and were treated like other executory contracts under section 365, the value of a commodity contract can swing widely (and wildly) in a short period of time, creating challenges not usually faced by debtors and creditors (as well as bankruptcy courts) when considering the merits of assuming or rejecting executory contracts.

Ultimately, the approach that garnered the support of the Conference did not rely solely on excluding contracts with end-users. Rather, it excluded certain contracts from the safe harbors, "excluded commodity contracts", but limited the debtor's/trustee's ability to assume or reject to avoid the potential for extraordinary prejudice to the counterparty. First, the debtor/trustee's decision to assume or reject must be made within a limited period of time; second, no cherry-picking with a counterparty would be allowed; third, the debtor would have to perform until it either assumed or rejected; and finally, the counterparty would be entitled to an administrative expense claim for postpetition loss and security for that claim at 105% of the claim amount. Failing assumption by the debtor/trustee, the counterparty would have a limited time to exercise any termination rights it may have. The debtor/trustee could also file a list of financial contracts that would not be treated as excluded commodity contracts within the first 48 hours of filing. In this way, the debtor/trustee could avoid having to perform under the agreement and the counterparty would have all the exemptions and safe harbors commodity contracts generally have under the Bankruptcy Code. Transfers to counterparties to excluded commodity contracts would not be exempt from avoidance actions under section 546.

Even as the Conference reached a consensus on this final, most detailed and elaborate of the Committee's recommendations, the conferees continued a spirited debate on the merits of the 2005 Amendments to the safe harbor provisions generally. This debate is likely to continue, as is the Capital Market's study and consideration of further modifications as the case law develops. There is also some sense in the Conference that the other initiatives and statutory regimes for containing the insolvencies of systemically important financial institutions may affect the need for the safe harbors under the Bankruptcy Code to some extent. Not surprisingly, SIFI initiatives are also a topic of Capital Market attention.

As a postscript to this story, the National Bankruptcy Conference presented all three recommendations to the then Chair of the House Committee on the Judiciary for his consideration. As far as I am aware, there has been no legislative action on these recommendations.

Thank you. I look forward to your report, as, I am sure, do all members of our Capital Markets Committee.

Letter from National Bankruptcy Conference dated March 15, 2010 to Representative Conyers regarding Proposed Amendments to the Bankruptcy Code Concerning Exemptions for Financial Contracts

NATIONAL BANKRUPTCY CONFERENCE
A Voluntary Organization Composed of Persons Interested in the Improvement of the Bankruptcy Code and Its Administration

March 15, 2010

The Honorable John Conyers, Jr.
Committee on the Judiciary
United States House of Representatives
Washington, DC 20515

Re: Proposed Amendments to the Bankruptcy Code
<u>Concerning Exemptions for Financial Contracts</u>

Dear Mr. Chairman:

The National Bankruptcy Conference (the "Conference")[1] is writing to you to propose amendments to the Bankruptcy Code concerning the current exemptions in the Bankruptcy Code for financial contracts. As you may know, following amendments made to the Bankruptcy Code in 2005 and 2006, there has been a significant concern raised by bankruptcy professionals, academicians and others as to whether the current exemptions for financial contracts contained in the Bankruptcy Code are unnecessarily broad. The proposals made by the Conference in this letter would narrow the exemptions for the reasons explained below.

Some background may be helpful. By financial contracts we mean swap agreements, repurchase agreements, securities contracts, commodity contracts and futures contracts, all as defined in the Bankruptcy Code. Financial contracts are currently exempt from many of the provisions of the Bankruptcy Code that would govern ordinary commercial transactions. For example, a non-debtor would normally be barred by the automatic stay in a bankruptcy case from terminating a contract with the debtor based on the commencement of the debtor's bankruptcy case. A non-debtor party to a financial contract is not so barred. Usually a creditor in possession or control of collateral would be barred by the automatic stay in a bankruptcy case from enforcing its rights against the collateral to obtain payment of amounts owed to by it the debtor. A non-debtor party to a financial contract is not so barred. Typically also a creditor who receives a payment or collateral from the debtor on the eve of the commencement of the debtor's bankruptcy case would be vulnerable to the payment or collateral being returned to the debtor's bankruptcy estate as a preference. A non-debtor party to a financial contract is exempt from any preference risk.

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[1] The Conference is a voluntary, non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. For approximately 70 years, its primary purpose has been and is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws. A fact sheet describing the Conference and a list of its current members is enclosed.

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The Honorable John Conyers, Jr.
March 15, 2010
Page 2

The justification for these exemptions is based on a concern about systemic risk. Financial contracts are so much a part of the capital markets that the bankruptcy of a participant may, absent exemptions from the Bankruptcy Code, "freeze" contracts with the debtor from unwinding and produce a "daisy chain" effect of multiple defaults among market participants. The Conference does not question this justification. However, the Conference does question whether the exemptions are currently drafted so broadly that they would exempt from the Bankruptcy Code various non-financial-contract commercial transactions for which the normal rules of bankruptcy should govern, and thereby undermine the goals of the Bankruptcy Code aimed at a collective proceeding involving all creditors and equal treatment of all creditors similarly situated. Indeed, the Conference is concerned that the breadth of the current exemptions affords parties the opportunity voluntarily to structure ordinary commercial transactions, such as loans or supply agreements, as financial contracts in order to fall within the exemptions and avoid the normal rules of bankruptcy, even though the transactions pose no or little systemic risk.

The Conference in this letter is making three proposals. The first proposal is to confine collateral securing performance under financial contracts and benefiting from the exemptions to so-called "financial collateral". The second proposal is to limit the defense relating to a settlement payment on a security so that the defense is not available to the beneficial holder of the security. The third proposal is to provide a separate scheme for forward and commodity contracts where the underlying commodity is actually used or sold in the ordinary course of the debtor's business. Each of these proposals is discussed below.

1. Financial Collateral

The current exemptions contain no limitation on the types of collateral against which a non-debtor counterparty may exercise contractual rights with the benefit of the exemptions. Therefore, a non-debtor counterparty to a financial contract, such as a swap agreement, may exercise its secured party rights against the collateral posted for such agreement free from any bankruptcy stay, regardless of whether the collateral is cash or securities (as would be common for a swap agreement) or the debtor's plants, equipment and other operating assets (which would be quite uncommon for a legitimate swap agreement). Indeed, the use of uncommon collateral in what is otherwise facially a protected financial contract may be a strong indicator that the transaction is, in fact, a secured loan or commercial arrangement that has been documented to appear to be a financial contract entitled to the exemptions.

The unfettered exercise of secured party rights against operating assets could end the debtor's prospects for reorganization, and thus likely lead to the termination of its employees and the loss of going concern values to other creditors and stakeholders. Where collateral is cash, securities or other fungible financial assets, affording a non-debtor counterparty the right to realize on such collateral free from the automatic stay should not deprive the debtor of its reorganization prospects. In contrast, where the collateral is operating assets – which can often be unique or practically irreplaceable – not only does the type of collateral raise serious issues as to the bona fides of the transaction as a protected contract, but the loss of the automatic stay can be fatal to the debtor's reorganization prospects. The Conference's proposal limits the special protections related to the exercise of contractual rights against collateral to financial assets of types that are usual for legitimate protected financial contracts and do not present as high a level of risk to reorganization prospects.

Attached as Exhibit A is a draft of the suggested amendments to the Bankruptcy Code to confine recourse to collateral under the financial contracts exemption provisions solely to collateral that is "financial collateral" as defined in the draft. The draft is designed to exclude from the exemptions recourse to collateral consisting of a debtor's operating assets on the theory that the transactions are likely abusive ones, i.e., transactions that in economic effect are ordinary commercial transactions, but are structured as derivative transactions merely to benefit from the exemptions. In the Conference's view, these abusive transactions do not implicate systemic risk and should not benefit from the exemptions.

II. Settlement Payments

Bankruptcy Code § 546(e) was designed to protect prepetition transfers under securities contracts from avoidance as preferential transfers or fraudulent transfers. For example, a mark-to-market margin payment under a securities purchase agreement, securities loan, margin loan, clearing advance or other securities contract might be subject to avoidance as a preferential transfer absent § 546(e) protection. Similarly, § 546(e) protects intermediaries in the national securities clearance and payment process from avoidance exposure with respect to the transfers for which they act as intermediaries.

There has been disagreement among the courts as to the scope of the § 546(e) protection with respect to payments to shareholders in connection with leveraged buyouts and similar transactions. Absent § 546(e), shareholders who received payouts for their stock in connection with a leveraged buyout that rendered the target company insolvent may be vulnerable to recovery of their payouts as constructive fraudulent transfers by the target company's bankruptcy estate. The recovered amounts would be available to repay the target company's unpaid creditors. Most (but not all) courts have interpreted § 546(e) sufficiently broadly as to immunize shareholders from such recoveries if they received their payouts through the national securities clearance or payment system or even merely from a bank, even though no securities contract was implicated and they are not themselves securities or payment intermediaries. The Conference believes that this result is unfair and unnecessary to protect the securities markets.

Attached hereto as Exhibit B is a draft of the suggested amendments to §§ 546 and 550 of the Bankruptcy Code to permit recourse to the beneficial holder of a security on which a settlement payment is made if the settlement payment otherwise constitutes a constructive fraudulent transfer. The proposed amendments would not affect the exemptions under those sections currently available to banks, brokers and other intermediaries who are not the beneficial holder of the security.

III. Forward and Commodity Contracts

The current Bankruptcy Code financial contract exemptions apply to forward and commodity contracts because forward and commodity contracts are regularly traded, much in the same way as securities are traded, and pose many of the same systemic risk issues. However, the exemptions for forward and commodity contracts are so broadly drafted that they could include ordinary commodity supply contracts by which the debtor in ordinary course of its business sells a commodity to an end-user or buys a commodity from a supplier for use in the debtor's business.

The Conference is of the view that commodity supply contracts in which in the ordinary course of its business the commodity is sold by the debtor to an end-user or is used by the debtor should not pose systemic risk issues and therefore should not be exempt from the ordinary bankruptcy rules. However, the Conference has been unable to formulate a "bright line" rule that would distinguish a forward or commodity contract that is regularly traded and that poses a systemic risk concern from an ordinary supply contract that does not pose a systemic risk concern. The difficulty in devising a "bright line" rule lies in part in the fact that many debtors enter into forward and commodity contracts not only to sell or use the underlying commodity but also to hedge market volatility risk. Accordingly, a supplier or end-user will often preserve the option to trade a forward or commodity contract even though it would otherwise sell or use the underlying commodity.

Given that the efforts of the Conference to distinguish a forward or commodity contract that is regularly traded from an ordinary supply contract have not been successful, the Conference instead proposes a different scheme for forward and commodity contracts. Under this scheme, a debtor in possession would have a very short opportunity to elect that all forward and commodity contracts between the debtor and a single counterparty not have the benefit of the exemptions otherwise applicable to the contracts. If the election is made, the forward and commodity contracts with the single counterparty would be governed by a set of rules under which, if the debtor in possession wishes to preserve the value of the forward and commodity contracts for the benefit of the debtor's bankruptcy estate, the debtor in possession is required to post cash collateral in favor of the counterparty to cover postpetition volatility risk. In this way, the debtor in possession may retain the value of the forward and commodity contracts by "putting its money where its mouth is," while at the same time the non-debtor counterparty is protected by the cash collateral posted.

Attached hereto as Exhibit C is a more detailed outline as to how these provisions would work. If there is sufficient interest in exploring this proposal, we would be happy to work with you to develop statutory language.

We encourage you to consider the Conference's proposals, and look forward to discussing them with you. If you would like any further information, please contact me by telephone at (617) 951-8615 or by email at Edwin.smith@bingham.com.

Yours sincerely,

Edwin E. Smith
Chair, Committee on Capital Markets

Attachments and Enclosure

EXHIBIT A

Amend section 362(b)(6), (7), (17) and (27) as follows:

(b) The filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay –

* * *

(6) under subsection (a) of this section, of the exercise by a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency of any contractual right (as defined in section 555 or 556) to foreclose on, dispose of, draw against, demand and receive payment under, or otherwise realize on any financial collateral under any security agreement or arrangement or other credit enhancement forming a part of or related to any commodity contract, forward contract or securities contract, or of any contractual right (as defined in section 555 or 556) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such contracts, including any master agreements for such contracts;

(7) under subsection (a) of this section, of the exercise by a repo participant or financial participant of any contractual right (as defined in section 559) to foreclose on, dispose of, draw against, demand and receive payment under, or otherwise realize on any financial collateral under any security agreement or arrangement or other credit enhancement forming a part of or related to any repurchase agreement, or of any contractual right (as defined in section 559) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreements for such agreements;

* * *

(17) under subsection (a) of this section, of the exercise by a swap participant or financial participant of any contractual right (as defined in section 560) to foreclose on, dispose of, draw against, demand and receive payment under, or otherwise realize on any financial collateral under any security agreement or arrangement or other credit enhancement forming a part of or related to any swap agreement, or of any contractual right (as defined in section 560) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreements for such agreements;

* * *

(27) under subsection (a) of this section, under subsection (a) of this section, of the exercise by a master netting agreement participant of any contractual

right (as defined in section 555, 556, 559, or 560) to foreclose on, dispose of, draw against, demand and receive payment under, or otherwise realize on any financial collateral under any security agreement or arrangement or other credit enhancement forming a part of or related to any master netting agreement, or of any contractual right (as defined in section 555, 556, 559, or 560) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such master netting agreements to the extent that such participant is eligible to exercise such rights under paragraph (6), (7), or (17) for each individual contract covered by the master netting agreement in issue; and

* * *

Amend section 101 to insert the following after paragraph (21B):

(21C) The term "financial collateral"

(A) means, with respect to one or more contracts of the kind described in paragraphs (1) through (5) of section 561(a), --

(i) any property sold or to be sold in the performance of such contracts, cash, cash equivalent, security, instrument, certificate of deposit, mortgage loan, or interest in a contract of the kind described in paragraphs (1) through (5) of section 561(a) (except in each case any security or instrument issued or executed by the debtor or a person under common control with the debtor), in each case which also secures obligations under such contracts;

(ii) any other property not used in the operation of any business owned or conducted by the debtor or a person under common control with the debtor, in each case which secures obligations under such contracts; or

(iii) any letter of credit, guarantee, reimbursement agreement or other credit enhancement issued or provided by a person other than the debtor for the obligations under such contracts (regardless of any recourse that such person may have to the debtor), in each case which provides credit enhancement for obligations under such contracts; and

(B) notwithstanding subparagraph (A), does not include --

(i) any receivable ~~(as defined in section 547(a)(3))~~ arising in the ordinary course of business of the debtor or a person under common control with the debtor relating to the sale or lease of goods, the provision of services or the licensing of information; and

(ii) any property that was not of a kind described in subparagraph (A) at the time of the filing of the petition, and the proceeds of such property.

EXHIBIT A

Note: The Section 362(b) portion of the foregoing is identical to the Drafting Committee report of July 23, 2008. The Section 101(21C) portion of the foregoing contains changes from such report in clauses (A)(i) and B(ii).

EXHIBIT B

Amend Section 546(e) as follows:

(e) Notwithstanding sections 544, 545, 547, 548(a)(l)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except

(1) a transfer that is otherwise avoidable under section 548(a)(l)(A) of this title; or

(2) a transfer that is otherwise avoidable under section 544, 545, 547, 548(a)(1)(B) or 548(b) of this title, but only to the extent such transfer is a redemption payment, principal payment, dividend payment, interest payment or other distribution on or in respect of a security, made for the benefit of the beneficial holder of the security, by or on behalf of the issuer of the security or another entity obligated with respect to the security.

Add a new Subsection (g) to Section 550 as follows:

(g) The trustee may not recover any transfer of a kind described in section 546(e)(2), except from the entity that is the beneficial holder of the security on or in respect of which such transfer is made.

Note: The Section 546(e) portion of the foregoing is identical to the Drafting Committee report of July 23, 2008. The Section 550(g) portion has been changed.

EXHIBIT C

Excluded Commodity Contracts
Outline of Key Provisions

New definition of "excluded commodity contract".

An "excluded commodity contract" would be any "forward contract" or "commodity contract" (or similar term, such as "forward agreement") for the purchase or sale of a commodity actually used or sold by the debtor in the ordinary course of its business, including a hedging contract for actual business operations, if the debtor is not a "financial participant".

Replacement protections applicable to excluded commodity contracts.

Except as to all excluded commodity contracts with a single counterparty listed by the debtor or trustee in a statement filed with the court within 48 hours after the order for relief, the Bankruptcy Code's exemptions for financial contracts would not apply to an excluded commodity contract. The exemptions that would not apply would include exemptions from avoidance relating to the excluded commodity contract itself or any guaranty of, security interest securing, or other credit enhancement of the excluded financial contract.

Instead, the following protections would apply:

Interim post-petition performance. Pending assumption or rejection of each excluded commodity contract, the trustee would be required to perform all terms of the contract (other than provisions described in section 365(b)(2)) that are required to be performed by the debtor post-petition. During this period the trustee would not be required to pay any unpaid amounts on an excluded commodity contract that were required to have been paid by the debtor pre-petition.

No cherry picking. The trustee would not be permitted to cherry pick among excluded commodity contracts with a single counterparty. All such contracts with the counterparty would have to be either assumed or rejected.

Administrative expense claim for "in the money" claims including post-petition changes in value. If, on the date on which excluded commodity contracts with a particular counterparty are assumed or rejected, the net market value to the counterparty of the excluded commodity contracts (measured across all such contracts) is positive, then the counterparty would have an administrative expense claim for any amount by which the net market value to the counterparty on that date is greater than the net market value (by the same measure) of all those contracts on the earlier of the date of the order for relief and the post-petition date on which the net market value (by the same measure) to the counterparty is first positive.

Cash collateral to be posted to secure the administrative expense claim. The trustee would be required to post cash collateral, starting no later than X (~5) days after the date of the order for relief, to secure payment of the administrative expense claim (determined, as to each counterparty, as if all of such excluded commodity contracts were being assumed or rejected as of the date of determination) in an amount equal to 105% of the allowable administrative expense claim, and the counterparty would be required to return any excess cash collateral. Cash collateral would be posted or returned each business day based on the closing price at the end of the prior business day. The amount of cash collateral to be posted under this provision would not be subject to modification by any agreement between the debtor and the counterparty, except a post-petition agreement approved by the court.

Period in which to assume or reject. The trustee would have up to Y (~30) days after the order for relief to move for court approval to assume or reject the contract. Cash collateral would continue to be posted or returned as required pending court approval. If the contract is not assumed within that time period, it is considered rejected.

Effect of rejection. If a counterparty's excluded commodity contracts are rejected, the counterparty's netting rights would be preserved, and the contracts would no longer be "excluded", i.e., all financial contract exemptions would apply (including with respect to collateral posted post-petition for any administrative expense claim). The counterparty would then have a period of up to 30 days following the rejection date to exercise the counterparty's right under the financial contract exemptions to terminate the contracts and exercise liquidation and netting rights without leave from the bankruptcy court. In addition, on rejection, the counterparty's damage claim under section 365(g) would be measured as of the rejection date (subject to sections 562(b) and (c)), rather than as of the petition date.

Stay relief. If the trustee fails to post cash collateral, otherwise perform the excluded commodity contract or timely assume the excluded commodity contract, then stay relief would be automatic for the counterparty, all excluded commodity contracts of that counterparty would cease to be excluded commodity contracts, and the general financial contract exemptions would be available to the counterparty.

Transition provisions

The foregoing treatment of excluded commodity contracts would apply to a contract entered into on or after the date of enactment. If a confirmation is entered into on or after the date of enactment under a master agreement entered before the date of enactment, the foregoing treatment would apply to the confirmation.

The foregoing treatment would not otherwise apply to a contract, or to a confirmation under a master agreement, entered into before the date of enactment unless the contract or confirmation were amended on or after the date of enactment to add a commodity or to increase the amount of a commodity, the price for a commodity or margin or collateral or to provide a guaranty or other credit enhancement of the debtor's performance.

National Bankruptcy Conference

A non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws.

History. The National Bankruptcy Conference (NBC) was formed from a nucleus of the nation's leading bankruptcy scholars and practitioners, who gathered informally in the 1930's at the request of Congress to assist in the drafting of major Depression-era bankruptcy law amendments, ultimately resulting in the Chandler Act of 1938. The NBC was formalized in the 1940's and has been a resource to Congress on every significant piece of bankruptcy legislation since that time. Members of the NBC formed the core of the Commission on the Bankruptcy Laws of the United States, which in 1973 proposed the overhaul of our bankruptcy laws that led to enactment of the Bankruptcy Code in 1978, and were heavily involved in the work of the National Bankruptcy Review Commission (NBRC), whose 1997 report initiated the process that led to significant amendments to the Bankruptcy Code in 2005.

Current Members. Membership in the NBC is by invitation only. Among the NBC's 60 active members are leading bankruptcy scholars at major law schools, as well as current and former judges from eleven different judicial districts and practitioners from leading law firms throughout the country who have been involved in most of the major corporate reorganization cases of the last three decades. The NBC includes leading consumer bankruptcy experts and experts on commercial, employment, pension, mass tort and tax related bankruptcy issues. It also includes former members of the congressional staff who participated in drafting the Bankruptcy Code as originally passed in 1978 and former members and staff of the NBRC. The current members of the NBC and their affiliations are set forth on the second page of this fact sheet.

Policy Positions. The Conference regularly takes substantive positions on issues implicating bankruptcy law and policy. It does not, however, take positions on behalf of any organization or interest group. Instead, the NBC seeks to reach a consensus of its members - who represent a broad spectrum of political and economic perspectives - based on their knowledge and experience as practitioners, judges and scholars. The Conference's positions are considered in light of the stated goals of our bankruptcy system: debtor rehabilitation, equal treatment of similarly situated creditors, preservation of jobs, prevention of fraud and abuse, and economical insolvency administration. Conferees are always mindful of their mutual pledge to "leave their clients at the door" when they participate in the deliberations of the Conference.

Technical and Advisory Services to Congress. To facilitate the work of Congress, the NBC offers members of Congress, Congressional Committees and their staffs the services of its Conferees as non-partisan technical advisors. These services are offered without regard to any substantive positions the NBC may take on matters of bankruptcy law and policy.

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Mr. BACHUS. Professor Jackson? And thank you.

TESTIMONY OF THOMAS H. JACKSON, DISTINGUISHED UNIVERSITY PROFESSOR & PRESIDENT EMERITUS, UNIVERSITY OF ROCHESTER, ROCHESTER, NY

Mr. JACKSON. Chairman Bachus, and Ranking Member Johnson, and other Members of the Subcommittee, thank you for inviting me here this afternoon. And it is an honor to have an opportunity to testify before you on a subject near and dear to my heart, which is bankruptcy law, and specifically the role bankruptcy law can and should play in the best possible resolution of a troubled large financial institution, and how modest, but important, amendments to the Bankruptcy Code can facilitate that outcome.

First, what do I mean by the best possible resolution of a troubled financial institution? I mean a resolution process that meets three important tests: first, one that both minimizes losses and places them on appropriate pre-identified parties; second, one that minimizes systemic consequences; third, one that does not result in a government bailout.

In reflecting on the 2008-'09 financial crisis, everyone seemed to acknowledge that bankruptcy law should play a major role, but few had confidence that it was up to the task. The Dodd-Frank Act, while placing bankruptcy at the core of a resolution regime, nonetheless created an administrative backstop to it. Bankruptcy's core role in Dodd-Frank is reflected in two places, first in the requirement of resolution plans—living wills—under Title I, which are focused on and tested against a bankruptcy resolution process. It is also reflected in the statutory requirements for implementing an administrative resolution proceeding, the orderly liquidation authority under Title II.

Such a resolution proceeding cannot be commenced without a finding that use of bankruptcy law would have serious adverse effects on U.S. financial stability. It is widely acknowledged that bankruptcy is the preferred resolution mechanism.

But there is a disconnect between those premises in today's Bankruptcy Code. There is an emerging consensus that the best resolution system, one that meets the three standards I noted above, involves, first, loss bearing capacity known in advance that can be jettisoned in a rapid recapitalization of a financial institution. In the United States, this system is represented by the FDIC's single point of entry proposal for the recapitalization via a bridge company of a SIFI holding company under Title II.

Compared to this administrative resolution proposal, the current Bankruptcy Code is, in my view, kind of "close but no cigar." Yes, Chapter 11 of the Bankruptcy Code is increasingly used to effectuate a going concern sale of a business, sometimes rapidly through a pre-packaged plan. But it will struggle to do this in the case of a large financial corporation. The essence of the recapitalization is, first, leaving behind equity and the loss-absorbing debt, presumably long-term, unsecured debt, to bear the losses. And second, the transfer of everything else—assets, liabilities, rights, and subsidiaries—to a bridge company that because of the stripping off the loss-absorbing debt is presumably both solvent and in a position to deal with the needs of its subsidiaries. And this must be done with great speed so as to restore market confidence without a contagion-producing run.

Yet because of the exemption of qualified financial contracts from most bankruptcy's provisions, including the automatic stay, and because of the lack of clear statutory language permitting the assignment of liabilities or the override of cross defaults or change of control provisions, the current Bankruptcy Code cannot provide the necessary assurance of a rapid recapitalization. This will lead, in my view, either to ineffective resolution plans and/or the reality that Title II will, contrary to desires, become the default resolution mechanism.

In my view, amending bankruptcy law is the solution. Doing so can harmonize resolution plans with what currently is perceived to be the best way to deal with a troubled large financial institution, and those fixes can assure that Title II of Dodd-Frank becomes, in fact, a process of last resort to deal with emergencies that we are simply not able to foretell.

What is required? In addition to specified loss absorbency capacity known in advance, and that I understand the Federal Reserve Board is working on, it requires explicit statutory authorization for a rapid transfer of the holding company's assets, liabilities, rights, and subsidiaries, minus the loss absorbing debt and equity to a bridge institution, and stays and overrides of certain provisions to enable that to happen.

In my written statement, in a proposed Subchapter 5 to Chapter 11, and there are other proposals that are called Chapter 14 that are referenced in it as well, goes into detail as to how to accomplish this. And while the details are many, the concept is simple. Through modest amendments to the Bankruptcy Code it indeed can become the primary resolution vehicle for large financial institutions as envisioned by the Dodd-Frank Act.

And because it is a judicial proceeding, bankruptcy places primacy on the rule of law, on market-based solutions rather than agency control, and on a process that is fair and known in advance, indeed planned for via resolution plans. I urge that you consider amending the Bankruptcy Code along these lines.

Again, I want to thank the Subcommittee for allowing me this opportunity to present my views. I would, of course, be delighted to answer any questions you may have.

[The prepared statement of Mr. Jackson follows:]

STATEMENT OF

THOMAS H. JACKSON

DISTINGUISHED UNIVERSITY PROFESSOR & PRESIDENT EMERITUS

UNIVERSITY OF ROCHESTER

BEFORE

THE SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL

AND ANTITRUST LAW

THE COMMITTEE ON THE JUDICIARY

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

MARCH 26, 2014

EXPLORING CHAPTER 11 REFORM:

CORPORATE AND FINANCIAL INSTITUTION INSOLVENCIES

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

I am a firm believer that the Bankruptcy Code, with a few significant changes, can be made an important player in the resolution of SIFIs and that *both* bankruptcy law *and* the Dodd-Frank Act can be made more effective as a result. Before discussing those changes, however, I believe it is important to set out, briefly, (a) the relationship envisioned between the Dodd-Frank Act and bankruptcy law, (b) the current status of the major alternative to bankruptcy—the Orderly Liquidation Authority (OLA) of Title II of the Dodd-Frank Act, (c) why bankruptcy law, without statutory changes, cannot adequately fulfill what virtually everyone believes should be its role, and (d) why this creates problems both for the Dodd-Frank Act's Title I provisions for resolution plans under Section 165(d)—so-called "Living Wills"—as well as for its OLA provisions under Title II. After setting out that important backdrop, I will discuss the core of changes that I would suggest be implemented in the Bankruptcy Code in order to make it an effective alternative to the FDIC's development of "single-point-of-entry" (SPOE) as its presumptive method of implementing OLA under Title II of the Dodd-Frank Act, thus fulfilling the intent of both Title I and Title II.

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

In two key places, the Dodd-Frank Act envisions bankruptcy as the preferred mechanism for the resolution of SIFIs. The first occurs in Title I, with the provision for resolution plans under Section 165(d). Covered financial institutions are required to prepare, for review by the Board of Governors of the Federal Reserve System (Federal Reserve Board), the Financial Stability Oversight Council, and the Federal Deposit Insurance Corporation (FDIC), "the plan of such company for rapid and orderly resolution in the event of material financial distress or failure . . . ."[1] If the Federal Reserve Board and the FDIC jointly determine 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 . . . ."[2] The failure to submit a plan that meets these tests

[1] Dodd-Frank Act § 165(d)(1).
[2] Dodd-Frank Act, § 165(d)(4)

can lead to restrictions, and divestiture, "in order to facilitate an orderly resolution of such company under title 11, United States Code . . . ."[3] For present purposes, the important point is that effective resolution plans are tested against bankruptcy law, *not* OLA under Title II of the Dodd-Frank Act. It therefore goes without saying—but is worth saying nonetheless—that the effectiveness of bankruptcy law in being able to resolve SIFIs is critically important to the development of credible resolution plans under Title I.

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.[4] That is, by its own terms, bankruptcy is designed by the Dodd-Frank Act to be the preferred resolution mechanism.[5] The FDIC has announced that it supports the idea that bankruptcy, not OLA, should be the presumptive resolution procedure.[6] 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

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[3] Dodd-Frank Act, § 165(d)(5)(A) & (B).

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

[5] 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").

[6] 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/spoct1313.html.

places them on appropriate, pre-identified, parties, (b) minimizes systemic consequences; and (c) does not result in a government bail-out.

The Current Status of the Orderly Liquidation Authority

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

But we are not in 2010, when the Dodd-Frank Act was envisioned and enacted. Much thinking and work has occurred since then, in terms of how, effectively, to resolve a SIFI *without* jeopardizing the financial system and *without* a government bailout.[7] Increasingly, attention has turned, in Europe as well as in the United States, on a rapid recapitalization. Europe has focused on a "one-step" recapitalization via bail-in[8] while the FDIC has focused, in its SPOE proposal, on a "two-step" recapitalization rather

[7] A useful discussion of whether and how well Title II of Dodd Frank 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).

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

than a formal bail-in[9] Under the FDIC's approach,[10] 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 "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 SIFI operating subsidiaries are directly recapitalized, hence the "one-step," whereas in the FDIC's SPOE proposal, the "recapitalized" bridge institution, a different legal entity, is formed first and effectively receives a "new" capital structure by virtue of having long-term unsecured debt left behind in the transfer to it and the bridge institution, in turn, recapitalizes (where necessary) its operating subsidiaries, hence the "two-step."[11]

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[9] FDIC SPOE, *supra* note 5. 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).

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

[11] 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

There are pre-conditions for making this work. Important among them are legal rules, known in advance, setting forth a required amount of long-term debt to be held by the SIFI that would be legally subordinate to other unsecured debt—in the sense of its debt-holders knowing that this debt would be "bailed-in" (in a one-step recapitalization) or left behind (in a two-step recapitalization).[12] And the effective use of a two-step recapitalization in Title II—the FDIC has promulgated for comments a working document on its SPOE proposal[13]—needs to straddle the tension between Title II's liquidation mandate (literally met because, following the transfer to the bridge company, the assets of the original holding company will have been removed from the SIFI holding company, which will subsequently itself be liquidated) and the notion of limiting financial contagion and using Title II only when its results are better than would occur in bankruptcy. That said, many recognize that the FDIC's SPOE proposal for Title II of Dodd-Frank, consistent with parallel work in Europe, is a significant development in terms of advancing the goals of avoiding "too big to fail"—a resolution process that (a) allocates losses among the appropriate parties, (b) limits systemic consequences, and (c) avoids a government-funded bail-out[14]

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.

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

[13] See FDIC SPOE, *supra* note 5.

[14] See Daniel Tarullo, *Toward Building a More Effective Resolution Regime: Progress and Challenges"* (Oct. 2013), available at http://www.federalreserve.gov/newsevents/speech/tarullo20131018a.html ("The single-point-of-entry approach offers the best potential for the orderly resolution of a systemic financial firm . . ."); William Dudley, President and Chief Executive Officer, Federal Reserve Bank of New York, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, Planning for the Orderly resolution of a Globally Systemically Important Bank, p. 1 (Wash. D.C. Oct. 18, 2013) ("I very much endorse the single-point-of-entry framework for resolution as proposed by the Federal Deposit Insurance Corporation (FDIC)."); John Bovenzi, Randall Guynn & Thomas Jackson, *supra* note 12; David Skeel, *supra* note 7.

The Inadequacies of Current Bankruptcy Law Seen in Light of SPOE

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

While it is probably the case that the original "intent" of Section 363 of the Bankruptcy Code—a provision providing for the use, sale, and lease of property of the estate—at the time of its enactment in 1978 was to permit piecemeal sales of unwanted property, Chapter 11 practice began, over time, to move in the direction of both (a) pre-packaged plans of reorganization and (b) procedures whose essential device was a going-concern sale of some or all of the business (whether prior to or in connection with a plan of reorganization), leaving the original equity and much of the debt behind and with the proceeds of the sale forming the basis of the distribution to them according to the plan of reorganization and bankruptcy's priority rules.[15] While these going-concern sales don't fit perfectly with the original vision, which assumed the Chapter 11 company would be reorganized, not sold, such sales have been used, repeatedly, as a way of continuing a business outside of bankruptcy while the claimants and equity interests, left behind, wind up as the owners of whatever was received by the

[15] David Skeel, Debt's Dominion: A History of Bankruptcy Law in America 227 (Princeton 2001); Barry Adler, Douglas Baird & Thomas Jackson, *supra* note 11, 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").

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

That said, a Section 363 sale is an imperfect competitor to SPOE in its current form. While both will require identification of long-term debt (or capital structure debt) that will be left behind—and presumably that may emerge from the current Federal Reserve Board consideration of this issue—a successful two-step recapitalization essentially requires the bridge company to be able to acquire all of the remaining assets, contracts, permits, rights, and liabilities of the SIFI holding company, while preserving the businesses of the transferred, non-bankrupt, operating subsidiaries.

That seems to me very difficult to accomplish under the current Bankruptcy Code. First, because of a series of amendments designed to insulate qualified financial contracts—swaps, derivatives, and repos—from many of bankruptcy's provisions, most notably the automatic stay and the unenforceability of ipso facto clauses—there is no effective mechanism in the current Bankruptcy Code to preclude counterparties on qualified financial contracts from running upon the commencement of a bankruptcy case.[16] Importantly, even if most such contracts reside in non-bankrupt operating

[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 provisions that exist.) While my statement today focuses on changes that are necessary in these existing protective provisions for counterparties on qualified financial contracts in the Bankruptcy Code in order to permit an effective two-step recapitalization of a SIFI holding company, I believe these existing Bankruptcy Code provisions, and their relationship to bankruptcy law more generally, needs to be rethought. See David Skeel & Thomas Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152 (2012).

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. 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.

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 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

[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 . . . ."

bankruptcy process to unfold without the regulator intervening at the foreign subsidiary level.

The Problems These Inadequacies Create for the Dodd-Frank Act

As noted above, resolution plans under Title I of the Dodd-Frank Act focus on bankruptcy, and Title II of the Dodd-Frank Act is, explicitly, designed to be a fall-back solution to be invoked when bankruptcy is determined to be inadequate to avoid serious financial consequences on the U.S. financial system. But if the "best" resolution process we currently envision—one that, as noted above, (a) both minimizes losses and places them on appropriate, pre-identified, parties, (b) minimizes systemic consequences, and (c) does not result in a government bail-out—involves, indeed, a recapitalization such as proposed by the FDIC with its SPOE procedure under Title II,[18] then there is a disconnect between design and implementation. As a result, the resolution plans will fail to do what they are supposed to do—prepare a SIFI for the most successful possible resolution—leading to OLA under Title II assuming primacy in terms of the resolution process. Moreover, the resolution plans, relentlessly focused on a bankruptcy process under Title I's own standards, will be addressing a different set of issues and will provide little guidance to the FDIC in its OLA proceeding. To have the statutory pieces "fit" together—to have resolution plans effectively prepare a firm for resolution, to have bankruptcy serve as its intended role as the primary resolution device, and (beneficially) to have the resolution plans be relevant to a proceeding under Title II of

[18] See sources cited, *supra* note 14.

the Dodd-Frank Act "just in case"—it makes sense to move, through limited but important changes to the Bankruptcy Code, from the "bones" of a successful two-step recapitalization process in the current Bankruptcy Code to a process that can deliver what it can only incompletely promise today.[19]

Proposed Amendments to the Bankruptcy Code

What might those necessary amendments be? Attached to this statement is a proposal for adding a "Subchapter V" to Chapter 11 of the Bankruptcy Code that contains what I believe are the necessary (and useful) amendments.[20] I do not intend to repeat the numerous (and sometime intricate) details here, but, rather, plan to use this statement to outline the heart of what they are designed to accomplish.

At the center of effectuating a bankruptcy-based two-step recapitalization of a SIFI holding company, are two principles. First, that there is sufficient long-term unsecured debt (or "capital structure debt") at the holding company level to be "left

[19] I recognize that many may want to reduce the size and complexity of SIFIs and may see bankruptcy's current inadequacies as one way to realize that goal. For, if bankruptcy is viewed as not adequate, then the resolution plans cannot be approved until the SIFI is reduced sufficiently in size and complexity to bring bankruptcy back into play. I think, however, it would be extremely unfortunate to mix the complex question of size ("too big") with the separate question of how to best resolve the institutions we might have at any moment. Thus, I hope that bankruptcy law—i.e., the failure to amend it—is not used in a chess game focused on a different set of issues.

[20] See Appendix A. S. 1861 (Dec. 2013) has a proposal designed to a similar end, albeit with several different features. The Hoover Institution's Resolution Project is working on a comprehensive proposal (dubbed "Chapter 14 2.0") that picks up many of the ideas from its original proposal in BANKRUPTCY *NOT* BAILOUT: A SPECIAL CHAPTER 14 (Kenneth Scott & John Taylor, eds., Hoover Press 2012), and adds to it features necessary to implement a rapid recapitalization sale. The principal (but not sole) difference is that the Resolution Project's current work is designed to produce a more comprehensive proposal for how the Bankruptcy Code should handle ***both*** a SIFI at the holding company level *and* at the operating division level, while the proposal in Appendix A is focused on accommodation in bankruptcy of a SPOE-like two-step recapitalization at the holding company level.

behind" in the transfer to a bridge company so as to effectuate the recapitalization. (This is—or should be—largely an issue outside of bankruptcy law itself—and, indeed, is central to a basically rule-based application of the FDIC's SPOE proposal under Title II of the Dodd-Frank Act. It is my understanding the Federal Reserve Board is working precisely on such a proposed requirement.) Second, that the bridge company otherwise be able to acquire all the assets, rights, and liabilities of the former holding company, including ownership of the former holding company's operating subsidiaries.[21]

Thus, the "guts" of the proposed amendments I believe are necessary to place bankruptcy law where the Dodd-Frank Act—in both Title I and Title II—envisions it should be, center on a provision that substantially sharpens the nature and focus of a sale of assets under Section 363 of the Bankruptcy Code. This provision contemplates a rapid transfer to and, in effect, recapitalization of, a bridge company (e.g., within the first 48 hours of a bankruptcy case)[22] by a SIFI holding company (the debtor), after which the bridge company can recapitalize, where necessary, its operating subsidiaries.[23] If the court approves the transfer, then the SIFI holding company's operations (and ownership of subsidiaries) shift to a new bridge company *that is not in bankruptcy*—and will be perceived as solvent by market-participants, including

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[21] There is a third, important, question of access to liquidity by the bridge company that, formally not a part of the bankruptcy process—and thus outside the jurisdiction of this Subcommittee—I do not address in any detail in this statement. See *infra*, note 24.

[22] In the Subchapter V proposal, Appendix A, Sec. 3, § 1183, commenced either under Sections 301 and 303 of the Bankruptcy Code or by the Federal Reserve Board, 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 would preserve or promote financial stability in the United States.

[23] The institutions that can use these new bankruptcy procedures, I would recommend, should track those who can be placed into OLA under Title II of the Dodd-Frank Act. See Appendix, Sec. 2 (amending Bankruptcy Code §§ 101, 103, & 109).

liquidity providers[24] 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 that would hold the equity interests in the bridge company until they are sold or distributed pursuant to a Chapter 11 plan, and whose claimants consist of the holders of the long-term debt that is not transferred to the bridge company and the old equity interests of the SIFI holding company. This debtor in Chapter 11 has no real business to conduct, and essentially waits for an event (such as the sale or public distribution of equity securities of the bridge company by the trust) that will value or generate proceeds from its assets (all equity interests in the new, recapitalized entity) and permit a distribution of those equity interests or proceeds, pursuant to bankruptcy's normal distribution rules, to the holders of the long-term debt and original equity interests of the debtor (the original SIFI holding company).

The details of accomplishing this are somewhat intricate and, of course, can vary, but it is useful, I believe, to trace the general ideas of how I envision this two-step

[24] 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 § 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, *supra* note 12—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). (Appendix A contains a proposed amendment adding paragraph 15 to Federal Reserve Act § 13, to authorize, under limited circumstances and for a limited time, temporary liquidity by the Federal Reserve Board. Appendix A, Sec. 5.)

recapitalization might be implemented in bankruptcy.[25] The transfer motion would be heard by the court[26] no sooner than 24-hours after the filing (so as to permit 24-hour notification to the 20 largest holders of unsecured claims, the Federal Reserve Board, the FDIC, and the Secretary of the Treasury, and the primary financial regulatory authority—whether US or foreign—with respect to any subsidiary whose ownership is proposed to be transferred to the bridge company).[27] And, because the provisions must stay qualified financial contract termination (and related) rights (including those based on cross-defaults in non-bankruptcy subsidiaries) for a period to allow the transfer to the bridge company to be effective in a seamless fashion, the transfer decision essentially must be made within a designated period (e.g., 48-hours) after the filing.[28] There should be conditions on the ability of the court to authorize the transfer to the bridge company—but conditions that can be satisfied by advanced planning (e.g., resolution plans) or otherwise within a very short time-frame. For example, the proposal in Appendix A provides that the court can order the transfer only if it finds the transfer will (a) preserve or promote financial stability in the United States and (b) does not provide for any assumption of the long-term unsecured debt and, in addition, the Federal Reserve Board certifies that it has found that the bridge company adequately provides assurance of future performance of any executory contract, unexpired lease, or debt agreement being transferred to the bridge company.[29]

[25] And reflected in the proposal in Appendix A, particularly Sec. 3.
[26] In Appendix A, the proposal includes an amendment to 28 U.S.C. § 298 to create a group of designated district judges, at least one from each circuit, to hear cases arising under Subchapter V of Chapter 11. Appendix A, Sec. 4.
[27] Appendix A, Sec. 3, § 1186(b).
[28] Appendix A, Sec. 3, §§ 1187, 1188.
[29] Appendix A, Sec. 3, § 1186(c)(3).

Many of the remaining provisions that I believe would need to be adopted as well, and are set out in Appendix A, 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.

First, there are provisions applicable to debts, executory contracts, and unexpired leases, including qualified financial contracts.[30] 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 operating subsidiaries once it assumes the assets and liabilities.[31] This requires overriding "ipso facto" clauses (of the type that would otherwise permit termination or modification based on the commencement of a bankruptcy case or similar circumstance, including credit-rating agency ratings, whether in the holding company or in its operating subsidiaries), [32] and it requires overriding similar provisions allowing for termination or modification based on a change of control, again whether in the holding

[30] See generally Appendix A, Sec. 3, § 1187 (debts, executory contracts, and unexpired leases); § 1188 (qualified financial contracts).

[31] I envision this including relevant tax attributes, such as a NOL carryforward. See Appendix A, Sec. 3, § 1190(b).

[32] Appendix A, Sec. 3, § 1188(f). While these provisions affect the contracts, permits, liabilities, and the like of entities (e.g., affiliates such as operating subsidiaries) not themselves in bankruptcy, I believe they are fully authorized (at least for domestic subsidiaries), if not by Congress' Article I bankruptcy power, then by application of the independent (albeit related) Congressional power pursuant to the "necessary and proper" clause of Article I, as interpreted since *McCulloch v. Maryland*, 4 Wheat. 316 (1819), see also *United States v. Comstock*, 560 U.S. ___ (2010), since the bankruptcy of the SIFI cannot successfully be concluded without these provisions that permit the unimpeded transfer of the operating subsidiary's ownership to the bridge company. (The question of foreign subsidiaries, while complex, is being actively discussion by U.S. and foreign regulators, and legislation is being discussed in Europe and elsewhere that is designed to help assure these results extend to non-U.S. operations in the case involving the resolution of a U.S.-based SIFI holding company.)

company or in its operating subsidiaries, since the ownership of the bridge company will be different than the ownership of the debtor prior to the bankruptcy filing.[33] These provisions need to be broader than Section 365 of the Bankruptcy Code, for at least two reasons. First, perhaps because of the limited scope of the original "purpose" of Section 363, bankruptcy doesn't have a provision expressly allowing for the "transfer" of debt (although many debts are in fact transferred as a matter of existing practice under Chapter 11 "going concern sales"). Unlike executory contracts, which might be viewed as net assets (and thus something to "assume") or as net liabilities (and thus something to "reject"), debt is generally considered breached and accelerated (think "rejected") upon the filing of a petition in bankruptcy.[34] But, if there is going to be a two-step recapitalization, the bridge company needs to take the liabilities it would assume "as if nothing happened." Thus, provisions designed to accomplish that need to be included.[35] Second, Section 365 doesn't deal with change-of-control provisions; amendments need to add that and extend it to debt agreements as well.[36]

With respect to qualified financial contracts, there should be provisions in addition to those just mentioned. The stay on termination, offset, and net out rights should apply for the period from the filing until the transfer occurs, it is clear it won't occur, or 48 hours have passed.[37] 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

[33] Appendix A, Sec. 3, § 1187(b)(2). This includes offsets and netting out under qualified financial contracts, § 1188.
[34] See David Skeel & Thomas Jackson, *supra* note 16.
[35] Appendix A, Sec. 3, § 1187.
[36] Appendix A, Sec. 3, § 1187(b)(2).
[37] Appendix A, Sec. 3, § 1188(a).

company, there is a requirement that the debtor and its subsidiaries shall continue to perform payment and delivery obligations.[38] Conversely, because the counterparty may not know for sure what the outcome will be during this interregnum, there is a provision that the counterparty may promptly "cure" any unperformed payment or delivery obligations after the transfer.[39]

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.[40]

Conclusion

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

[38] Appendix A, Sec. 3, § 1188(b)(1).
[39] Appendix A, Sec. 3, § 1188(b)(2).
[40] Appendix A, Sec. 3, § 1189.

that the FDIC's inevitable discretion, compared to a judicial proceeding, becomes a virtue rather than a concern.

Absent that (hopefully rare) need, however, I view the virtues of bankruptcy resolution over agency resolution to be several. First, the new company formed in the Section 363-like recapitalization sale (or transfer) is neither (a) subject to the jurisdiction of a bankruptcy court[41] nor (b) subject to "control" by a government agency, such as the FDIC, whereas the bridge company created in the SPOE process is effectively run, for a while at least, by the FDIC.[42] 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.[43] Third, because of language in the

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[41] Explicitly stated in Appendix A, Sec. 3, § 1185(f).

[42] See, e.g., FDIC SPOE, *supra* note 5, 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 Appendix A, Sec. 3, § 1185(b)(3), where the trustee is authorized to make such decisions only after "provid[ing] notice to and consult[ing] with parties in interest in the case . . . ."

[43] FDIC SPOE, *supra* note 5, 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.").

Dodd-Frank Act,[44] 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).[45] 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 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.[46] 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.[47] Fifth, Title II treats the bridge company created in an OLA under Title II as a government entity, exempt from taxes;[48] I think that provision is a 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. Sixth, and (perhaps) finally, I am concerned—as I suspect the FDIC is as

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44 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).

45 See FDIC SPOE, *supra* note 5, 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").

46 Appendix A, Sec. 3, § 1185(a)(3)(ii). See also Appendix A, Sec. 3, § 1185(3)(A), where the trustee, in the case of a change in officers and directors, is required to first "provide notice to and consult with parties in interest in the case . . . ."

47 See, e.g., FDIC SPOE, *supra* note 5, p. 76618 (in addition to identified categories, the FDIC retains "a limited ability to treat similarly situated creditors differently.").

48 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.").

well—that the actual use of SPOE under Title II will be subject to ex post criticism and investigation. Bankruptcy, with appropriate amendments, is in a more robust position to "do the right thing" in terms of fairly addressing the consequences of financial failure without having it necessarily lead to economic failure.

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

APPENDIX A:

PROPOSED AMENDMENTS TO FACILITATE THE RESOLUTION OF FINANCIAL INSTITUTIONS UNDER THE BANKRUPTCY CODE: FOCUSED ON A NEW SUBSECTION V TO CHAPTER 11

Title: To _insert purpose_

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the ["______ Act of 2013".]

SEC. 2. GENERAL PROVISIONS RELATING TO COVERED FINANCIAL CORPORATIONS.

(a) Definition.—Section 101 of title 11, United States Code, is amended by inserting the following after paragraph (9):

"(9A) The term 'covered financial corporation' means any corporation incorporated or organized under any Federal or State law, other than a stockbroker, a commodity broker, or an entity of the kind specified in paragraph (2) or (3) of section 109(b), that is—

"(A) a bank holding company, as that term is defined in section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a)); or

"(B) predominantly engaged in activities that the Board of Governors of the Federal Reserve System has determined are financial in nature or incidental to such financial activity for purposes of section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k)).".

(b) Applicability of Chapters.—Section 103 of title 11, United States Code, is amended by adding at the end the following:

"(l) Subchapter V of chapter 11 applies only in a case under chapter 11 concerning a covered financial corporation.".

(c) Who May Be a Debtor.—Section 109 of title 11, United States Code, is amended—

(1) in subsection (b)—

(A) in paragraph (2), by striking "or" at the end;

(B) in paragraph (3)(B), by striking the period at the end and inserting "; or"; and

(C) by adding at the end the following:

"(4) a covered financial corporation."; and

(2) in subsection (d)—

(A) by striking "and" before "an uninsured State member bank";

(B) by striking "or" before "a corporation"; and

(C) by inserting ", or a covered financial corporation" after "Federal Deposit Insurance Corporation Improvement Act of 1991".

SEC. 3. LIQUIDATION, REORGANIZATION, OR RECAPITALIZATION OF A COVERED FINANCIAL CORPORATION.

Chapter 11 of title 11, United States Code, is amended by adding at the end the following:

"SUBCHAPTER V—LIQUIDATION, REORGANIZATION, OR RECAPITALIZATION OF A COVERED FINANCIAL CORPORATION

"1181. Inapplicability of other sections

"Sections 321(c) and 322(b) do not apply in a case under this chapter concerning a covered financial corporation.

"1182. Definitions for this chapter

"In this subchapter, the following definitions shall apply:

"(1) The term 'Board' means the Board of Governors of the Federal Reserve System.

"(2) The term 'bridge company' means a corporation whose equity securities are transferred to a special trustee under section 1185(a).

"(3) 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 1 year.

"(4) The term 'contractual right' means a contractual right of a kind defined in section 555, 556, 559, or 560.

"(5) The term 'qualified financial contract' means any contract of a kind specified in paragraph (25), (38A), (47), or (53B) of section 101, section 741(7), or paragraph (4), (5), (11), or (13) of section 761.

"1183. Commencement of a case concerning a covered financial corporation

"(a) A case under this chapter concerning a covered financial corporation may be commenced by the filing of a petition with the bankruptcy court—

"(1) under section 301 or 303; or

"(2) by the Board, if and only if the Board certifies in the petition that it has determined that—

"(A) the covered financial corporation—

"(i) has incurred losses that will deplete all or substantially all of the capital of the covered financial corporation, and there is no reasonable prospect for the covered financial corporation to avoid such depletion;

"(ii) is insolvent;

"(iii) is not paying, or is unable to pay, the debts of the covered financial corporation (other than debts subject to a bona fide dispute as to liability or amount) as they become due; or

"(iv) is likely to be in a financial condition specified in clause (i), (ii), or (iii) sufficiently soon so that the immediate commencement of a case under this title concerning the covered financial corporation is necessary to preserve or promote financial stability in the United States; and

"(B) the commencement of a case under this title and the effect of a transfer under section 1186 would preserve or promote financial stability in the United States.

"(b) The commencement of a case under subsection (a)(2) constitutes an order for relief under this chapter.

"(c) In a case commenced under section 303, the court shall order relief against the debtor under this chapter if the Board—

"(1) makes a certification of the kind described in subsection (a)(2); and

"(2) consents to an order for relief against the debtor under this chapter.

“1184. Regulators

“(a) The Board may raise and may appear and be heard on any issue in any case or proceeding under this title relevant to the regulation of the debtor by the Board or to financial stability in the United States.

“(b) The Federal Deposit Insurance Corporation may raise and may appear and be heard on any issue in any case or proceeding under this title in connection with a transfer under section 1186.

“1185. Special trustee and bridge company

“(a) On request of the trustee or the Board, the court may order the trustee to appoint 1 special trustee and transfer to the special trustee all of the equity securities in a corporation to hold in trust for the sole benefit of the estate if—

“(1) such corporation does not have any property, debts, executory contracts, or unexpired leases, other than any property acquired or debts, executory contracts, or unexpired leases assumed, in a transfer under section 1186;

“(2) such equity securities are property of the estate; and

“(3) the court approves—

“(A) the trust agreement governing the special trustee;

“(B) the governing documents of the bridge company; and

“(C) the identity of—

“(i) the special trustee; and

“(ii) the directors and senior officers of the bridge company.

“(b) The trust agreement governing the special trustee shall provide—

“(1) for the payment of the costs and expenses of the special trustee from the assets of the trust and not from property of the estate;

“(2) that the special trustee provide—

“(A) periodic reporting to the estate; and

“(B) information about the bridge company as reasonably requested by a party in interest to prepare a disclosure statement for a plan providing for distribution of any securities of the bridge company;

“(3) that the special trustee provide notice to and consult with parties in interest in the case regarding—

“(A) any change in a director or senior officer of the bridge company;

"(B) any modification to the governing documents of the bridge company; and

"(C) any major corporate action of the bridge company, including—

"(i) recapitalization;

"(ii) a liquidity borrowing;

"(iii) termination of an intercompany debt or guarantee;

"(iv) a transfer of a substantial portion of the assets of the bridge company; or

"(v) the issuance or sale of any securities of the bridge company;

"(4) that the proceeds of the sale of any equity securities of the bridge company by the special trustee be held in trust for the benefit of or transferred to the estate; and

"(5) that the property held in trust by the special trustee is subject to distribution in accordance with the plan and subsection (e).

"(e) The special trustee shall distribute the assets held in trust in accordance with the plan on the effective date of the plan, after which time the office of the special trustee shall terminate, except as may be necessary to wind up and conclude the business and financial affairs of the trust.

"(f) After a transfer under section 1186, the special trustee shall be subject only to applicable nonbankruptcy law, and the actions and conduct of the special trustee shall no longer be subject to bankruptcy court approval.

"1186. Special transfer of property of the estate

"(a) On request of the trustee or the Board, and after notice and a hearing, beginning 24 hours after the commencement of the case, the court may order a transfer under this section of property of the estate to a bridge company. Except to the extent inconsistent with this section, section 363 applies to a transfer under this section.

"(b) Unless the court orders otherwise, notice of a request for an order under subsection (a) shall consist of electronic or telephonic notice of not less than 24 hours to—

"(1) the holders of the 20 largest unsecured claims against the debtor;

"(2) the Board;

"(3) the Federal Deposit Insurance Corporation;

"(4) the Secretary of the Treasury;

"(5) the United States trustee; and

"(6) each primary financial regulatory agency, as defined in section 2(12) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5301(12)), with respect to any affiliate that is proposed to be transferred under this section.

"(c) The court may not order a transfer under this section unless the court determines, based upon a preponderance of the evidence, that—

"(1) the transfer under this section will preserve or promote financial stability in the United States;

"(2) the proposed transfer does not provide for the assumption of any capital structure debt by the bridge company; and

"(3) the Board certifies to the court that the Board has determined that the bridge company provides adequate assurance of future performance of any executory contract or unexpired leased assumed and assigned to the bridge company, and of payment of any debt assumed by the bridge company, in the transfer under this section.

"1187. Automatic stay; assumed debt

"(a)(1) A petition filed under section 301, 303, or 1183 operates as a stay, applicable to all entities, of the termination, acceleration, or modification of any debt (other than capital structure debt), executory contract (other than a qualified financial contract), or unexpired lease of the debtor, any agreement under which the debtor issued or is obligated for debt (other than capital structure debt), any debt, executory contract (other than a qualified financial contract), or unexpired lease of an affiliate, or any agreement under which such affiliate issued or is obligated for debt, or of any right or obligation under any such debt, contract, lease, or agreement, solely because of a provision in such debt, contract, lease, or agreement that is conditioned on—

"(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

"(B) the commencement of a case under this title concerning the debtor;

"(C) the appointment of or taking possession by a trustee in a case under this title concerning the debtor or by a custodian before the commencement of the case;

"(D) a default by the debtor under any agreement; or

"(E) a credit rating agency rating, or absence or withdrawal of a credit rating agency rating—

"(i) of the debtor at any time after the commencement of the case;

"(ii) of an affiliate during the 48 hours after the commencement of the case; or

"(iii) while the special trustee is a direct or indirect beneficial holder of more than 50% of the equity securities of the bridge company—

"(I) of the bridge company; or

"(II) of an affiliate, if all of the estate's direct or indirect interests in the affiliate are transferred under section 1186.

"(2) The stay under this subsection terminates—

"(A) as to the debtor, upon the earliest of—

"(i) 48 hours after the commencement of the case;

"(ii) assumption of the debt, contract, or lease under an order authorizing a transfer under section 1186; or

"(iii) a determination by the court not to order a transfer under section 1186; and

"(B) as to an affiliate, upon the earliest of—

"(i) entry of an order authorizing a transfer under section 1186 in which the direct or indirect interests in the affiliate that are property of the estate are not transferred under section 1186;

"(ii) a determination by the court not to order a transfer under section 1186; or

"(iii) 48 hours after the commencement of the case, if the court has not ordered a transfer under section 1186.

"(3) Sections 362(d), 362(e), 362(f), and 362(g) apply to a stay under this subsection.

"(b) Notwithstanding a provision in an agreement or in applicable nonbankruptcy law, an agreement under which the debtor has issued any debt, executory contract (other than a qualified financial contract), or unexpired lease that is assumed by the bridge company in a transfer under section 1186 may not be terminated or modified, and any right or obligation under the agreement, debt, contract, or lease may not be terminated or modified, as to the bridge company solely because of—

"(1) a provision in the debt, contract, lease, or agreement of the kind specified in subsection (a)(1); or

"(2) a provision in an agreement or in applicable nonbankruptcy law that prohibits, restricts, or conditions the assignment of the debt, contract, or lease or that terminates or modifies, or permits a party other than the debtor to terminate or modify, the debt, contract, or lease on account of the assignment of the debt, contract, or lease or a change in control of any party to the debt, contract, or lease.

"1188. Treatment of qualified financial contracts and affiliate contracts

"(a) Notwithstanding sections 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, 560, and 561, a petition filed under section 301, 303, or 1183 operates as a stay, during the period specified in section 1187(a)(2)(A), applicable to all entities, of the exercise of a contractual right—

"(1) to cause the liquidation, termination, or acceleration of a qualified financial contract of the debtor or an affiliate;

"(2) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with a qualified financial contract of the debtor or an affiliate; and

"(3) under any security agreement or arrangement or other credit enhancement forming a part of or related to a qualified financial contract of the debtor or an affiliate.

"(b)(1) During the period specified in section 1187(a)(2)(A), the trustee or the affiliate shall perform all payment and delivery obligations under a qualified financial contract of the debtor or the affiliate, as the case may be, that become due after the commencement of the case. The stay provided under subsection (a) terminates as to a qualified financial contract of the debtor or an affiliate immediately upon the failure of the trustee or the affiliate, as the case may be, to perform any such obligation during such period.

"(2) A counterparty to any qualified financial contract of the debtor that is assumed and assigned in a transfer under section 1186 may perform any unperformed payment or delivery obligation under the qualified financial contract promptly after the assumption and assignment with the same effect as if the counterparty had timely performed such obligations.

"(c) A qualified financial contract between an entity and the debtor may not be assigned to or assumed by the bridge company in a transfer under section 1186 unless—

"(1) all qualified financial contracts between the entity and the debtor are assigned to and assumed by the bridge company in the transfer under section 1186;

"(2) all claims of the entity against the debtor under any qualified financial contract between the entity and the debtor (other than any claim that, under the terms of the qualified financial contract, is subordinated to the claims of general unsecured creditors) are assigned to and assumed by the bridge company;

"(3) all claims of the debtor against the entity under any qualified financial contract between the entity and the debtor are assigned to and assumed by the bridge company; and

"(4) all property securing or any other credit enhancement furnished by the debtor for any qualified financial contract described in paragraph (1) or any claim described in paragraph (2) or (3) under any qualified financial contract between the entity and the debtor is assigned to and assumed by the bridge company.

"(d) Section 365(b)(1) does not apply to a default under a qualified financial contract of the debtor that is assumed and assigned in a transfer under section 1186 if the default—

"(1) is a breach of a provision of the kind specified in section 1187(a)(1)(E);

"(2) in the case of a breach of a provision of the kind specified in section 1187(a)(1)(E)(iii), occurs while the bridge company is a direct or indirect beneficial holder of more than 50 percent of the equity securities of the affiliate.

"(e) Notwithstanding any provision in a qualified financial contract or in applicable nonbankruptcy law, a qualified financial contract of the debtor that is assumed or assigned in a transfer under section 1186 may not be terminated or modified, and any right or obligation under the qualified financial contract may not be terminated or modified, at any time after the entry of the order under section 1186 until such time as the special trustee is no longer the direct or indirect beneficial holder of more than 50 percent of the equity securities of the bridge company, solely because of a condition described in section 1187(b).

"(f) Notwithstanding any provision in any agreement or in applicable nonbankruptcy law, an agreement of an affiliate (including an executory contract, an unexpired lease, or an agreement under which the affiliate issued or is obligated for debt) and any right or obligation under such agreement may not be terminated or modified, at any time after the commencement of the case, solely because of a condition described in section 1187(b) if and only if—

"(1) all direct or indirect interests in the affiliate that are property of the estate are transferred under section 1186 to the bridge company within the period specified in subsection (a);

"(2) the bridge company assumes—

"(A) any guarantee or other credit enhancement issued by the debtor relating to the agreement of the affiliate; and

"(B) any right of setoff, netting arrangement, or debt of the debtor that directly arises out of or directly relates to the guarantee or credit enhancement; and

"(3) any property of the estate that directly serves as collateral for the guarantee or credit enhancement is transferred to the bridge company.

"1189. Licenses, permits, and registrations

"(a) Notwithstanding any otherwise applicable nonbankruptcy law, if a request is made under section 1186 for a transfer of property of the estate, any Federal, State, or local license, permit, or registration that the debtor or an affiliate had immediately before the commencement of the case and that is proposed to be transferred under section 1186 may not be terminated or modified at any time after the request solely on account of—

"(1) the insolvency or financial condition of the debtor at any time before the closing of the case;

"(2) the commencement of a case under this title concerning the debtor; or

"(3) the appointment of or taking possession by a trustee in a case under this title concerning the debtor or by a custodian before the commencement of the case.

"(b) Notwithstanding any otherwise applicable nonbankruptcy law, any Federal, State, or local license, permit, or registration that the debtor had immediately before the commencement of the case that is included in a transfer under section 1186 shall vest in the bridge company.

"1190. Exemption from securities laws and special tax provisions

"(a) For purposes of section 1145, a security of the bridge company shall be deemed to be a security of a successor to the debtor under a plan if the court approves the disclosure statement for the plan as providing adequate information (as defined in section 1125(a)) about the bridge company and the security.

"(b) [Tax treatment to come.]

"1191. Inapplicability of certain avoiding powers

"Except with respect to a capital structure debt, a transfer made or an obligation incurred by the debtor, including any obligation released by the debtor or the estate, to or for the benefit of an affiliate in a transfer under section 1186 is not avoidable under section 544, 547, 548(a)(1)(B), or 549 or under any similar nonbankruptcy law.".

SEC. 4. AMENDMENTS TO TITLE 28, UNITED STATES CODE.

(a) Amendment to Chapter 13.—Chapter 11 of title 11, United States Code, is amended by adding at the end the following:

"SEC. 298. JUDGE FOR A CASE UNDER TITLE 11 CONCERNING A COVERED FINANCIAL CORPORATION.

"(a) Notwithstanding section 295, the Chief Justice of the United States shall designate at least 1 district judge from each circuit to be available to hear a case under title 11 concerning a covered financial corporation.

"(b)(1) Notwithstanding section 295, and except as provided in section 157, a case under title 11 concerning a covered financial corporation shall be heard by a district judge who—

"(A) is the district judge designated under subsection (a) from the circuit in which the case is pending;

"(B) if more than 1 district judge has been designated under subsection (a) from the circuit in which the case is pending, is 1 such district judge who is designated by the chief judge of that circuit to hear the case; or

"(C) if none of the district judges designated under subsection (a) for the circuit in which the case is pending are immediately available, is designated under subsection (a) from another circuit by the Chief Justice of the United States.

"(2) If the district judge specified in paragraph (1) is not assigned to the district in which the case is filed, the district judge shall be temporarily assigned to the district.

"(3) The case and all proceedings in the case shall take place in the district where the case is pending.

"(c) Notwithstanding section 157, a district court may not refer a proceeding under section 1186 of title 11, except that the district judge assigned to the case under subsection (b) may appoint the bankruptcy judge to whom the case is assigned as a special master to assist the district judge in the proceeding.

"(d) An appeal under section 158(a) in a case under title 11 concerning a covered financial corporation shall be heard by the district judge assigned to the case under subsection (b).

"(e) In this section, the term 'covered financial corporation' has the meaning given that term in section 101(9A) of title 11.".

(b) Amendment to Section 1334.—Section 1334 of title 28, United States Code, is amended by adding at the end the following:

"(f) This section does not grant jurisdiction to the district courts after a transfer pursuant to an order under section 1186 of title 11 of any proceeding related to a special trustee appointed, or to a bridge company formed, under section 1185 of title 11, and after a transfer pursuant to an order under section 1186 of title 11, the district courts in the district in which a case under title 11 concerning a covered financial corporation (as defined in section 101(9A) of title 11) is pending shall not have jurisdiction over the property held in trust by the special trustee or over the property of the bridge company.".

(c) Technical and Conforming Amendment.—The table of sections for chapter 13 of title 28, United States Code, is amended by adding at the end the following:

"298. Judge for a case under title 11 concerning a covered financial corporation.".

SEC. 5. DISCOUNT WINDOW FOR CASES UNDER SUBCHAPTER V OF CHAPTER 11 OF THE BANKRUPTCY CODE.

Section 13 of the Federal Reserve Act (12 U.S.C. 342 et seq.) is amended by adding at the end the following:

"(15) Advances to Covered Financial Corporations and Bridge Companies.—Subject to such restrictions, limitations, and regulations as the Board of Governors of the Federal Reserve System may prescribe, any Federal reserve bank may make advances to any covered financial corporation (as defined in section 101(9A) of title 11, United States Code) that is a debtor in a pending case under chapter 11 of title 11, United States Code, or to a bridge company (as defined in section 1182(2) of title 11, United States Code) during any period in which the special trustee appointed under section 1185 of title 11, United States Code, is the direct or indirect beneficial holder of more than 50 percent of the equity securities of the bridge company, in the same manner and to the same extent that the Federal reserve bank may make advances to a member bank, provided that—

"(A) the covered financial corporation or bridge company is solvent and in generally sound condition at the time of each advance;

"(B) each advance is secured to the satisfaction of the Federal reserve bank; and

"(C) the rate of interest on each advance is above the market rate of interest at the time of the advance, as determined by the Federal reserve bank.".

Mr. BACHUS. Thank you very much, Professor Jackson.
Professor Harner?

TESTIMONY OF MICHELLE M. HARNER, PROFESSOR OF LAW, DIRECTOR, BUSINESS LAW PROGRAM, UNIVERSITY OF MARYLAND FRANCIS KING CAREY SCHOOL OF LAW, BALTIMORE, MD

Ms. HARNER. Thank you. Chairman Bachus, Ranking Member Johnson, and Members of the Subcommittee, thank you for the opportunity to testify today. I am honored to appear before you.

My research at the University of Maryland Francis King Carey School of Law focuses on corporate governance and financial distress, so I am very familiar with the topic of today's hearing. I want to note, however, that I am testifying in my capacity as reporter to the ABI Commission to Study the Reform of Chapter 11. My comments are on behalf of the commission and not my personal capacity.

The commission was formed in 2012 to study the utility of the Bankruptcy Code. The commission comprises 20 of the Nation's leading practitioners, judges, and academics, and it was constituted by the American Bankruptcy Institute, the largest multidisciplinary, non-partisan organization dedicated to research and education on matters related to insolvency.

My testimony will summarize the potential need for Chapter 11 reform, the commission study process, and certain testimony and research received by the commission.

The Bankruptcy Code has served us well for many years. Nevertheless, today's financial markets, credit and derivative products, and corporate structures are very different than what existed in 1978 when the Bankruptcy Code was enacted. Companies' capital structures are more complex and rely more heavily on leverage. Their asset values are driven less by hard assets and more by services, contracts, and intangibles. And both their internal business structures and their external business models are more global. In addition, claims trading and derivative products have changed the composition of creditor classes.

These developments are not necessarily unwelcome or unhealthy, but the Bankruptcy Code was not designed to rehabilitate companies in this environment. Moreover, anecdotal evidence suggests that Chapter 11 has become too expensive, particularly for small and middle market companies, and is no longer achieving certain policy objectives, such as stimulating economic growth, preserving jobs and tax bases, and helping to rehabilitate viable companies.

The commission study process was designed to explore the new environment in which financially distressed companies operate, and to determine what is and is not working as effectively as possible. Notably, the commission study process has involved over 250 individuals who work in or are affected by business insolvency. These individuals are serving as commissioners or advisory committee members or have testified as hearing witnesses.

The commission has been actively engaged in the study process since January of 2012. It has received detailed research reports from its advisory committees on 12 broadly defined areas of Chapter 11 practice, such as governance, finance, financial contracts and derivatives, sales, and plans. It also has received a comparative analysis of many of these issues from an international working group representing over 12 different countries. The commission is currently reviewing this impressive body of work.

In addition, the commission has held 16 public field hearings in 11 different cities. The testimony at each of these hearings has been substantively rich and diverse and has covered a variety of topics. Several common themes have emerged from the field hearings, including an acknowledgment that Chapter 11 cases have changed over time, that Chapter 11 may no longer work effectively for small and middle market companies, that the safe harbors for financial contracts and derivatives have in some respects been extended beyond the original intent of that legislation, and that despite some issues, Chapter 11 continues to be an important restructuring tool for U.S. companies.

The commission's study process is winding down, and the commission is beginning its deliberations. It currently anticipates producing a preliminary report in December of this year. Although the commission does not yet know what it ultimately will recommend, it is guided by its mission statement to study and propose reforms to Chapter 11 and related statutory provisions that will better balance the goals of effectuating the effective reorganization of business debtors with the attendant preservation and expansion of jobs, and the maximization and realization of asset values for all creditors and stakeholders.

Again, I want to thank the Subcommittee for this opportunity to testify, and I, of course, am happy to answer any questions.

[The prepared statement of Ms. Harner follows:]

Written Testimony

Michelle M. Harner
Professor of Law
Director, Business Law Program
University of Maryland Francis King Carey School of Law

"Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives"

Subcommittee on Regulatory Reform, Commercial and Antitrust Law
Committee on the Judiciary
United States House of Representatives

2141 Rayburn House Office Building

March 26, 2014

Chairman Bachus, Ranking Member Johnson, and members of the Subcommittee, thank you for the opportunity to testify today. My name is Michelle Harner, and I am a Professor of Law and the Director of the Business Law Program at the University of Maryland Francis King Carey School of Law. Prior to my academic career, I was a Partner at the law firm of Jones Day in Chicago, Illinois, and I practiced primarily in the corporate restructuring area. As an academic, my research and scholarship focuses on corporate governance and corporate restructuring issues. I am honored to appear before you today.

I have been asked to testify today in my capacity as Reporter for the ABI Commission to Study the Reform of Chapter 11 (the "Commission"). As such, my comments today are on behalf of the Commission and not in my personal capacity. The Commission was formed in 2012 to study the utility of chapter 11 of the U.S. Bankruptcy Code. The Commission comprises twenty of the nation's leading practitioners, judges, and academics.[1] It was constituted by the American Bankruptcy Institute, the largest multi-disciplinary, non-partisan organization dedicated to research and education on matters related to insolvency. The University of Maryland Francis King Carey School of Law received a grant from the American Bankruptcy Institute and the Anthony H.N. Schnelling Endowment Fund to support my research and service as Reporter.[2]

Chapter 11 of the Bankruptcy Code facilitates the resolution of financial distress primarily in the business context.[3] It emerged as a compromise to chapter X and chapter XI of the U.S. Bankruptcy Act of 1898 (introduced by the Chandler Act of 1938), under which large, public business debtors were subject to the mandatory appointment of

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[1] A list of the Commissioners is attached at ***Appendix A***.
[2] The ABI has committed approximately $300,000 to fund the overall study and reform project.
[3] The Commission and the study are not addressing issues unique to the resolution of an individual debtor's financial distress under chapter 11.

a bankruptcy trustee and oversight by the Securities and Exchange Commission and smaller business debtors essentially negotiated a resolution with their creditors.[4] After almost forty years of experience under chapter X and chapter XI of the prior Bankruptcy Act, policymakers and practitioners agreed that reform was needed, resulting in one business bankruptcy chapter—chapter 11 of the Bankruptcy Code.[5] After more than thirty years of experience under chapter 11, many practitioners and commentators again agree that it is time for reform.[6]

The Commission is conducting a thorough investigation of business bankruptcies and the potential need for reform. The Commission is still in its study and deliberation phase of the process, and it is not yet putting forth any conclusions or recommendations. The Commission does not anticipate doing so until the study phase is completed and the Commissioners have fully vetted all relevant issues. Accordingly, my testimony today will summarize: (i) the potential need for reform of chapter 11 of the existing Bankruptcy Code; (ii) the Commission's study process; and (iii) certain testimony and research received to date by the Commission on reform issues.

The Potential Need for Reform

The Bankruptcy Code has served us well for many years. Nevertheless, today's financial markets, credit and derivative products, and corporate structures are very different than what existed in 1978 when the Bankruptcy Code was enacted. Companies' capital structures are more complex and rely more heavily on leverage; their asset values are driven less by hard assets (e.g., real estate and machinery) and more by services,

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[4] *See, e.g.*, DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA (2001) (reviewing history of the Bankruptcy Code); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717 (1991) (same); Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5 (1995) (same); Daniel J. Bussel, *Coalition-Building Through Bankruptcy Creditors' Committees*, 43 UCLA L. REV. 1547, 1557-58 (1996) (same and discussing components of chapter X and chapter XI of the Bankruptcy Act). *See also* SEC v. Am. Trailer Rentals Co., 379 U.S. 594, 603–606 (1965) (discussing the Chandler Act of 1938); CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY (1935) (reviewing early history of Bankruptcy Code).

[5] Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 371–73 (1993) (explaining that "[o]ne of the key reasons for the adoption of the 1978 Code was the widespread perception that the old Code was unworkable").

[6] *See* Richard Levin & Kenneth Klee, *Rethinking Chapter 11*, 2012 INT'L INSOLVENCY INST., *available at* http://www.iiiglobal.org/component/jdownloads/finish/337/5966.html. *See also* Stephen J. Lubben, *Some Realism About Reorganization: Explaining the Failure of Chapter 11 Theory*, 106 DICK. L. REV. 267 (2001); Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003); Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153 (2004); Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. REV. 129 (2005); James H. M. Sprayregen et al., *Chapter 11: Not Perfect, but Better than the Alternative*, AM. BANKR. INST. J., Oct. 2005, at 1; Harvey R. Miller, *Chapter 11 in Transition—From Boom to Bust and into the Future*, 81 AM. BANKR. L.J. 375 (2007).

contracts, and intangibles; and both their internal business structures (e.g., their affiliates and partners) and external business models are more global. In addition, claims trading and derivative products have changed the composition of creditor classes. These developments are not necessarily unwelcome or unhealthy, but the Bankruptcy Code was not designed to rehabilitate companies in this environment.

Moreover, anecdotal evidence suggests that chapter 11 has become too expensive (particularly for small and middle market companies) and is no longer achieving certain policy objectives such as stimulating economic growth, preserving jobs and tax bases at both the state and federal level, or helping to rehabilitate viable companies.[7] Some suggest that more companies are liquidating or simply closing their doors without trying to rehabilitate under the federal bankruptcy laws.[8] Some suggest that companies are waiting too long to invoke the federal bankruptcy laws, which limits restructuring alternatives and may lead to premature sales or liquidations.[9] Still others suggest that the system continues to work well enough.[10] These issues are at the core of the Commission's study. As explained below, the Commission's process was designed to explore the new environment in which financially distressed companies operate and to determine what is—and is not—working as effectively as possible.

The Commission's Study Process

The Commission has undertaken a methodical study of chapter 11 of the Bankruptcy Code. Over 250 individuals (as either Commissioners, committee members, or hearing witnesses) who work in or are affected by corporate insolvencies have been involved in this study process. The Commission has strived to include all perspectives, ideologies, and geographic and industry segments.

The Commission has met on a regular basis since January 2012. During these meetings, the Commission has, among other things, discussed issues perceived as potential problems in chapter 11, reviewed recent developments in the case law and practice norms, and developed an effective process for identifying, researching, and analyzing chapter 11 as a whole. As explained below, the Commission has used an advisory committee structure and numerous public field hearings to amass the information and research it requires to critically analyze chapter 11 and consider any reform measures.

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[7] *See, e.g.*, Stephen J. Lubben, *What We "Know" About Chapter 11 Cost is Wrong*, 17 FORDHAM J. CORP. & FIN. L. 1 (2012) (reviewing literature and presenting empirical data to contradict common perceptions of bankruptcy costs).

[8] *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 777-85 (2002) (discussing decrease in traditional stand-alone reorganizations).

[9] *See, e.g.*, Michelle M. Harner & Jamie Marincic Griffin, *Facilitating Successful Failures*, 66 FLA. L. REV. ___ (forthcoming 2014) (analyzing literature and presenting results of empirical survey on, among other things, timing of bankruptcy filings).

[10] *See, e.g.*, Stuart C. Gilson, *Coming Through a Crisis: How Chapter 11 and the Debt Restructuring Industry Are Helping to Revive the U.S. Economy*, 24 J. APPLIED CORP. FIN. 23 (Fall 2012).

The Advisory Committees. To launch its study, the Commission identified thirteen broad study topics to facilitate a detailed analysis of the various components of chapter 11. These study topics are: administrative expense claims and other pressures on liquidity; avoiding powers (e.g., preferences and fraudulent conveyances); bankruptcy-remote entities and bankruptcy proofing; distributional issues under plans; executory contracts and unexpired leases; financial contracts, derivatives, and safe harbors; financing issues; governance and supervision of cases; labor and benefits issues; multiple entities and corporate groups; procedural and structural issues under plans; role of valuation; and sales in chapter 11.[11] The Commission then enlisted the volunteer service of over 150 of the profession's very talented and dedicated judges, lawyers, financial advisors, academics, and consultants to serve on advisory committees for each of the study topics.[12]

The advisory committees began their work in April 2012. The Commission provided each advisory committee with a preliminary assessment containing initial study questions for its general topic area. Each advisory committee devoted (and some continue to devote) significant time to researching and evaluating the study questions. The advisory committees met either in-person or telephonically on a frequent basis, reviewing their research and debating the issues. The advisory committees engaged in this work for approximately eighteen months and submitted research reports on most topics to the Commission in December 2013.

The Commission then held a three-day retreat in February 2014 to meet with each advisory committee and discuss the research reports. At the retreat, the advisory committees presented their reports and highlighted complex and nuanced issues for the Commission, and Commissioners actively engaged in a direct dialogue with committee members. The Commission also used the forum to begin integrating the study topics and reconciling overlapping issues. The retreat and the work of the advisory committees leading up to the retreat have been informative and very helpful to the Commission in this process. The Commission currently is reviewing the entire body of work produced by the advisory committees and conducting follow up research and analysis on a variety of issues.

The Commission also formed an international working group consisting of leading practitioners and academics from twelve different countries. The working group

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[11] The Commission has asked the financial contracts, derivatives, and safe harbors advisory committee to consider related issues involving systemically important financial institutions and the chapter 14 proposal developed by Professor Thomas Jackson and his colleagues. It also has deferred the work of the multiple entities and corporate groups advisory committee until a later point in the process.

[12] The names and affiliations of members of the advisory committees are listed at the Commission's website: www.commission.abi.org. Two of the witnesses appearing before the Subcommittee today are members of the financial contracts, derivatives, and safe harbors advisory committee—Seth Grosshandler (Co-Chair of the advisory committee) and the Honorable Christopher S. Sontchi.

is studying targeted questions posed by the Commission and the advisory committees to provide a comparative analysis of the relevant issues.

The Field Hearings. The Commission held its first public hearing in April 2012 at the House of Representatives, Committee on the Judiciary, Rayburn House Office Building, Washington, D.C. Since that time, the Commission has held fifteen public field hearings in eleven different cities: Boston, Las Vegas, Chicago, New York, Phoenix, San Diego, Tucson, Philadelphia, Austin, Atlanta, and Washington, D.C. In these hearings, almost ninety individuals have testified.[13] The testimony at each of these hearings has been substantively rich and diverse. The hearings have covered a variety of topics including chapter 11 financing, general administrative and plan issues, governance, labor and benefits issues, priorities, sales, safe harbors, small and middle market cases, valuation, professional fees, executory contracts (including commercial leases and IP licenses), trade creditor issues, and avoiding powers reform. Transcripts and videos of the hearings, and the related witness statements, are available at the Commission's website: www.commission.abi.org. A summary of the hearing topics is attached at ***Appendix C***.

Several common themes emerged from the field hearings. First, most witnesses acknowledged that chapter 11 cases have changed over time.[14] These changes include a perceived: increase in the number and speed of asset sales under section 363 of the Bankruptcy Code,[15] decrease in stand-alone reorganizations, decrease in recoveries to unsecured creditors,[16] and increase in the costs associated with chapter 11.[17] Second, the

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[13] The names and affiliations of these witnesses are listed at ***Appendix B***.

[14] *See* Bryan Marsal, Statement to the Commission, Hearing, October 26, 2012 (NCBJ Transcript pp. 15-19), *available at* http://commission.abi.org ("There is a gradual erosion of the underlying public principle of the Code which was to preserve jobs and maximize value through rehabilitation.").

[15] *See* Gerald Buccino, Statement to the Commission, Hearing, November 3, 2012 (TMA Transcript p. 19), *available at* http://commission.abi.org. ("When sales occur too quickly before the rehabilitative process, the yield to pre-petition creditors is diminished."); Michael Richman, Statement to the Commission, Hearing, October 26, 2012 (NCBJ Transcript p. 20), *available at* http://commission.abi.org (recommending that section 363 sales should be modified so that courts can restrain hasty sales and better monitor expedited sales).

[16] *See* Paul Calahan, Written Statement to the Commission for the May 21, 2013 Hearing, *available at* http://commission.abi.org ("The Code and the economic environment have made it more difficult for unsecured creditors to realize fair payment of their claims… A voice for unsecured creditors is clearly needed and provides valuable insight to the court and other parties."); Joseph McNamara, Written Statement to the Commission for the May 21, 2013 Hearing, *available at* http://commission.abi.org ("A tremendous disparity remains between payment of secured and unsecured claims and some evidence suggests secured creditors with first liens experienced outstanding recoveries, while unsecured recoveries were around 20%, with the median recovery set at 10%.").

[17] *See* John Haggerty, Written Statement to the Commission for the April 19, 2013 Hearing, *available at* http://commission.abi.org (recommending that the level of professionals should be rationalized at the onset of a case and fees and billing should be more transparent and have greater oversight during the process to keep overall costs down).

witnesses who testified on issues relating to small and middle market companies generally opined that chapter 11 no longer works for these companies. Witnesses cited cost and procedural obstacles as common barriers.[18] Third, the witnesses who testified on financial contracts and derivatives generally agreed that the safe harbor protections have been extended to contracts and situations beyond the original intent of the legislation.[19] They did not necessarily agree, however, on appropriate limitations or revisions to the relevant sections of the Bankruptcy Code.[20] Finally, witnesses—even those who were highly critical of certain aspects of chapter 11—all perceived value in the U.S. approach to corporate bankruptcies, including the debtor in possession model.[21]

The Process Going Forward

The Commission's study process is winding down, and it will begin deliberations in April 2014. Prior to that time, the Commission and the ABI are co-sponsoring a symposium with the University of Illinois College of Law to address issues relating to secured credit and bankruptcy. This symposium is gathering many of the leading bankruptcy scholars to explore the rights of debtors and secured creditors under state law and the Bankruptcy Code. Many scholars also will address the related Constitutional and public policy issues.[22] The research papers presented at that symposium will inform the Commission's work and appear in the University of Illinois Law Review.

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[18] *See* Hon. Dennis Dow, Written Statement to the Commission for the April 19, 2013 Hearing, *available at* http://commission.abi.org (noting that the complexity, time and costs of the chapter 11 process impose obstacles that small business debtors often cannot overcome); Prof. Anne Lawton, Written Statement to the Commission for the November 1, 2013 Hearing, *available at* http://commission.abi.org ("The Code's small business debtor definition should be simplified."); Gerald Buccino, Statement to the Commission, Hearing, November 3, 2012 (TMA Transcript pp. 7, 15), *available at* http://commission.abi.org ("A one-size-fits-all approach for the Code does not work because smaller businesses have special needs.").

[19] *See* Daniel Kamensky on behalf of Managed Funds Association, Written Statement to the Commission for the October 17, 2012 Hearing, *available at* http://commission.abi.org (asserting that the breadth of safe harbors has had unintended consequences and some courts have held that safe harbors extend to protect one-off private transactions that do not involve financial institutions); Jane Vris, Statement to the Commission, Hearing, May 15, 2013 (NYCBC Transcript p. 9), *available at* http://commission.abi.org ("The original purpose of the safe harbors was to preserve the clearing of payments and delivery within a fair closed system, the protections have now expanded beyond that.").

[20] *See* Hon. James Peck, Statement to the Commission, Hearing, May 15, 2013 (NYCBC Transcript p. 32), *available at* http://commission.abi.org (recommending that judges should have more discretion to determine whether contracts fit the criteria for protection under the safe harbors).

[21] *See* William Greendyke, Written Statement to the Commission for the November 22, 2013 hearing, *available at* http://commission.abi.org (reporting that the membership of the Bankruptcy Law Section of the State Bar of Texas noted that the chapter 11 process still worked, but found it to be more expensive and "faster" than 10 years ago.).

[22] The names and affiliations of the academics presenting at this symposium are listed at ***Appendix D***.

The Commission will devote significant time to reviewing the vast body of research, data, and testimony generated through its two-year study process. It will debate the issues internally and work to build consensus around a set of findings and conclusions. The Commission currently anticipates producing a preliminary report in December 2014.

Although the Commission does not yet know what it ultimately will recommend in that report, it is guided by its mission statement to "study and propose reforms to Chapter 11 and related statutory provisions that will better balance the goals of effectuating the effective reorganization of business debtors—with the attendant preservation and expansion of jobs—and the maximization and realization of asset values for all creditors and stakeholders."

Appendix A

ABI Commission to Study the Reform of Chapter 11

D.J. (Jan) J. Baker, Latham & Watkins LLP

Donald S. Bernstein, Davis Polk & Wardwell LLP

Geoffrey L. Berman (*ex officio*), Development Specialists, Inc.

William A. Brandt, Jr., Development Specialists, Inc.

John Wm. Butler, Jr., Skadden, Arps, Slate, Meagher & Flom LLP

Babette A. Ceccotti, Cohen, Weiss & Simon LLP

Samuel J. Gerdano (*ex officio*), American Bankruptcy Institute

Hon. Arthur J. Gonzalez (retired), U.S. Bankruptcy Court, Southern District of New York

Steven M. Hedberg, Perkins Coie LLP

Robert J. Keach (Co-chair), Bernstein Shur

Prof. Kenneth N. Klee, University of California at Los Angeles, School of Law

Richard B. Levin, Cravath, Swaine & Moore LLP

James T. Markus (*ex officio)*, Markus Williams Young & Zimmerman, LLC

Harvey R. Miller, Weil, Gotshal & Manges LLP

James E. Millstein, Adjunct Professor of Law, Georgetown Law Center

Harold S. Novikoff, Wachtell, Lipton, Rosen & Katz

James P. Seery, Jr., River Birch Capital, LLC

Sheila T. Smith, Deloitte Financial Advisory Services LLP

James H.M. Sprayregen, Kirkland & Ellis LLP

Albert Togut (Co-chair), Togut, Segal & Segal, LLP

Clifford J. White III, Director (non-voting), Executive Office for the U.S. Trustees (DOJ)

Bettina M. Whyte, Alvarez & Marsal

Deborah D. Williamson, Cox Smith Matthews Incorporated

Appendix B

Public Filed Hearing Witness List

Rep. Howard Coble, NC

Hon. Joan Feeney, Bankruptcy Court D. Ma.

Sen. Charles E. Grassley, IA

Prof. Edward I. Altman, New York University, School of Business

Ted Basta, LSTA

John Greene, Halcyon Asset Management LLC

Prof. Edith S. Hotchkiss, Boston College, School of Management

Daniel B. Kamensky, Paulson & Co., Inc. (on behalf of MFA)

A.J. Murphy, Bank of America Merrill Lynch

Lee Shaiman, GSO Capital Partners, Blackstone

Hon. Eugene R. Wedoff, Bankruptcy Court N.D. Ill

John Collen, Tressler, LLP

Howard Brownstein, The Brownstein Corp.

Bryan P. Marsal, Alvarez & Marsal

Michael P. Richman, Hunton & Williams LLP

Brad B. Erens, Jones Day

Craig Goldblatt, Wilmer Hale

Ronald Barliant, Goldberg Kohn Ltd., Bankruptcy Court N.D. Ill. (Ret.)

Hon. Melanie Cyganowski, Otterbourg, Steindler, Houston & Rosen, PC, Bankruptcy Court E.D. N.Y. (Ret.)

Michael Haddad, Newstar Business Credit (on behalf of CFA)

Jonathan N. Helfat, Otterbourg, Steindler, Houston & Rosen, PC (on behalf of CFA)

Richard M. Kohn, Goldberg Kohn Ltd. (on behalf of CFA)

Randall Klein, Goldberg Kohn Ltd.

Robert Katz, Executive Sounding Board Associates, Inc.

Gerald Buccino, Buccino & Associates

Kathryn Coleman, Hughes, Hubbard & Reed

Richard Mikels, Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C.

Danielle Spinelli, Wilmer Hale

J. Scott Victor, SSG Capital Advisors, LLC

William Derrough, Moelis & Company LLC

Mark Shapiro, Barclays Capital

Jennifer Taylor, O'Melveny & Myers LLP

Janet Chubb, Armstrong Teasdale

Hon. Robert D. Drain, Bankruptcy Court S.D.N.Y.

Hon. Gregg W. Zive, Bankruptcy Court D. Nev

Peter S. Kaufman, Gordian Group LLC

Hon. James M. Peck, Bankruptcy Court S.D.N.Y.

Sandra E. Horwitz, CSC Trust Company of Delaware

Eric Siegert, Houlihan Lokey

Prof. David C. Smith, University of Virginia, McIntire School of Commerce

David R. Jury, United Steelworkers

Michael L. Bernstein, Arnold & Porter

Hon. Stephen S. Mitchell, Bankruptcy Court E.D. Va (Ret.)

Joshua Gotbaum. Pension Benefit Guaranty Corporation

James C. Little, Transportation Workers Union

Michael Robbins, Air Line Pilots Association

Deborah Sutor, CWA – Association of Flight Attendants

Robert Roach, International Association of Machinists and Aerospace Workers

Wilbur L. Ross, WL Ross & Co.

Hon. Dennis R. Dow, Bankruptcy Court W.D. Mo.

Hon. Barbara G. Houser, Bankruptcy Court N.D. Tx.

Hon. Pamela Pepper, Bankruptcy Court E.D. Wi.

Daniel F. Dooley, MorrisAnderson

John M. Haggerty, Argus Management

Holly Felder Etlin, AlixPartners

Daniel J, Ehrmann, Alvarez & Marsal

Christopher K. Kiplok, Hughes Hubbard & Reed LLP

Edward Murray, Allen & Overy LLP

Jane L. Vris, Millstein & Co. (on behalf of National Bankruptcy Conference)

Prof. David A. Skeel, University of Pennsylvania, School of Law

Valerie Venable, CCE, Ascend Performance Materials LLC

Kathleen M. Tomlin, CCE, Central Concrete Supply Co., Inc.

Thomas Democvic, CCE, CICP, Sharp Electronics Corp.

Joseph P. McNamara, CCE, Samsung Electronics USA

Paul D. Calahn, CCE, CICP, Cargill, Inc.

Sandra Schirmang, CCE, ICCE, Kraft Foods Global, Inc.

Lawrence C. Gottlieb, Cooley, LLP

Elizabeth I. Holland, Abbell Credit Corporation

David L. Pollack, Ballard Spahr LLP

Robert L. Eisenbach, III, Cooley, LLP

Lisa Hill Fenning, Arnold & Porter

Jeffrey A. Wurst, Ruskin Moscou Faltischek, P.C.

Grant Newton, Association of Insolvency and Restructuring Advisors

Grant Stein, Alston & Bird LLP (on behalf of AIRA)

Prof. Jonathan C. Lipson, Temple University, School of Law

Prof. Daniel L. Keating, Washington University, School of Law

Dennis F. Dunne, Milbank, Tweed, Hadley & McCloy, LLP

William K. Snyder, Deloitte CRG

Brady C. Williamson, Godfrey & Kahn, S.C.

Mark A. Gittelman, PNC Bank

Prof. Anne Lawton, Michigan State University, College of Law

W. Clarkson McDow, United States Trustee, Region 4 (Ret.)

Thomas J. Salerno, Squire Sanders LLP

Prof. George W. Kuney, University of Tennessee, College of Law

Maria Chavez-Ruark, Saul Ewing LLP

Courtney Engelbrecht Barr, Locke Lord LLP (on behalf of IWIRC)

Kathleen M. Miller, Smith, Katzenstein & Jenkins LLP (on behalf of IWIRC)

Prof. Anthony J. Casey, University of Chicago, School of Law

Prof. S. Todd Brown, University of Buffalo, School of Law

William R. Greendyke, Norton Rose Fulbright

Michael R. Rochelle, Rochelle McCullough, LLP

G. Eric Brunstad, Jr., Dechert LLC

Hon. Steven W. Rhodes, Bankruptcy Court D. Mi.

Prof. Jay Westbrook, University of Texas, School of Law

Douglas B. Rosner, Goulston & Storrs, PC

Michael Luskin, Luskin Stern & Eisler LLP

James L. Patton, Jr., Young Conaway Stargatt & Taylor, LLP

Appendix C

Summary of Field Hearings and Topics of Discussion

The October 17, 2012 field hearing was at held the Loan Syndications and Trading Association (LSTA) annual meeting in New York, New York. The hearing generally covered finance and governance concerns in chapter 11, and witnesses testified on debtor in possession (dip) lending, distressed debt trading, and the role of secured credit. The Managed Funds Association (MFA) testified on various aspects of governance reform, suggesting changes involving the appointment of trustees, the addition of new members to a debtor's board of directors, and the appointment and management of creditors' committees. Representatives from LSTA presented data on the relationship between dip lending and reorganization, and witnesses encouraged the Commission to consider the positive role that distressed debt trading has on the market.

The Commission hosted a roundtable discussion on sales as part of a field hearing on October 26, 2012 during the annual meeting of the National Conference of Bankruptcy Judges (NCBJ) in San Diego, California. During the roundtable, witnesses recommended reviewing the time limits on the section 363 sale process, in particular for small business cases, and with respect to plan exclusivity. Another witness discussed the scope and ambiguity in sales approved under section 363(f) of the Code. Witnesses also spoke more generally on the challenges faced by small and middle market companies using chapter 11, and on potential reforms in credit-bidding and lender control provisions.

On November 3, 2012, the Commission held a field hearing at the Turnaround Management Association's annual meeting in Boston, Massachusetts. During the field hearing, witnesses provided comments on reforming the Federal Rules of Bankruptcy Procedure, the impact of *Stern v. Marshall*, the role of judicial discretion, executory contracts, and DIP lending. Comments from witnesses included: the suggestion that the time to assume or reject non-residential real property was too short; that the speed of a section 363 sale was too quick, diminishing value to pre-petition creditors; and that section 503(b)(9) protections should be abolished. One witness suggested reforms to DIP lending and amending the standard in section 1111(b) in the context of credit-bidding.

The field hearing on November 15, 2012 was held at the annual convention of the Commercial Finance Association (CFA) in Phoenix, Arizona. The primary focus of the field hearing was finance, and the witnesses testified on DIP lending, the use of carve-outs, and challenges to small and medium-size enterprises. The leadership of CFA testified on behalf of their membership and suggested the Commission study the following topics: adequate protection for secured creditors, carve-outs, the inclusion of all contract rights in the definition of secured claims, and the enforceability of inter-creditor agreements. Included among the potential reforms proposed by witnesses were: modifying the Code to allow for the statutory appointment of a sale monitor or examiner; codifying local rules to provide guidance or standards for the court to base its discretion on; clarifying sections 1129 and 1104 of the Code; codifying gifting; providing for the enforcement of fraudulent conveyance savings clauses; and shifting the burden of proof in preferential transfer claims.

During the ABI Winter Leadership Conference in Tucson, Arizona, the Commission held a field hearing on November 30, 2012. This field hearing centered on finance and governance under chapter 11, in particular the role of creditors' committees, DIP lending, the use of secondary markets, surcharges, and roll-ups. While discussing the use of secondary markets, one witness suggested that the Code should clarify that bad faith does not turn solely upon a creditor's motivation and that bad faith does not exist solely because a creditor took actions that are associated with distressed investing.

The Commission held a field hearing during the VALCON Conference in Las Vegas, Nevada, on February 21, 2013. The field hearing focused on valuation, including: different valuation methodologies; the pros and cons of judicial valuation; and the timing of valuations in chapter 11 cases. Witnesses made a number of suggestions to improve the valuation process used during chapter 11, including the use of the Discounted Cash Flow Analysis over the Market Test, and offering the court, at its election, access to a valuation consultant.

The March 14, 2013 field hearing was held at the spring meeting of the American College of Bankruptcy in Washington, DC. The field hearing centered on labor provisions within the chapter 11 process, in particular sections 1113 and 1114 of the Code and the impact of the proposed Conyers Bill. Recommendations for reform included: eliminating the 14-day time frame for a court hearing on section 1113 and 1114 motions; modifying the test to terminate a defined-benefit pension plan; restoring concessions if unsecured creditors ultimately get paid in full or receive value equal to 100% of their claims; and maintaining the right to self-help. Many of the witnesses felt that payment into pension funds or 401(k) plans should be more strongly enforced and that the labor force should be permitted to participate more actively in a debtor's business plan.

In conjunction with the ABI Annual Spring Meeting in Washington, DC, the Commission held a field hearing on April 19, 2013. This particular field hearing included testimony on professional fees and the challenges of small and middle market companies utilizing the chapter 11 reorganization process. A number of recommendations were made to address the perception of excessive professional fees, including: a guideline in the present billing system that would provide a ceiling for the class' fees as a percentage of total recovery; weekly reports accompanied by memos that explained the firm's prior week's fees and expenses; or other systems that would promote greater transparency, enhance debtor supervision of professionals, and rationalize the level of professionals at the onset. Other witnesses provided insight into the unique challenges that small and middle market companies face in efforts to reorganize under chapter 11 of the Code, like the 300-day deadline for filing a plan and disclosure statement, the section 1129(a) 45-day requirement to confirm a plan, and the application of the Absolute Priority Rule. For comparison purposes, the witnesses offered observations about the increased use of state law alternatives to chapter 11.

As part of the New York City Bankruptcy Conference, the Commission held a field hearing on May 15, 2013 in New York, New York. The focus of the field hearing was the role of financial contracts and derivatives, and the use of safe harbors, in chapter 11 cases. A number of recommendations for reform were proffered by the witnesses, including: tailoring the settlement payment definition to confirm more closely to Congress' original intent; imposing a self-reporting requirement on counterparties exercising safe harbors; allowing the debtor continued access to information from its clearing banks; and providing more protection to the estate's operating assets. In addition, a discussion was held surrounding the appropriateness of a three-day automatic stay for the exercise of safe harbors, the level of judicial discretion that should be granted within the definition and enforcement of safe harbors, and whether a set interest rate should apply to payouts.

The Commission heard from a number of witnesses regarding administrative claims and avoiding powers during its May 21, 2013 field hearing at the National Association of Credit Management conference in Las Vegas, Nevada. During a robust discussion on section 503(b)(9), one witness suggested the inclusion of drop shipment transactions in the protections of that section. A number of witnesses supported changes to the preference statute to afford more protections and defenses to creditors and place more of the burden on trustees and debtors to evaluate preference claims prior to demands. Additionally, witnesses shared that the window for bringing preference actions was too broad and a cost-benefit analysis should be required when evaluating preference demands, demonstrating that pursuing the preference action would provide benefit to the unsecured creditors above the cost to pursue the action.

On June 4, 2013, the Commission held a field hearing on executory contracts, leases, and related intellectual property issues in bankruptcy at the New York Institute of Credit conference in New York, New York. A panel of witnesses represented two distinct and opposite views on the impact and value of the 210-day rule to assume or reject non-residential leases. The witnesses also discussed the treatment of stub rents, a lessee's post-petition obligations under section 365(d)(3), and the definition of adequate assurance of future performance in the context of the assumption and assignment of leases. The panel of witnesses that discussed intellectual property issues offered suggestions to reform section 365(c) to adopt the "Actual Test," and to reform sections 365(g), (n) to adopt the *Lubrizol* decision. Further, the suggestion was made to modernize the definition of patents to include foreign issued patents and clarify change of control provisions.

Another field hearing of the Commission was held on June 7, 2013 in Chicago, Illinois, at the annual meeting of the Association of Insolvency & Restructuring Advisors (AIRA). The field hearing began with a report from AIRA leadership on those issues most concerning to their membership, including the format and detail of disclosure statements, the use of judicial discretion, and the revival of "KERPs." The Commission also heard from two academics regarding the interaction between labor law and the Code, and the role of governance and the value of information, in particular control discovery, in chapter 11.

The Commission again held a field hearing at the National Conference of Bankruptcy Judges Annual Meeting, which took place on November 1, 2013 in Atlanta, GA. The discourse of this hearing focused on a number of general proposals for reform of the Code, including: the oversight of committee work; the value of a third-party reorganization professional; and the role and selection of a trustee. The Commission also heard from an academic reporting on her study of small business debtors under the current Code and proposals for reform, including modifying the definition of "small business debtor" and eliminating the 45-day plan-confirmation deadline for those debtors.

On November 7, 2013, the Commission held its first field hearing in the third judicial circuit at the 10th Annual Complex Restructuring Program at the Wharton School of Business in Philadelphia, PA. The Commission heard from a number of different witnesses that testified on the role and responsibility of the debtor in possession and other parties in interest, the unique challenges faced in asbestos-related chapter 11 cases, and issues within priority rules, in particular, codifying the new value corollary of the absolute priority rule. One witness focused on reform proposals that would reduce the costs and ease the timetables applicable in small or middle market cases. The Commission also heard testimony on behalf of the International Women's Insolvency and Restructuring Confederation (IWIRC). IWIRC's testimony focused on streamlining the process for asserting section 503(b)(9) claims, including standardizing the forms and procedures for asserting such claims and establishing a timeline in which they must be asserted.

The last field hearing of 2013 for the Commission occurred at the University of Texas/Jay Westbrook Conference in Austin, TX on November 22, 2013. The Commission heard from two representatives of the Bankruptcy Law Section of the State Bar of Texas on the results of an online survey of its members, including general suggestions for reform of the chapter 11 process like standardizing the role and practices of the U.S. Trustee across districts and/or regions, legitimizing the section 363 sale process, and making bankruptcy judges Article III judges. In addition to a number of focused proposals on reform within the Code, the Commission heard testimony regarding two larger issues: the impact of *Stern v. Marshall* and the role venue plays in bankruptcy proceedings.

Appendix D

Academics Currently Scheduled for April 2014 Symposium

David C. Smith, University of Virginia McIntire School of Commerce
Mark Jenkins, University of Pennsylvania, Wharton School of Business
Michelle M. Harner, University of Maryland, School of Law
Adrian J. Walters, IIT Chicago-Kent, College of Law
Melissa B. Jacoby, University of North Carolina
Edward J. Janger, Brooklyn Law School
Kenneth M. Ayotte, North Western University, School of Law
David G. Carlson, Yeshiva University, School of Law
Gary Holtzer, Weil, Gotshal & Manges LLP
Juliet M. Moringiello, Widener University, School of Law
David A. Skeel, Jr., University of Pennsylvania, School of Law
Steven L. Schwarcz, Duke University, School of Law
Edward Morrison, University of Chicago, School of Law
Bruce A. Markell, Florida State University, College of Law
Charles W. Mooney, Jr., University of Pennsylvania, School of Law
Steven L. Harris, IIT Chicago-Kent, College of Law
Charles J. Tabb, University of Illinois, College of Law
Barry E. Adler, New York University, School of Law
Stephen J. Lubben, Seton Hall University, School of Law
Jay Lawrence Westbrook, University of Texas, School of Law

Mr. BACHUS. Thank you very much. At this time, with consent of Mr. Marino, we are going to Congressman Collins first. Is that right?

Mr. COLLINS. Thank you, Mr. Chairman. I do appreciate my dear friend, Congressman Marino, for allowing me to go here. Professor Jackson, in looking——

Mr. BACHUS. He has been in the back listening on TV, so he is——

Mr. COLLINS. You all make great television stars. You all ought to think about this. You look good back there.

Mr. BACHUS. And they are wondering, this guy shows up and he starts asking questions, and he has not heard a thing.

Mr. COLLINS. Yes, I have heard every bit of it back there. It is great. But again, Professor Jackson, your testimony indicates, and also your written statement, that transparency, certainty, judicial oversight of the bankruptcy process make it the preferred method for resolution of a financial firm. I just have a question. Could those same attributes make bankruptcy the ideal process for the resolution of Fannie and Freddie?

Mr. JACKSON. I am not an expert on the details of Fannie and Freddie, but in general it seems to me the structure of bankruptcy law, with well-defined rules about how you deal with assets and liabilities and priorities, a huge body of judicial law and judicial review of the processes, in my view, generally makes it the preferred resolution mechanism for almost any institution.

That does not mean that there will not be perturbations to a system if a Fannie or Freddie went into a bankruptcy proceeding, but bankruptcy is pretty good at knowing how to deal with this. Trust assets will be set aside, priorities will be determined by the kind of priorities that they should have had.

So as I said at the start, I am a big fan of bankruptcy law because I think it, in general, we have decades of decision making under it. We have strict priority rules. We have a judicial process that I think is pretty free from political pressure most of the time, that does a wonderful job of adhering to the rule of law.

Mr. COLLINS. Okay. And I think that is the interesting, you know, process here of amending the Bankruptcy Code because it does have the history, for not only Fannie and Freddie, but also large and middle-sized banks as well. Would that follow along that same pattern of your answer?

Mr. JACKSON. Yes. When you are talking about depository banks, they are historically done under the Federal Deposit Insurance Corporation, but there is an actual feature of depository banks that makes them distinguishable from other kinds of even financial institutions. The Federal Government is, in fact, the residual owner of these institutions almost anyway because of the deposit insurance guarantees. So it is really their own institution that they are resolving at the end of the day, and that is very different from all other financial institutions.

Mr. COLLINS. I am very glad you all are here. Just on the question line now, Professor Jackson, doing that, especially with Fannie and Freddie, I am looking at derivatives, the bigger issues that we have here, whether stockholder equity and enterprise is meeting its financial obligations to creditors, but it needs to be restructured or, you know, put into a run-off. This is where the bankruptcy if we amend it would probably work in situations like that given its history, given its structure. Would that be a fair statement?

Mr. JACKSON. That would be a fair statement. Again, what bankruptcy would do is impose losses first on the shareholders, on the equity. And then if any company was, in fact, insolvent, it would impose those losses on the lower tiered debt in the first instance. For example, in the SIFI process, the stripped off long-term debt that is left behind will be the group that bears losses in case the entity is insolvent so that you have to go deeper than wiping the equity out. But all of that is firmly established by priority rules in the Bankruptcy Code, which is one of the reasons I am such a fan of it.

Mr. COLLINS. Okay. And a final part here just is looking at this and continuing on this sort of theme that we have developed here. And after this, if anybody else would like to jump in on this question. I see that bobble head going.

Financial obligations. Are Fannie and Freddie right now meeting the financial obligations to creditors? If we did have a process like this, you know, should a bankruptcy filing leaves derivatives contracts and other financing arrangements in place? Would that be something that could be done through this?

Mr. JACKSON. Well, again, leaving them in place requires something like what I have been talking about with the single point of entry. It requires you to transfer everything to a new entity.

Mr. COLLINS. Right.

Mr. JACKSON. Currently under the Bankruptcy Code if you did not have a stay to allow that continuation process to occur, and the others who were talking about the qualified financial contracts, under the Bankruptcy Code, those people can run. So you do need amendments to the Bankruptcy Code to at least allow you to transfer these to an entity where everything could stay in place.

Mr. COLLINS. Go ahead.

Mr. GROSSHANDLER. Yes. I agree with everything Professor Jackson said, but I wanted to put one important point, extra point, which is Fannie and Freddie, of course, issue guaranteed securities, right?

Mr. COLLINS. Right.

Mr. GROSSHANDLER. And those securities consist of the holder has a right to the payments on the mortgage loans that they are holding in trust, plus the Fannie and Freddie guarantee. What is going to happen to that guarantee in the bankruptcy? And the usual Bankruptcy Code rule is there is a long time to determine what happens to that guarantee in bankruptcy. It is a contingent claim. You do not know whether those mortgages are going to default or not, whether you need to draw on it. And it is very complicated. I think that kind of extended uncertainty in a regular bankruptcy proceeding would make the value of those securities tank.

Mr. COLLINS. Well, even though this is the late hour and all, this is something that needs to be looked at, I think, as we look at the vast derivatives and other things that need to be looked at possibly in the structure bankruptcy. And I thank you, and I do thank my colleagues for allowing to question. And I hope you all have a wonderful evening. Thank you.

Mr. BACHUS. I thank the gentleman. Now, Ranking Member Johnson is recognized.

Mr. JOHNSON. Thank you, Mr. Chairman. To be clear, Title II of Dodd-Frank is only triggered by the determination of the Treasury Secretary that a non-bank financial institution is systemically important. Could an entity like Lehman Brothers, whose impending failure puts the financial marketplace into a free fall and freezes the lending market? Is that enough to trigger a Title II orderly liquidation?

Mr. JACKSON. Everybody can jump in on this. I think actually Title II designed precisely for an entity such as Lehman. I mean, if you look at when Dodd-Frank was being enacted, Lehman was the elephant in the room because of the Lehman bankruptcy, and a sense that Lehman had done zero pre-bankruptcy planning.

And so, I think a lot of effort that went into Dodd-Frank and Title II was trying to design a process that could, in fact, happen for Lehman. So, yes, I would assume that the Treasury and the Fed and the FDIC would conclude that Lehman was a systemically important financial institution for purposes of triggering Title II.

Mr. GROSSHANDLER. I think that is right certainly if Title II was in effect in 2008. Today the question would be, because the standard is would there be severe and adverse effects on the economy if there were not a Bankruptcy Code proceeding. If, in fact, the Bankruptcy Code were changed along the lines of Chapter 14, et cetera, in fact, and given the resolution planning that is happening, it might be that Lehman today or tomorrow, assuming changes to the Bankruptcy Code, would not require the Title II intervention.

Mr. JACKSON. I think that is completely correct. I was playing with the world that exists today where I think you have a disconnect between the desire of the Dodd-Frank Act, which is bankruptcy takes primacy. You cannot trigger a Title II proceeding until you have found the bankruptcy is not up to the task. And the reality is, which is because have not changed bankruptcy law, I think today if a Lehman Brothers was to fail, it is almost inevitable that the trigger would be pulled on Title II

The proposals I have talked about today, it seems to me, are explicitly designed to reduce almost to the vanishing point the need to implement Title II, and instead use a judicially-based proceeding in bankruptcy. So that I believe if you went in the direction I talked about today with a Chapter 14 or Chapter 5 of Chapter 11, you today would use bankruptcy and not Title II for Lehman Brothers.

Mr. JOHNSON. Well, Professor Jackson, it is clear that you believe that the judicial system would be better equipped to deal with the resolution of a SIFI as opposed to a regulatory body. Can I ask each of you what you think——

Mr. BACHUS. But he is saying with the changes that he has proposed.

Mr. JOHNSON. Yes. Yes. But what Professor Jackson is saying is that we need to do this judicially as opposed to administratively. And I would like to get the other witnesses' opinions on that.

Judge SONTCHI. Well, I think that——

Mr. JOHNSON. And I would also point out the case of GM bankruptcy and the government money that went into that. And, of course, Professor Jackson, you do not want any bailouts, any government bailouts. And so, how can you restructure a company like GM in a bankruptcy proceeding without public dollars? So in light of that, what is the best way to deal with this?

Mr. JACKSON. Do you want me to take that one on, and I think the other question went to the other people at the table. The difference between General Motors, I think, and what we are talking about here is I am explicitly talking about a system in which there is loss absorbency built into the financial structure so that what you do in the financial institution case, it is like a bail-in. You strip the debt out, leave it behind in the bad company, and you start out with a new company that is solvent again.

That option was not really available at the time of General Motors, nor was it available at the time of the 2008-2009 financial crisis for other institutions. The beauty of this, and it does require regulatory requirements that there is loss absorbency capacity built into the system, is that by doing that, you get away from what I think is the Hobson's choice that they faced in 2008-2009, which is either allow the financial system to crater or to bail them out. And what this does is I think it allows you to get away from that Hobson's choice.

It is a very different thing because the financial institutions have a different sort of structure and importance than a General Motors so that I am not really talking now about what you do with corporate reorganization.

Mr. JOHNSON. I understand. I understand. Could I, Mr. Chairman?

Mr. BACHUS. You want to——

Mr. JOHNSON. Yes, if the others could respond.

Mr. BACHUS. That is all right.

Mr. JOHNSON. Thank you.

Ms. HARNER. Certainly. Thank you, Ranking Member Johnson, for that question. So first, I will say in my personal capacity, I, like Professor Jackson, am a true believer in the bankruptcy system. I think the transparency, the due process, the certainty and the judicial oversight hold tremendous value when you are trying to restructure any company, including SIFIs and companies like GM. Do we need to change the Bankruptcy Code to accommodate those types of companies? Yes, I think we do.

Now, from the commission's perspective, we have not made any determinations about the type of issues Professor Jackson or you, sir, have raised, but we are looking at them. In fact, we have asked the Subcommittee that Judge Sontchi and Mr. Grosshandler are on to help us consider ways to handle issues that come up in a Chapter 14 and SIFI type situation.

I also will just point out that one of the themes we are hearing continuously is that a one-size-fits-all approach in bankruptcy may not be the most effective or best approach. So we may be considering ways to think differently about very large corporations, very small corporations, and then what constitutes the majority of U.S. companies and U.S. debtors, the small middle market companies.

Judge SONTCHI. If I may very quickly. First of all, it is nice to hear everybody trusts the bankruptcy system. [Laughter.]

I do not know if we deserve it, but I will take it.

Mr. GROSSHANDLER. You may hear a little dissent.

Judge SONTCHI. I think one of the primary problems is time is your enemy. Time is your enemy in almost every Chapter 11. But when you are talking about these SIFIs, you are talking about trying to close out billions dollars in very short order, time becomes a very difficult thing to deal with. And what the bankruptcy court gives you is transparency. It gives you due process, but it takes time.

So the difficult balance in trying to figure out how you can handle a SIFI in a bankruptcy process I think has a lot to do with the balance of due process, which takes time, and the need, the real economic need, to move very, very quickly.

We actually do this every day. Every Chapter 11 case I have, when you have an operating business under court supervision, time is critical. And we are required to, and I think we do a pretty good job, of balancing the issue about due process with the emergent nature of the case. And why I say that is because you will hear that a regulatory position or a regulatory answer might be better for it because things can happen more quickly because we cannot wait around for a court to get around to doing things.

And I would counter that, yes, there is a tension there. There is no question. But I think the bankruptcy system does a pretty good job of handling that on a day-to-day basis in all our cases. And I think it would be a challenge, but I think we would be more likely than not to handle it in a SIFI type situation that we are talking about.

Ms. VRIS. I think that the bankruptcy judges are very good at some tasks and some missions, and that the regulators are better for other tasks and other missions. I think if we are talking about a claims dispute process resolving disputes, I think the bankruptcy judges are better for that. I think if we are talking about a planned process or valuation, I think the bankruptcy judges are better suited for that.

I think if we say for resolution of SIFIs we are broadening the mission and we want to also try and safeguard the disruptive effect on our entire financial system and the economy of the country, I think that is a lot to put on the shoulders of our bankruptcy judges, as wonderful as they are. In Lehman, Judge Peck had an extraordinarily short period of time to decide whether or not to approve the sale of the broker dealer to Barclays. He did an admirable job. Everybody and their brother objected. He had, as I said, very little time.

And ultimately he made a decision, which I think most people would say was the right decision, notwithstanding that people later tried to upset that decision. But I do not think that is really what we should ask of the bankruptcy courts if, as I say, our mission with the SIFIs is to look at the broader effect on the economy as a whole, and to do so quickly.

But I would also note that I think with any of the sort of Chapter 14 or bridgeco solutions that we are thinking of, those require extraordinarily fast action at the beginning of the case. Twenty-four hours, 48 hours. If you are anywhere in that kind of timeframe, it is very hard, as the judge has said, for the judges to really provide due process and make all the decisions they will be asked to make in that process.

So I think that it is hard to ask the judges to make too many concrete decisions for approving the transfer of assets and certain liabilities to bridgeco.

I do want to address your GM question, but if you will allow me, I will speak instead to Chrysler since I was involved in that. I represented the equity there, so I can speak more from personal knowledge.

I think it was the same situation in the sense that there was no one else who would have provided the liquidity that was needed. There was testimony presented that Chrysler needed $100 million a month just to keep the lights on, and there was no one who was willing to do that. If the government had not stepped in, I think everyone there who had heard that testimony would agree the company would have to have been shut down, including the people who were objecting to the whole process in Chrysler. They acknowledged that there was no one else there to step in and provide that liquidity.

And perhaps a little less optimistically than Professor Jackson, I think we at the conference believe that with a SIFI, they are going to need liquidity, too. I do not think that the single point of entry structure removes the need for liquidity. And so, the question is who provides that liquidity. And, you know, I cannot speak to that today, and I do not know how much would be needed and what the private markets would or would not be willing to do at that point. But some liquidity and access to it will be needed we think.

Mr. JOHNSON. Thank you.

Mr. GROSSHANDLER. I agree very much with Judge Sontchi and Ms. Vris. Time is the enemy, and also the bankruptcy courts, I think, are very well situated for sort of the after the fact adjudication of things. But approving that transfer is a lot to put on a bankruptcy judge. And I am just not so wary of the Federal regulators' ability to make those decisions.

Mr. BACHUS. Thank you.

Ms. VRIS. I am sorry. Could I just interject briefly?

Mr. BACHUS. Sure.

Ms. VRIS. I would just also point out that with the living will process, hopefully regulators will have had access to more information. They will know more about the assets and the liabilities. And even if the living wills are not a perfect blueprint to solve the problem, it is at least a huge head start.

Mr. BACHUS. Thank you. And what we did, and I think it is good. I mean, instead of just shoehorning everything into 5 minutes, we actually went 15 minutes with this, but I think that is good because we can get into the substance. And so, you can have as long as you want. I mean, 15 minutes.

Mr. MARINO. I have one issue that I want to zero in on. I was a prosecutor for 18 years, and I was a U.S. attorney, so I am used to the Federal court system. And I actually shared an office with one of the bankruptcy judges because we needed room, and we split things. [Laughter.]

So I have heard a lot of war stories. And I am going to ask each of you to respond to this. I am going to ask Professor Harner, would you respond first, and I am going to set up the scenario.

Whatever position you take, whether we need to change the Bankruptcy Code particularly concerning safe harbors or not, what impact would the change or not having the change have on our international financial system, particularly dealing with the EU at this point, because my area of expertise-ish concerning finance is international finance. So could you please address that?

Ms. HARNER. Certainly. Thank you, Congressman, for the question. So I think you raise a key point. Markets are no longer domestic. They certainly are global in nature. And that was one reason the commission felt so strongly about constituting an international working group.

And so, we are working with academics and practitioners in the following countries, Austria, Australia, Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, People's Republic of China, South Africa, Spain, and the United Kingdom, to help consider possible reform if the commission would determine it is necessary. And they have been giving us very thoughtful research reports on issues that would integrate and impact the financial markets just as you mentioned.

So I think like any change to the Bankruptcy Code, it is a matter of finding that sweet spot, finding the balance where we are not disrupting the financial markets either domestically or globally significantly. But we are actually giving companies an opportunity to rehabilitate.

Mr. MARINO. Okay. Thank you. Professor Jackson, please? Thank you, Professor Harner.

Mr. JACKSON. Not particularly my expertise area, but I have a couple of comments on it.

Mr. MARINO. Please.

Mr. JACKSON. I think we need to think about doing what we think is right with respect to qualified financial contracts. I think even if you wanted to modify, the world is not going to look like they have been repealed. I think you want to look at what the rest of the world does particularly with, I will go to the large financial institutions, these holding companies and subsidiaries. Lehman had over a thousand different subsidiaries. That is probably too complicated. But the reality is these are global companies, and anything we try to do that is going to work for these, even at the holding company level, is going to require the cooperation of the subsidiaries and the regulators of the subsidiaries to go along.

We can solve that domestically, but when we are dealing with foreign subsidies, and if our rules look weird to the foreign regulators, we are going to have a hard time getting them to play by our rules. And so, I think those cross-border issues, particularly at the large financial institutions, is something we need to be very sensitive to.

Mr. MARINO. Thank you, sir. Ms. Vris?

Ms. VRIS. I agree with what Professor Jackson said. And the conference believes that any kind of resolution will require discussion between the U.S. and the foreign regulators. They have to have confidence in whatever we are proposing to do. If they do not, then they are going to circle the fences around the assets in their country. This happened in Lehman. It has happened in other cases. And so, cash that is overseas is going to stay there. Those creditors are going to get favored.

Mr. MARINO. Yes.

Ms. VRIS. And you have to put it in context. Even with the best of coordination, you may still encounter that in countries. It is a natural instinct of the regulators to want to hold the cash in their own country. But if you do not at least work with them up front, you are going to have no chance at cooperation.

Some of our big SIFIs, I think, Lehman did have subsidiaries around the world. I had the pleasure of representing the Central Bank of Germany in that case. But you have to look a little more carefully. Not all foreign subsidiaries are necessarily critical to the long-term survival of some of our SIFIs. So it is a case by case situation.

Mr. MARINO. Sir. Thank you.

Mr. GROSSHANDLER. Yes. I have two basic points to make. The first is, as I had indicated earlier, the safe harbors are an international phenomenon in Europe as well as Asia. Most of the developed countries have safe harbors for financial contracts. And so if one were to get rid of them here or substantially narrow them, that would have competitive issues, all of those sorts of things.

Also the single point of entry mechanism, one of the reasons for it is because of the very difficult cross-border issues. So the idea is the holding company goes under, but the operating bank, broker dealer does not, and, therefore, the operating banks and broker dealers overseas do not go under. Great thing if it works. It requires cooperation.

At a very technical level, I think it is very important to think about cross-border recognition. So Europe, the European Union, is considering the BRRD, the Banking Recovery and Resolution Directive, which in Article 85 gives local regulators in Europe the ability to recognize U.S. law. So, for instance, if U.S. law, like under Title II overrides defaults and cross-defaults in financial contracts, Article 85 allows recognition of that.

There is no comparable vice versa. So if the U.S. wants to recognize a European law, which the BRRD also has that overrides defaults and cross-defaults, it is just basic comity law, which in many courts very, very difficult. It would be wonderful if there were a centralized bankruptcy court kind of mechanism like Chapter 15, which does not apply to many of these contexts because it does not apply to financial institutions, but a Chapter 15 expansion to recognize European law.

Mr. MARINO. Thank you. Judge?

Judge SONTCHI. First of all, I think you just found out how incredibly knowledgeable Mr. Grosshandler is about these issues. His encyclopedic knowledge is amazing, and I have a lot of respect for him.

I think about it just maybe a little differently. I was at a conference in Vancouver last month, and one of the main issues was corporate groups. What do we do about cases like this where we have holding companies, we have subsidiaries, they may be in different countries? How do we deal with that on a cross-border basis? And the Chapter 15 we have today that covers cross-border cases does not deal with that.

So UNCITRAL, which is the UN organization that came up with Chapter 15 in the first place, and the European Union, and people in those entities, are today exploring, and there is a lot of talk about how do we deal with corporate groups on an international level.

And I do not know frankly whether anyone in the United States is sort of on board with that discussion. But the discussion is going forward, and I would hope and I think that as that moves forward, I think you are going to start to see an international consensus growing, at least on a procedural way, to deal with some of these issues from a cross-border perspective.

Mr. MARINO. Thank you all very much. I could talk with you for hours, but I am sure that you folks have important things to do as well. But thank you very much, and I yield back.

Mr. BACHUS. Thank you. Listening to the testimony, I had written several things down. And the second thing I wrote down was international institutions during the testimony, and then Mr. Marino went into that. I was actually thinking I might want to move that up to number one, and I think this discussion has gotten around it.

When we talk about SIFIs, we are talking about international institutions. I am not sure we knew that before 2007, 2008, Members of Congress, but we sure did after that because with AIG, you had a British subsidiary that caused all the problems. The insurance business was fully reserved, so bailout was not of AIG. It was the counterparties, and they were paid 100 cents on the dollar.

And that money went through AIG within a matter of hours. It went to the counterparties. Most of those were in Europe. And then many of them then had agreements back with Goldman, had agreed to ensure that. So you had the credit default swaps. So you had money coming in here, going out there, coming back to the United States. And it took literally a year before the public and many Members of Congress knew where the money went.

If you are talking SIFI, you could not possibly have a chapter that you used on middle and small or even large companies, and these too big to fail. That is another word for that. And, you know, there is a big debate here whether or not we are going to allow too big to fail or SIFIs significantly.

There is tremendous debate on does that give them a preference. Does that give them an advantage? And of course the regulatory agencies are saying, well, we are going to protect them by requiring more capital of them. And then they are saying, well, you know, that makes us less efficient. So there are all these subplots.

But sitting here, I believe when it comes to the SIFIs, maybe not the only, but the most rational approach would be a Chapter 16 or whatever, you know, a chapter for this because Chapter 15 is not designed for that. And it is going to be an international agreement because there are some that I have disagreed with that say we do not need financial institutions that big. Well, they are going to exist. They will exist in other countries if they do not exist here.

And those are maybe the first choices, but I think they are going to exist.

When it comes to them getting in trouble, there is going to have to be an international resolution because if you try to change Title 11 to fit that, then you are going to have smaller companies. You are going to have them structuring different things to fall under safe harbor. And you are going to have all kinds of abuses because, according to the judge, we are already having some market distortions or people designing things to take advantage or to get a preference when that was not what was intended.

The second thing I wrote down, and this is sort of reminiscing, but the American Securitization Forum, I asked one of the staffers, I said, that was about 10 years ago. Find out when their first annual conference of the American Securitization Forum was because I spoke at their first conference, and it was 2004.

And the reason I went is because Chairman Oxley said, we were sitting around, and the Subcommittee Chair of securities, Chairman Oxley, said, do you want to go and speak. And he said, well, what would I speak about? And he said, CDOs, and CDSs, and mortgage-backed securities. And he said, you know, I do not think I want to go. [Laughter.]

And I had read sort of a book like derivatives for idiots. And so, I was able to—what is a credit default swap? I said, well, it is a form of insurance. So that one question got me a trip to Arizona because we were dealing with things that we really did not know what they were. I mean, Members of Congress did not know the difference in a CDS and a CDO and a mortgage-backed.

And if you think about it, the Budget Control Act, 1978, a lot of things we now have instruments we did not have then. And 2005 we may have had them, but I am not sure we knew we had them, and we certainly did not know how prevalence they were. And the OTS who regulated Thrift regulating, they were the regulator for the AIG. And they may have been the least qualified, and I do not mean that in a bad sort of way.

I will say this. Dodd-Frank, half of it was written in a 2-week period in the Senate. But one thing that we actually in a bipartisan way discussed—Chairman Frank, myself, others—we worked on a living will, Title I. Does everybody agree that is a good thing? And I think that you again, we have talked. I have very little debate since then, and everybody agrees that is a good thing.

But we also, and you have talked about this, another thing I wrote down is “panic/stable economic environment.” You know, a lot of what works in a stable economic environment in a panic, you know, it is a different environment, much of what was done then. And I, for instance, received a call from Speaker Boehner, who may have been minority leader—no, he was Speaker then—that had I lost my mind because I had said we needed to get warrants from these institutions. And the his staffer called and said he is saying we need to get arrest warrants for these people. [Laughter.]

And I was talking about warrants, you know, the money that we loaned them, which was not an arrest warrant.

So, you are dealing with Members of Congress who simply on an ordinary day are overwhelmed. But on a day like this, we do not understand. We were listening, and, you know, to varying degrees we understand what we are talking about. But something this complex has got to have your institutions and your groups to tell us what to do.

Safe harbor to most of us that have a legal background means shielding from liability. That is usually how we consider it. It shields us, not that it gives a preference to one asset or one creditor or one over another. So we are going to need an awful lot of guidance on these things. And that is what we are going to depend heavily on you for. And I think part of it we may could do this year, but when it comes to the SIFI part, it is going to have to be some international agreement because, you know, a lot of the things that were put in as a safe harbor, the original intent was not to allow some of the things that happened.

But I found everything else said has been very helpful to us. And what I think this Congress does best is not when it makes sweeping changes in a crisis, but if you can come to agreement on a few things, it can be done now. Not a reform bill to reform a whole thing, but something to address a few specifics. And we might could actually accomplish that this year.

So I am not going to ask any questions. You have answered the question that needed to be asked without anybody asking it. But if any of you want to make final comments, we would love to hear those.

Judge SONTCHI. Well, Chairman Bachus, what you said at the very end about being able to deal with perhaps discrete items, I would take you back to what I talked about, which is amending Section 546(e) of the Bankruptcy Code. I think that is not a very controversial topic. There are some, you know, bumps about how exactly you treat public shareholders, for example. But I think for the most part it is not controversial.

And I think frankly there is an immediate need to deal with that safe harbor because as it is being applied now, and we have really no choice given how it is drafted, there are people who are directors, officers, insiders who are using 546(e) to shield themselves from potential fraudulent conveyance liability in private transactions.

Mr. BACHUS. And that undermines the people's trust——

Judge SONTCHI. I think so.

Mr. BACHUS [continuing]. When they hear things of that nature. And obviously it is not fair to shareholders. It is not fair to creditors, you know. Anybody else?

Ms. VRIS. Yes. The conference agrees with that, and, in fact, we did propose some specific statutory changes to, I think, pretty much, in fact, what you are discussing, Judge. And, you know, we would be more than pleased to dust that off and work with your staff on that.

Mr. GROSSHANDLER. And the Committee on Safe Harbors, in addition to mostly agreeing on changes to 546(e), and the differences are in some of the details that are very detailed. There were a number of other items where we agreed on things. But when you get to issues of the scope of the repo safe harbor, there was a lot of disagreement, but there was a lot of agreement on a number of things.

And I think the process is that the full commission is going to take the committee's recommendations and come out with something. But I would be surprised if they did not take the recommendations that were pretty much unanimous.

Ms. HARNER. And, Chairman Bachus, I will just add onto that the commission would be more than happy to work with the Subcommittee in any way that would be helpful. And to the extent that there are issues that you would like us to prioritize, certainly let us know. And the safe harbor issues may be a starting point.

Mr. BACHUS. Well, obviously, Judge, what you said in your testimony was disturbing that that is going on, that there are people that are sort of insulating or looking out for themselves as opposed to the corporation.

I personally would rather you make the determination of what is a priority because you know much more than I do on this subject. Now, if it is railroad law, come to me and I will give you some advice, but most of it will be 22 years old.

Mr. JOHNSON. Well, Mr. Chairman, you told me about that railroad case, and I find those country experiences to be inconsistent with your knowledge in this particular area. [Laughter.]

And so I am perplexed, but I am also intrigued. And I look forward to our Committee doing some good work in this area. This has been a great panel, and I have learned a lot myself. And I realize that our process often impedes our ability to learn from the private sector, the academic sector, the commercial sectors. And when we can take a few minutes to let ourselves question and try to understand outside of the 5-minute period that many so rigorously adhere to, it gives us a better chance of coming to some sound decision making. So I definitely appreciate you.

Mr. BACHUS. Let me say this. In a bipartisan way, the Congress was concerned over not following rule of law, you know, not going by an established Bankruptcy Code. What Professor Jackson—I am not saying yes, yes, yes. You know, this is the preferred method. This is rule of law. This is precedent. This is people. There is predictability. There are all these things, the transparency. It is not politics or somewhat insulated, I mean, I think, to a great extent. And you would really be doing, I think, a great service to the American people because if this issue is not resolved, I mean, then there is going to be an outcry from the American people to do things that I think would damage our free market system and our capitalism, and would be damaging to our financial system.

What you are saying is people are beginning to think, well, the government owns the banks anyway, which I hope that is not the case. But I can understand exactly what you meant. And so, you would be doing a great service, even if we were able to make a few changes to the things that most all of you agree with. And we would have a much greater likelihood of enacting some law this year. So I think this hearing is adjourned.

But I think your testimony has been excellent. The interchange between the panel I think has been most helpful. And where you can reach a reasonable consensus, if you can do that, I think we can do our part.

So thank you very much, and this concludes today's hearing. I thank all the witnesses for attending.

Without objection, Members will have 5 legislative days to submit additional written questions for the witnesses or additional materials for the record.

This hearing is adjourned.

Mr. JOHNSON. Thank you, Mr. Chairman.

Voices. Thank you.

[Whereupon, at 6:28 p.m., the Subcommittee was adjourned.]

A P P E N D I X

Material Submitted for the Hearing Record

Prepared Statement of the Honorable John Conyers, Jr., a Representative in Congress from the State of Michigan, and Ranking Member, Committee on the Judiciary

This is the second hearing examining whether current law would adequately address the insolvency of a significant financial institution given what we learned from the near collapse of our Nation's economy just five years ago.

As we consider this issue, it is critical that we keep in mind exactly what precipitated the Great Recession.

Basically, it was the regulatory equivalent of the Wild West.

In the absence of any meaningful regulation in the mortgage industry, lenders developed high risk subprime mortgages and used predatory marketing tactics that targeted the most vulnerable by promising them that they could finally share in the Great American Dream of homeownership.

This proliferation of irresponsible lending caused home prices to soar even higher, ultimately resulting in a housing bubble.

In the absence of any meaningful regulation in the financial marketplace, these risky mortgages were then bundled and sold as investment grade securities to unsuspecting investors, including pension funds and school districts.

Once the housing bubble burst, the ensuing 2008 crash stopped the flow of credit and trapped millions of Americans in mortgages they could no longer afford, causing vast waves of foreclosures across the United States, massive unemployment, and international economic upheaval.

And, to this day, we are still dealing with the lingering effects of the Great Recession of 2008 in the form of a sluggish national economy, neighborhoods blighted by vast swaths of abandoned homes, and municipalities struggling with reduced revenues.

As I noted, this is the *second* hearing at which this Subcommittee is exploring how the Bankruptcy Code could be improved to deal with systemically significant financial institutions.

Indeed, the Committee and Subcommittee combined have held *23 hearings* since the last Congress on various anti-regulatory matters and measures that have absolutely no hope of becoming law.

But when it comes to examining how the bankruptcy law can better accommodate the needs of consumers and municipalities struggling with financial distress, the Subcommittee has not held a *single* hearing on any of these critical issues: not during the last Congress and not during the current Congress as of this date.

And, these are not frivolous issues. They include, for example:

- exploring ways to give homeowners who are victims of predatory lending relief from excessive mortgage interest rates and hidden "gotcha" penalties;
- determining how to provide relief to well-meaning students ensnared by profit-driven schools and private educational loan lenders into obligations they will never be able to repay; and

- conducting a long-overdue examination of the various ways how Chapter 9 of the Bankruptcy Code, which deals with municipal bankruptcies, could be improved.

Accordingly, I implore the esteemed Chairman of Subcommittee to focus on these other issues that are more than equally deserving of being considered before the end of the current Congress.

Finally, as one who was here during the consideration of the 2005 amendments to the Bankruptcy Code, I can attest that measure illustrates just what happens when special interests control the legislative process.

One of the issues that will be addressed at this hearing is whether the expansion in 2005 of the Bankruptcy Code's safe harbors for derivatives—in the aftermath of the Great Recession—may have, in fact, contributed to the Nation's near economic collapse.

Over the course of prior hearings, we have learned how these derivative safe harbors not only destroyed billions of dollars of value in the Lehman Brothers bankruptcy case, but how the precipitous collapse of that entity nearly froze the Nation's financial marketplace.

As I recall, these safe harbors were included in the 2005 law at the special insistence of the industry, which later was very much traumatized by them.

I would hope that this could be at least one area where there may be the potential for bipartisan resolution.

In particular, the National Bankruptcy Conference has a number of thoughtful suggestions about how we can restore the original intent of these safe harbors, namely, to protect the stability of the financial marketplace not the bottom lines of private parties.

For example, the Conference recommends:

- closing the financial contract loophole that allows creditors to foreclose collateral consisting of the debtor's operating assets; and
- limiting recourse for settlement payments that otherwise constitute constructive fraudulent transfers.

Accordingly, I look forward to hearing the testimony from our witnesses about these and other recommendations to improve the bankruptcy process.

Testimony of Hon. Christopher S. Sontchi

United States Bankruptcy Judge for the District of Delaware

"Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives"

Response to Questions Posed By Members of Subcommittee

Before the

Subcommittee on Regulatory Reform, Commercial and Antitrust Law

The Committee on the Judiciary

United States House of Representatives

Washington, D.C.

August 8, 2014

1. **Setting the Bankruptcy Code aside for a moment, are there any practical differences between a warehouse secured loan and a master repurchase agreement?**

The primary distinguishing characteristic between a warehouse secured loan and a master repurchase agreement is that warehouse loans are secured loans where the underlying mortgage is the collateral. As such, they are subject to the long standing law regarding security interests and tend to be issued by large institutional (and regulated) banks. In a repurchase agreement, on the other hand, the mortgage is actually sold to the counter party and there is an obligation to repurchase that mortgage at a future date. There is no formal legal mechanism governing the parties' relationship as there is with secured lending. Finally, while repurchase agreements often involve institutional banks, much of the lending is with non-traditional lenders such as hedge funds or special purpose entities that are not part of the banking system. This is often referred to as "shadow banking" and it takes place outside of the regulations and protections that govern banking.

2. **Is it possible that the existing safe harbors could cause mortgage originators and other mortgage market participants who use repurchase agreements to be more sensitive to market events? In other words, by allowing repo counterparties to quickly grab collateral, could that cause or accelerate the bankruptcy of an otherwise solvent entity?**

Yes, I believe that the existing safe harbors make mortgage originators and other mortgage market participants who use repurchase agreements to be more sensitive to market events. In an upcoming article entitled **Rolling Back the Repo Safe Harbors** that I have co-authored with Prof. Mark J. Roe of Harvard Law

School and Edward R. Morrison of Columbia Law School, we address this issue in detail.[1]

Briefly, proponents of the use of repurchase agreements for mortgages argue that they increase the liquidity of what is otherwise an illiquid asset. But, liquidity does not come for free. The safe harbors enhance liquidity in repurchase agreement markets by reducing liquidity in other markets, especially markets for traditional, long-term lending. Because safe harbor benefits are available for some kinds of financing (repurchase agreements, which are largely short-term credit facilities) but not others (traditional, longer-term lending; other shorter-term markets like asset backed securities), the Bankruptcy Code is implicitly subsidizing some markets at the expense of others.[2] Liquidity is shifted from one market to another. In the process, the safe harbors artificially distort the capital structure of financial institutions toward less stable, run-prone financing.

The safe harbors encourage less stable financing for our largest and most important financial institutions, making it more likely that a stressed institution will need to liquidate in a costly way. Those who might be prepared to lend long-term to an important financial institution would, all else equal, be induced by the

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[1] The article is scheduled to be published in the next issue of The Business Lawyer. I am happy to forward a copy to the Committee upon its publication. The following brief response is drawn from the upcoming article.

[2] In the event of financial failure, non-safe-harbored creditors (oftentimes longer-term creditors) will be less likely to be paid immediately, while safe-harbored creditors (oftentimes shorter-term creditors) are permitted to immediately liquidate collateral—this thereby contributes to a market preference for safe-harbored debt over non-safe-harbored funding, all else equal.

safe harbors to lend short-term (via repurchase agreement) and roll over that repurchase agreement on a regular basis. They are then incentivized to decline to rollover (to run) in the event of a financial crisis or in the event of financial difficulty with the borrower. The result can be disastrous for a borrower. As most repurchase agreements are for less than 90 days with many limited to thirty days, a mortgage originator can see its entire source of financing dissipate in weeks. Moreover, most repurchase agreements allow the counterparty to put the repurchase agreement back to the mortgage company in the event of a default, including the termination of other repurchase agreements. The "run" on the mortgage companies can be shortened from weeks to days. Indeed, this is exactly what occurred in the *American Home Mortgage* case.

a. **Could the same principles be applied broadly to other markets such that safe harbors have the potential to cause instability in the market generally?**

Yes, the safe harbors have the potential to cause instability in the market generally. As drafted, the safe harbor for repurchase agreements is not limited to mortgages. For example, it can apply to corporate bonds and equity securities. The same problems relating to mortgages applies to those securities.

In our upcoming article, we argue that the safe harbors should be narrowed to protect only repurchase agreements involving highly liquid securities backed by the full faith and credit of the U.S. government, including Treasuries and some agency securities (e.g., those guaranteed by Ginnie Mae). This category amounts to about half of the outstanding securities in the repurchase agreement market, so it is not small. Repurchase agreements on other collateral—such as private mortgage-backed securities, equities, bonds, and Agency securities that lack the backing of the United States' full faith and credit—should not receive safe harbor treatment.

3. **Near the conclusion of the hearing, it appeared that all of the witnesses were in general agreement regarding a proposed amendment to the Bankruptcy Code that would address concerns raised in your testimony regarding section 546(e) of the Bankruptcy Code. To what degree does similar consensus in support of such an amendment exist in the wider bankruptcy community? To this end, any feedback and input you have on developing a solution to these concerns as the Committee looks at these issues would be appreciated.**

While I believe that there is a general agreement in the wider bankruptcy community that section 546(e) as applied is overly broad and should be amended, that belief is not universal. More vexing, however, is that there is not a broad consensus among those who believe amendment is appropriate as to the proper scope of the section 546(e) safe harbor. I believe virtually all members of the bankruptcy community agree that financial intermediaries such as clearing houses should be protected in connection with public transactions. Holding aside the distinct minority that believe the statute is fine as is, however, there is sharp disagreement over what other parties and what type of transactions should and should not be protected. For example, some believe that in transaction involving the public securities markets that all parties, including the ultimate recipients of otherwise avoidable transactions, should be protected while others have called for limiting the safe harbor in those transactions to parties that have acted in good faith. Also, some believe that private transactions should be completely outside the safe harbors while other call for the protection of intermediaries even in private transactions.

As a practical matter, I think the Committee should not act prior to the issuance of the upcoming report of the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11.[3] The Commission is charged with reviewing a broad range of topics related to Chapter 11, including the safe harbors. Indeed, the Commission formed a *Committee on Financial Contracts, Derivatives and Safe Harbors* upon which I served. Our Committee made confidential recommendations on various safe harbor topics, including the amendment of section 546(e). The Commissioners represent a wide variety of members of the bankruptcy community and I expect their recommendations to be broadly supported by most of the community.

Once the Commission has issued its report, I think the Committee should consider working with the National Bankruptcy Conference to draft legislation adopting those recommendations, which would possibly include amendment to section 546(e). The end result of this process should be legislation that is carefully considered and broadly supported.

4. **Would the judicial system be better equipped to deal with the resolution of a systematically important financial institution than a federal regulatory agency such as the FDIC?**

[3] I believe the Commission is scheduled to issue its report in December, 2014.

This is a difficult question. The short answer is that it depends. If the goal is to quickly transfer the assets of the financial institution to another financial institution on a "where is, as is" basis then the regulatory agency is better equipped. Indeed, the FDIC regularly performs this task with failed banks. Importantly, in such situations the regulatory agency is able to act much more quickly than the bankruptcy court.

However, if the financial institution is seeking to reorganize or to sell some but not all of its assets I think the bankruptcy court is better suited. This is particularly true if there are disputes that need to be resolved prior to or in concert with a sale or reorganization. The tools and protections of the Bankruptcy Code work well in such situations and large firms are routinely sold or reorganized in bankruptcy court.

5. Is the ability to access new capital for liquidity essential to a bankruptcy regime designed to resolve a systematically important financial institution?

Yes, the access to new capital for liquidity is essential for a systematically important financial institution (or SIFI) to reorganize in a bankruptcy regime. Indeed, no debtor can survive in bankruptcy for long without access to capital through either existing channels or through new lending.

One of the primary problems with repurchase agreements is that they provide liquidity on a pre-petition basis but, as a result of the safe harbors that allow the post-petition termination of the agreements, the liquidity disappears upon the bankruptcy filing. When a debtor, including a SIFI, is a party to secured loans liquidity may continue to exist on a post-petition basis. For example, a debtor may still have access to the loan or line of credit provided it can provide adequate protection to the lender.

While being a party to secured loans is no guarantee that a SIFI can reorganize or sell its assets in an orderly fashion in Chapter 11, a debtor who has financed its operations through repurchase agreements faces an almost impossible hurdle to reorganization.

Christopher S. Sontchi
U.S. Bankruptcy Judge

August 8, 2014

Questions for the Record submitted to Seth Grosshandler, Partner, Cleary Gottlieb Steen & Hamilton LLP, New York, NY*

Questions for the Record from
Mr. Conyers
for the Hearing on "Exploring Chapter 11 Reform:
Corporate and Financial Institution Insolvencies; Treatment of Derivatives"

March 26, 2014

Questions for Mr. Grosshandler

1. Would the judicial system be better equipped to deal with the resolution of a systemically important financial institution than a federal regulatory agency such as the FDIC?

2. Is the ability to access new capital for liquidity essential to a bankruptcy regime designed to resolve a systemically important financial institution?

*The Subcommittee had not received a response to these questions at the time this hearing record was finalized and submitted for printing on September 25, 2014.

Questions for the Record from
Mr. Conyers
for the Hearing on "Exploring Chapter 11 Reform:
Corporate and Financial Institution Insolvencies; Treatment of Derivatives"

March 26, 2014

<u>Questions for Ms. Vris</u>

<u>ANSWERS PROVIDED BELOW FOLLOWING EACH QUESTION</u>

1. Mr. Grosshandler says that the "Bankruptcy Code safe harbors serve a vital role in promoting systemic stability and resilience, have significantly increased the availability to end-users of derivatives and repurchase agreements and the liquidity of these transactions and related assets, have reduced the cost of transactions to end-users and have decreased the cost of financing to issuers of assets."

   What is your response to this statement?

   <u>Response</u>: The Capital Markets Committee of the NBC has supported the existence of safe harbors for certain financial contracts such as derivatives and repurchase agreements. It recognizes that the provisions are intended to provide a high degree of certainty to the capital markets and to minimize systemic risk to the capital markets by allowing settlement to continue across a broad spectrum of the capital markets, including securities clearance and payment systems. The NBC has noted, though, that the existing safe harbors go further than is necessary to achieve this and has recommended various changes over the years to narrow the breadth of the safe harbors. We have not studied the effect the safe harbors have on the cost of financing and transactions.

2. From Judge Sontchi's testimony, it appears that the immediate closeout of mortgage repurchase agreements in the American Home Mortgage bankruptcy case effectively led to fire sale prices for these assets.

   Do you agree with Judge Sontchi that the Bankruptcy Code's safe harbors should not apply to illiquid assets such as mortgages?

   <u>Response</u>: The NBC has observed that with inventive structuring, many types of commercial financing can be protected by the safe harbors. Previously, the NBC has recommended that the safe harbors be modified so that ordinary operating assets of a debtor securing obligations would be protected by the automatic stay and the obligations not included in the safe harbors. It is my view that this position was not driven by the liquid or illiquid nature of the assets. Instead, the NBC has recognized that the safe harbors are inconsistent with bankruptcy principles of fairness and collective action but are necessary to protect the capital markets and that the scope of the safe harbors should therefore go no further than required to provide that protection.

With respect to mortgages, the NBC has noted that repurchase agreements covering mortgages present a difficult situation: the borrower's entire business could be funded through financing which would be protected by the safe harbors and therefore, the automatic stay could do nothing to preserve the going concern value for the benefit of creditors. The situation in *American Home Mortgage, Inc.*, 379 B.R. 503 (Bankr. D. Del. 2008) was noted specifically. The NBC does not have a specific recommendation, although the only companies I personally am aware where this has been an issue, other than ones involving financial institutions, were all in the mortgage origination business.

3. Judge Sontchi states that Bankruptcy Code section 546(e) "should not protect settlement payments or other transfers with respect to the beneficial owners of privately placed debt securities or of equity securities of a closely held entity."

What are your thoughts about this observation?

Response: The NBC agrees with this.

4. What are some of the benefits of a single point of entry for a systemically important financial institution?

Response:

Single of point entry as a resolution mechanism for systemically important financial institutions takes advantage of the holding company structure commonly used in the US. Depending on how it is implemented, it can immediately subordinate the unsecured debt at the parent structurally to new debt at the new bridge company and potentially put control of the operating entities in the hands of a third party and away from both existing management and the creditors at the parent. The approach assumes a holding company structure.

5. Is the ability to access new capital for liquidity essential to a bankruptcy regime designed to resolve a systemically important financial institution?

Response: Yes. There may be difference of opinion as to whether any of it needs to be advanced or drawn on, but the Conference is of the view that the availability of some facility will be necessary at a minimum to instill confidence at the subsidiary level. The expectation is that the need will be of even greater importance to the extent there are regulated foreign subsidiaries or a broker dealer. For regulated foreign entities, the regulators may not have the confidence necessary not to seize the regulated institution once some single point of entry resolution begins, but liquidity at the bridge company may give them a sufficient degree of confidence in the process to wait. Likewise, at broker dealers, which lack access to the discount window and are dependent on short term financing, their lenders may lack sufficient confidence to roll over their exposure without some credit support from the parent. Even with credit support, the lenders may insist on being refinanced. These concerns assume there is no merger or acquisition by a stronger financial institution of the operating subsidiaries all prepared and approved by the regulators by the time the filing is public.

Note: In my response, I assume that by the phrase "capital for liquidity", you are referring to liquidity, i.e., funds to pay obligations, which can be provided either by borrowing money on a secured or unsecured basis or by new equity. To the extent the question may also include whether recapitalization is necessary at the operating subsidiaries, I would say that, unlike liquidity, this depends on the circumstances, but the single point of entry is designed to provide immediate recapitalization of the institution on a consolidated basis by the subordination of liabilities at the parent, as I described in answer to the previous question.

6. Professor Jackson argues that there is no need for government funding under his bankruptcy proposal for systemically important financial institutions.

What are your thoughts about his argument?

Response: The NBC has not taken an official position on this important issue. The question will be how much is needed to restore the confidence of the market and the foreign regulators. In one sense, the response could be no amount will be adequate unless it comes from the government with the implicit promise of more if needed; I believe some of our members would respond in this manner. However, speaking for myself, I have noted an absence of any public studies estimating what might be necessary in the event of a single point of entry resolution of a truly large and global systemically important financial institution (to my knowledge, at least). Without at least this information, examined assuming there is some stay for qualified financial contracts here and abroad, I would not know how to assess whether there is even sufficient availability at any given time in the capital markets to provide the necessary funding on some basis.

Note: As with the prior question, this response assumes you are asking about the need for the government to provide the liquidity which will be necessary to stabilize the bridge company and markets as they react to the news of the bankruptcy filing. I believe in his Statement, Professor Jackson has distinguished between recapitalization, which occurs by the structural subordination I referred to above in response to question 4 without government assistance, and funding for the liquidity needs of the bridge company. With respect to the latter, in his written testimony, I understood him to be hesitant to predict whether only the federal government could provide the liquidity. (See Jackson, Statement, notes 21 and 24.)

7. Would the judicial system be better equipped to deal with the resolution of a systemically important financial institution than a federal regulatory agency such as the FDIC?

Response: I understand this question to be with respect to a resolution process at the parent and not at one of the regulated entities, where the regulators already have the authority to seize the institution. Although we have not addressed the issue framed so clearly, we have discussed and understood that speed is the key to preserving value at a systemically important financial institution once the decision has been made to put it through some form of resolution process. Bankruptcy courts can and have acted quickly when necessary to stop value erosion at troubled companies. In the Lehman cases, the bankruptcy court approved the sale of its investment banking business to Barclays in the first week of the bankruptcy. Yet even that may not be speedy enough if fundamental business decisions must be made over a weekend when markets are closed. On the other hand, any collective resolution process requires asset recovery and a claims dispute mechanism. These do not require the same speed, and the judiciary is obviously well equipped to handle both. It is therefore no surprise that over the past several years, when we have examined the various changes to the Bankruptcy Code parties have proposed to accommodate and implement the single point of entry resolution, we have ultimately decided that if the process is judicial, and if extraordinary relief is required immediately to serve the public interest, then there needs to be some regulatory involvement as well, probably more than has been proposed. We have not examined whether the reverse is true, that is, whether a regulatory process alone is better than a process involving both.

Questions for the Record from
Chairman Bachus
for the Hearing on "Exploring Chapter 11 Reform:
Corporate and Financial Institution Insolvencies; Treatment of Derivatives"

March 26, 2014

<u>Questions for Professor Jackson</u>

1. Does the "single point of entry" approach utilized in your subchapter V proposal address concerns related to international regulatory cooperation? If so, could you please explain how the single point of entry approach would address international issues? Is your view related to the single point of entry's approach held by others? If so, who else shares your view?

   The "single point of entry" approach in the draft bill proposing a subchapter V of Chapter 11 to the Bankruptcy Code attached to my written statement does not, directly, address issues of international regulatory cooperation. This is very difficult, if not impossible, to do in a U.S. statute. Rather, there is a growing international consensus, at least in Europe as well as in the U.S., that "single point of entry" approaches—whether they be done in the fashion as proposed by the F.D.I.C. in the U.S. or through various forms of "bail-in" being proposed in Europe, is the appropriate resolution mechanism. 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). That is the important first-step towards necessary governmental cooperation in terms of ensuring that a resolution involving a "single point of entry" commenced in the country where the holding company resides will not be undermined by differing regulatory approaches to the operating subsidiaries in other countries. Indeed, this cooperation will be as necessary in the case of the resolution of a global financial institution by the F.D.I.C. under Title II of Dodd-Frank as it would be in any subchapter V of Chapter 11 resolution; the issues are identical. (The one possible difference would be in greater regulatory "comfort" with U.S. regulators, rather than judges, although this could be mitigated, if not eliminated, by strong regulatory support of a bill such as subchapter V of Chapter 11.)

2. Are there elements of the "single point of entry" approach that require international cooperation, and have there been any developments by international regulatory authorities to address these issues? Does Article 85 of the December 18, 2013 European Council directive address any of these issues?

   See my answer to Question 1, above. The most important aspects of the single point of entry approach requiring international cooperation has to do with ensuring that "runs" do not occur at the operating subsidiary level, if the operating subsidiary is located in a foreign jurisdiction. While the draft subchapter V bill has provisions stopping counterparties on qualified financial contracts from terminating their contracts based on cross-default clauses (involving the holding company) or based on change-of-control provisions, these provisions will not apply extraterritorially. In my view, it is here where the greatest international cooperation is necessary. European and U.S. regulators have asked ISDA to amend its standard contracts so as to reach this result; while a promising start, resolving this concern may, in my view, require regulatory cooperation, rather than just an ISDA standardized contract.

Article 85 of Council of the European Union, Proposal for a Directive of the European Parliament and of the Council Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms, is a major step in the direction of international cooperation because, similar to Chapter 15 of the U.S. Bankruptcy Code, it will allow a European regulator to "recognize" (i.e., make enforceable under European law) the FDIC's exercise of powers under Title II, although this would need to encompass the judiciary's powers under the provisions of the Subchapter V bill as well. As importantly, Article 60a of the Council of the European Union directive gives European resolution authorities the powers to support a single point of entry strategy initiated in the U.S., including the power to override cross-default rights of counterparties to European contracts.

3. Near the conclusion of the hearing, it appeared that all of the witnesses were in general agreement regarding a proposed amendment to the Bankruptcy Code that would address concerns raised in Judge Sontchi's testimony regarding section 546(e) of the Bankruptcy Code. To what degree does similar consensus in support of such an amendment exist in the wider bankruptcy community? To this end, any feedback and input you have on developing a solution to these concerns as the Committee looks at these issues would be appreciated.

It is my understanding that there is broad support for an amendment along the lines proposed by Judge Sontchi with respect to Section 546€ of the Bankruptcy Code in the broader bankruptcy community. However, this question is best addressed to the other panelists, who come from two of the most important national bankruptcy organizations.

Questions for the Record from Mr. Conyers

4. If a systemically important financial institution was able to guarantee that it would be able to repay the federal government for a loan with interest and that it would provide collateral to the government to secure the loan, would you oppose this transaction even if it enabled the debtor to complete its financial resolution in an orderly fashion without disrupting the financial marketplace?

I, personally, would not oppose the identified transaction. I am the co-author of a Bipartisan Policy Center report, "Too Big to Fail: The Path to a Solution" (May 2013), that (a) draws a distinction between capital and liquidity, see pp. 46-50, and supports access to a temporary, fully-secured liquidity facility that is structured "to comply with the traditional safeguards for lender-of-last-resort facilities announced by Walter Bagehot in his classic 1873 book on central banking . . . . Under Bagehot's rules, 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." *Id.*, p. 67. I believe that even fully solvent entities, such as a bridge company following a section 1185 transfer under the draft subchapter V bill, can suffer runs—as there is strong evidence that runs occur not just on troubled banks—or otherwise lack liquidity, particularly if it is in the context of a broader market-concern with the financial system.

5. How does your proposal differ from Senator Cornyn's chapter 14 bankruptcy bill, S. 1861, the "Taxpayer Protection and Responsible Resolution Act"?

   The substance of the two bills are very similar. One, of course, proposes a new chapter to the Bankruptcy Code (Chapter 14) with the other proposes a new subchapter (V) to the existing Chapter 11 of the Bankruptcy Code, but this is not a substantive difference. While there are a number of other differences (such as whether involuntary petition appeals go to the district judge or to a court of appeals panel), the heart-and-soul of the two are very much aligned, and both point to the same end—the successful implementation of a "rapid recapitalization" via a transfer to a bridge company of all assets and liabilities (other than capital structure debt), so that the bridge company will be rendered solvent and able to proceed on its own, and provisions (such as stays on termination rights) designed to make this happen. Senators Cornyn's and Toomey's bill, S. 1831, of course has provisions regarding repealing Title II and explicitly prohibiting access to Federal Reserve Bank funds that the draft subchapter V bill, which is focused exclusively on the Bankruptcy Code itself, does not.

Questions *and Responses* for the Record from
Chairman Bachus
for the Hearing on "Exploring Chapter 11 Reform:
Corporate and Financial Institution Insolvencies; Treatment of Derivatives"

March 26, 2014

Questions for, and Responses from, Professor Michelle M. Harner

Question No. 1:

What are some of the reasons that have been submitted to the ABI for the reduction in stand-alone reorganizations?

Response No. 1:

In general, witnesses before the ABI Commission to Study the Reform of Chapter 11 (ABI Commission) have commented on two perceived trends in chapter 11 practice: a decrease in stand-alone plans of reorganization and an increase in the use of section 363 of the Bankruptcy Code to facilitate quick sales of all or substantially all of a company's assets.[1] Although largely anecdotal in nature, the testimony as a whole suggests that companies often do not have the liquidity or postpetition financing necessary to fund a more traditional plan of reorganization process. This fact then leads the company to a section 363 sale process or results in a dismissal or conversion of the case rather than plan confirmation. In addition, if the company is able to secure postpetition financing, the terms of that facility may include milestones or covenants that require the company to pursue a sale process.

A company's lack of liquidity may result from a variety of factors, including a delay in utilizing the chapter 11 tool and refinancings that increase the company's overall leverage. Testimony before the ABI Commission suggests that a company may delay a chapter 11 filing because of

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[1] *See* Mark Gittelman, Written Statement to the Commission, November 1, 2013, *available at* http://commission.abi.org ("Chapter 11 is no longer being used for true reorganizations in the manner it was envisioned when originally enacted. Now the 'normal' chapter 11 leads either to a fairly quick [section] 363 sale or to a forced or orderly liquidation of assets."); Bryan Marsal, Statement to the Commission, Hearing, October 26, 2012 (NCBJ Transcript pp. 15-19), *available at* http://commission.abi.org ("There is a gradual erosion of the underlying public principle of the Code which was to preserve jobs and maximize value through rehabilitation."); Gerald Buccino, Written Statement to the Commission, November 3, 2012, *available at* http://commission.abi.org ("Today's problems are even more daunting than the economic landscape faced during the creation of the 1978 Code. In light of the changes that led to BAPCPA, it appeared that debtors simply lost hope of reorganizing their businesses, instead opting for Chapter 7. BACPA seems to have impaired the rehabilitative goal of bankruptcy by leaving insufficient time to rehabilitate or fix many bankruptcy businesses."); Kathryn Coleman, Written Statement to the Commission, November 3, 2012, *available at* http://commission.abi.org ("As a result of amendments and changes in the worldview and behavior of creditors, the trend appears to be turning chapter 11 into an ever-more-efficient system for transferring value to creditors, making the 'fresh start' of a true reorganization somewhat rare.").

Responses of Prof. Michelle M. Harner (cont.)

concerns regarding loss of control in the case and costs associated with the process.[2] Some testimony also suggests that certain deadlines imposed by the Bankruptcy Code make reorganizations under chapter 11 more difficult for companies in certain industries, as well as for small and middle market companies.[3] Moreover, at several field hearings, participants discussed the increased use of secured debt by distressed companies and the impact of this development on business bankruptcies.

Notably, no one factor has been identified as the sole trigger for the changing chapter 11 landscape. Rather, various factors have been identified as contributing to that change.[4] Moreover, testimony has not definitively established that all of these factors are counterproductive in every case. For example, some witnesses emphasize the importance of robust credit markets to the restructuring of distressed companies.[5] Accordingly, the ABI Commission is carefully reviewing and considering the entire record from the public field hearings and the vast body of research produced by its advisory committees and academics in the field.

Question No. 2:

In your written testimony, you state that small and middle market companies are unable to effectively use Chapter 11. Could you elaborate on the testimony the ABI has received to date on that issue?

Response No. 2:

The testimony on small and middle market companies almost uniformly establishes that the process is too expensive, litigious, and complicated for these companies. The following witness statements are representative of these sentiments:

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[2] *See* John Haggerty, Written Statement to the Commission, April 19, 2013, *available at* http://commission.abi.org ("In the last ten years, there has been an increase in the use of out of court alternatives…because the process is too time consuming and complex, and as a result, too costly.").
[3] *See* Response No. 2 for representative testimony.
[4] The following witness statement is representative of this sentiment: "It is my perception that there are a number of factors that have led to the decline in 'true' reorganization, including: (i) escalating professional fees; (ii) uncertainty as to the outcome of a Chapter 11 case; (iii) inability to secure debtor-in-possession or exit financing; and (iv) lower cost alternatives, such as out-of-court restructurings, and traditional assignments for the benefit of creditors." (Jeffrey Wurst, Written Statement to the Commission, June 4, 2013, *available at* http://commission.abi.org).
[5] *See* A.J. Murphy, Written Statement to the Commission, October 17, 2012, *available at* http://commission.abi.org ("Secured lending is a critical part of the capital markets….Any movement towards allowing courts 'flexibility' to disregard secured creditors' rights in bankruptcy will introduce uncertainty and hamper the flow of credit into the marketplace."); John Greene, Written Statement to the Commission, October 17, 2012, *available at* http://commision.abi.org ("Access to the capital markets, particularly the market for distressed debt, is essential to improving a company's chances of reorganizing successfully.").

Responses of Prof. Michelle M. Harner (cont.)

- "The process of preparing a disclosure statement, obtaining approval of that document, soliciting creditor votes and satisfying the numerous requirements to obtain confirmation of the plan takes time and money. Adding to the costs is the requirement that the Chapter 11 debtor pay the costs of professional fees incurred by other entities in the case, such as creditor's committees. Provisions offering accommodations for small business debtors have been in the Code for some time, but do not appear to have alleviated these problems." (Hon. Dennis Dow, Written Statement to the Commission, April 19, 2013, *available at* http://commission.abi.org)
- "The application of the [absolute priority rule] and the so-called 'new value exception' to it in small to mid-size chapter 11 cases proves problematic.... There should be consideration as to whether small and mid-sized companies should have the opportunity to reorganize over the objection of an under-secured creditor who controls the unsecured vote. Perhaps requirements should vary depending on the size of the business being reorganized." (Hon. Barbara Houser, Written Statement to the Commission, April 19, 2013, *available at* http://commission.abi.org)
- "It's really widely understood and agreed, I think, in the community right now, that Chapter 11 just isn't cost-effective in the middle market. It doesn't really provide an opportunity of companies to rehabilitate themselves.... So people believe and I think I'm in this category as well, that Chapter 11 and the middle market is simply too slow, and it's simply too costly for almost all the cases." (Daniel Dooley, Statement to the Commission, Hearing, April 19, 2013, (ASM Transcript Pg. 37), *available at* http://commission.abi.org)
- "If we wish to preserve smaller businesses that provide the majority of new jobs in our economy, bankruptcy legislation cannot be a one-size-fits-all process. Special needs for small businesses must be considered in drafting bankruptcy legislation that addresses issues such as the debtor's period of exclusivity, the amount of time to assume or assign leases, and the ability to raise capital." (Gerald Buccino, Written Statement to the Commission, November 3, 2012, *available at* http://commission.abi.org)
- "The 45-day plan-confirmation deadline is unworkable. Data from the 2004 random sample demonstrates that in less than 3% of confirmed-plan cases was a plan confirmed within 45 days of its proposal. That figure is even more dismal for small business cases; less than 1% of small businesses that confirmed a plan in 2004 did so within 45 days of first-plan proposal. Had BAPCPA's 45-day deadline existed in 2004, 112 small business cases would not have confirmed a plan had debtor's counsel not sought and the bankruptcy court granted, pursuant to §1121(e)(3), an extension of the 45-day period." (Prof. Anne Lawton, Written Statement to the Commission, November 1, 2013, *available at* http://commission.abi.org)
- "The number of middle market and smaller businesses entering chapter 11 and emerging as viable enterprises is falling. Administrative costs for plans in middle market and smaller cases are too high and as a result, debtors are increasingly relying on numerous alternatives to the traditional chapter 11 process." (Prof. George Kuney, Written Statement to the Commission, November 7, 2013, *available at* http://commission.abi.org)

Question No. 3:

Near the conclusion of the hearing, it appeared that all of the witnesses were in general agreement regarding a proposed amendment to the Bankruptcy Code that would address

Responses of Prof. Michelle M. Harner (cont.)

concerns raised in Judge Sontchi's testimony regarding section 546(e) of the Bankruptcy Code. To what degree does similar consensus in support of such an amendment exist in the wider bankruptcy community? To this end, any feedback and input you have on developing a solution to these concerns as the Committee looks at these issues would be appreciated.

Response No. 3:

The treatment of financial contracts and derivatives under the Bankruptcy Code is a very complex and, in many respects, controversial issue. The ABI Commission recognized this in constituting its advisory committee on financial contracts, derivatives, and safe harbors, striving to enlist the help of judges, academics, and practitioners on all sides of the issue. As evidenced by the list of advisory committee members attached here to as Appendix A, the ABI Commission believes that it achieved this goal.

Judge Sontchi's testimony highlights an important issue in this area of the law. As a general proposition, I believe that many judges, academics, and practitioners believe that section 546(e) of the Bankruptcy Code has been extended beyond its original legislative purpose of protecting the securities transfer system. The ABI Commission and the advisory committee are studying these issues carefully and currently are working to identify the scope of these concerns and a tailored, effective resolution. They also are working to assess support for any proposed reforms in the larger restructuring community. I will update the Subcommittee as additional information becomes available.

Question No. 4:

As you know, the National Bankruptcy Review Commission issued its report and recommendations to Congress in 1997, some of which were ultimately enacted in 2005 as part of a comprehensive legislative package.

> Is the process that the ABI is using to solicit public input similar to that used by the 1997 Commission?
>
> Have all of the Commission's meetings and those of its advisory committees been open to the public?

Response No. 4:

I have studied at great length the processes of, and the final reports issued by, the National Bankruptcy Review Commission (NBRC) in 1997 and the Commission on Bankruptcy Laws of the United States in 1971. I believe that the ABI and the ABI Commission are drawing upon and learning from each of these prior Commission projects.

Specifically, with respect to the NBRC, the ABI Commission is using a similar advisory committee structure to undertake in-depth, substantive studies of broad topic areas. Whereas the

Responses of Prof. Michelle M. Harner (cont.)

NBRC used eight topic working groups, the ABI Commission is using thirteen topic advisory committees and an international working group. The thirteen topic advisory committees are:

- Financing Chapter 11
- Governance and Supervision of Chapter 11 Cases and Companies
- Multiple Enterprise Cases/Issues
- Financial Contracts, Derivatives and Safe Harbors
- Executory Contracts and Leases
- Administrative Claim Expansion, Critical Vendors and Other Pressures on Liquidity; Creation and/or Preservation of Reorganization Capital
- Labor and Benefit Issues
- Avoidance Powers
- Sales of Substantially All of the Debtor's Assets, Including Going-Concern Sales
- Plan Issues: Procedure and Structure
- Plan Issues: Distributional Issues
- Bankruptcy Remote Entities, Bankruptcy-Proofing and Public Policy
- The Role of Valuation in Chapter 11

These advisory committees spent approximately 18 months researching and discussing a variety of issues within their topic areas and submitted study reports to the ABI Commission in December 2013.[6] Similar to the NBRC, the ABI Commissioners retain authority for addressing and deciding each issue, and the ABI Commission is currently engaged in this deliberative process. It anticipates producing a preliminary report in December 2014.

To inform both the work of the advisory committees and the ABI Commission, the ABI Commission conducted 16 public field hearings in 11 different cities. Each of these hearings was open to the public, and the transcripts (and, in many cases, video recordings) are posted on the ABI Commission website at www.commission.abi.org. Over 90 individuals have submitted oral and/or written testimony in connection with these hearings. In addition, the ABI Commission proactively sought out and secured witnesses and forums that would represent the various constituents involved in and perspectives concerning the chapter 11 process. For example, the ABI Commission held public field hearings at events organized by the National Conference of Bankruptcy Judges, the National Association of Attorneys General, the States' Association of Bankruptcy Attorneys, the Association of Insolvency and Restructuring Advisors, the National Association of Credit Management, the Association of the Bar of the City of New York, the American College of Bankruptcy, the Commercial Finance Association, the Turnaround Management Association, and the Loan Syndications and Trading Association. Several hearings attracted more than 100 attendees.

The ABI Commission also worked with the University of Illinois College of Law to organize an academic symposium on the role of secured credit in business bankruptcies. Nineteen of the nation's leading bankruptcy scholars contributed to the symposium. The symposium was open to

[6] The ABI Commission has deferred the work of the multiple entities and corporate groups advisory committee until a later point in the process.

Responses of Prof. Michelle M. Harner (cont.)

the public, and the papers and a video recording of the event are (or will be) posted on the ABI Commission's website. The papers from this symposium also will be published in the *Illinois Law Review*.

Minutes from the meetings of the advisory committees and the ABI Commission are posted on the ABI Commission's website. The ABI Commission has not made any of its or the advisory committees' working papers or deliberations publicly available. Upon the completion of its deliberations, the ABI Commission will issue a report not only setting forth any reform proposals but also incorporating relevant materials from the ABI Commission's and advisory committees' study processes.

In addition, similar to the process followed by the NBRC, ABI Commissioners are appearing at restructuring events throughout the country to discuss and publicize the ABI Commission's work and solicit feedback from affected constituents. To this end, ABI Commissioners will be appearing at the following upcoming events: the O'Neill Institute in Cleveland in May, the NACM Credit Congress in Orlando in June, the Northeast Bankruptcy Conference in Stowe, Vermont in July, among other scheduled public events. The ABI Commission intends to continue these outreach efforts even after the issuance of its report in December 2014.

Question No. 5:

You note that over the course of the Commission's work to date, there is a perception that the number and speed of asset sales under Bankruptcy Code section 363 has increased.

Is that a positive or negative development?

Response No. 5:

The testimony before the ABI Commission suggests an increase in the number and speed of asset sales under section 363 of the Bankruptcy Code. The testimony is not, however, consistent on the impact of this development. Some witnesses view the quick section 363 sale as a detrimental change that, among other things, strips creditors of their right to vote on the company's restructuring plan and prematurely determines and cuts off the value available to satisfy creditors' claims.[7] Here, a repeated concern was the pressure on courts and creditors to assess and determine these critical issues with insufficient information and time. Other witnesses characterize this development as an effective means to preserve value and limit the costs associated with a bankruptcy case.[8] The ABI Commission is reviewing each of these

[7] *See* Gerald Buccino, Statement to the Commission, Hearing, November 3, 2012 (TMA Transcript Pg. 19) *available at* http://commission.abi.org ("363 sales should be delayed so as to improve the value to pre-petition creditors. If sales occur too quickly before the rehabilitative process, the yield to the pre-petition creditors is diminished.").

[8] *See* John Scott Victor, Statement to the Commission, Hearing, November 3, 2012 (TMA Transcript Pg. 10), *available at* http://commission.abi.org ("The overwhelming prevalence of section 363 sales is the result of good lawyering, market sophistication and efficiency – it preserves jobs and maximizes value.").

Responses of Prof. Michelle M. Harner (cont.)

perspectives, as well as conducting its own research, to assess the issues and find an appropriate balance of the competing considerations.

Question No. 6:

Has the ABI Commission taken into consideration any lessons learned from the experience of the National Bankruptcy Review Commission?

Response No. 6:

The ABI Commission has studied carefully the work and procedures used by the NBRC. One member of the NBRC, Babette Ceccotti, also serves on the ABI Commission, providing unique insight into the earlier experience. There are of course many differences between the ABI Commission and the 1994-97 Commission. The latter employed a reporter, three senior advisors, a general counsel, three staff attorneys, one volunteer staff attorney, a legislative counsel on detail from the U.S. Department of Justice, a part-time attorney responsible for the Commission's computerized database, and two administrative support personnel—funded by a multi-million dollar budget. The ABI Commission operates on a much smaller scope and scale, but has attempted to borrow the best practices of the NBRC, including ample public hearings with witnesses from a broad cross-section of the insolvency community: attorneys, financial advisors, judges, academics, lenders, and others. Although the NBRC was notable for sharp disagreements on many issues, particularly in the area of consumer bankruptcy where many Commission's votes were divided 5 to 4, there were several areas on which there was broad agreement, such as on cross-border insolvency procedures, provisions for direct appeal of bankruptcy court decisions, partnership bankruptcies, mass tort claims, and a number of procedures in small business bankruptcies. Several of these recommendations were enacted into law as part of the 2005 amendments. The ABI Commission, with its field of vision limited largely to chapter 11 matters, plans to emphasize consensus recommendations that can form the basis for a package of solid reforms to the Bankruptcy Code and Rules.

Question No. 7:

You note in your written testimony that there was a general consensus in the Commission's field hearings that chapter 11 cases have changed over time, causing an increase in the costs associated with chapter 11.

How have chapter 11 cases changed over time?

How have these changes resulted in higher costs?

Could costs be more transparent in chapter 11 cases?

How would greater cost transparency help parties in chapter 11 cases?

Responses of Prof. Michelle M. Harner (cont.)

Would greater oversight over the chapter 11 process help reduce costs?

Response No. 7:

The testimony at the public field hearings suggests that chapter 11 cases have changed over time in a number of ways, including: the use of different and more complex financial instruments; fewer traditional banks and more private funds and claims traders holding the company's debt; more and quicker section 363 sales of all or substantially all of the company's assets; companies entering chapter 11 with more secured debt and less equity available to support their restructuring efforts; and companies having to make certain decisions quicker to accommodate deadlines in the Bankruptcy Code or covenants in their lending documents.

Notably, the existence of this testimony does not mean that all of these changes are unhealthy or unwelcome or that all of them increase the cost of chapter 11. In fact, an increase in costs often was cited as an independent change that makes chapter 11 more difficult or impractical for certain companies, particularly small and middle market companies. According to the testimony, increases in chapter 11 costs might arise from the litigious nature of some case and, for small and middle market companies, from the process itself—e.g., the disclosure and reporting requirements, solicitation requirements, and the expertise often needed to help these companies simply understand the complex requirements of chapter 11. The following witness statements are representative of the testimony the ABI Commission has received on chapter 11 costs:

- "I believe [cost] has been going up. I believe that there is a proliferation of counsel. I believe that there is a proliferation of committees, ad-hoc committees that are getting paid for in certain cases. I also believe that we often don't police ourselves. I believe there's too often unnecessary fighting or issues that are raised." (Bryan Marsal, Statement to the Commission, Hearing, October 26, 2012, (NCBJ Transcript Pg 24) *available at* http://commission.abi.org)
- "My view is that the perceived Chapter 11 deficiencies regarding slow speed and high cost are one in the same. The more hand to hand legal combat on issues you have in a case, the slower the case progresses and the more expensive the case becomes. It is clear that Chapter 11 has become increasingly litigious of late." (Daniel Dooley, Written Statement to the Commission, April 19, 2013, *available at* http://commission.abi.org)
- "I believe there are several reasons for the high level of fees. At the onset of a case and sometimes even well into it, it is difficult for the judge to decide how many constituencies may be out of the money. This can lead to a proliferation of committees...The second problem is that committees whose claims are at or near the cusp of worthlessness have every reason to delay the case in the hope that the Debtor's business may turnaround...The third problem is the individual large creditor or ad hoc group of such creditors who may or may not be on the official committee for that class but who in any event play a proactive individual role in the proceeding and ultimately seek reimbursement of professional fees based on the argument of 'substantial contribution.'" (Wilbur Ross, Written Statement to the Commission, April 19, 2013, *available at* http://commission.abi.org)
- "The cost of financial advisors in bankruptcy is escalated by every constituency retaining an advisor at the company's expense. These multiple financial advisors often duplicate each other's work and duplicate each other's demands on the company's finance team which interferes with

Responses of Prof. Michelle M. Harner (cont.)

their ability to run the business. This pain is particularly acute in smaller companies with less finance staff. The composition and quantity of professionals and their cost estimates should be evaluated at the onset of the case in relation to the size of the case and the company's cash generation." (John Haggerty, Written Statement to the Commission, April 19, 2013, *available at* http://commission.abi.org)

- "Secured lender professional fees are a contributor to the escalating cost of Chapter 11. These fees seem to be far higher than they were years ago. In many cases, I can only attribute this escalation to the increasingly complex nature, size and composition of lender groups where much of the cost appears to be related to managing the group, avoiding exposure, and/or dealing with dissidents within the group. It is not clear that these incremental costs should be passed on to the company. FA's [financial advisors] and attorneys for the secured lenders should be required to be more transparent as to billings amount and work performed if their fees are being passed through to the debtor." (John Haggerty, Written Statement to the Commission, April 19, 2013, *available at* http://commission.abi.org)
- "We spend so much time, especially in this district looking at mega cases, it's nice to have the *Delphi*'s and *G.M.*'s and it's nice to be a court of choice for very large cases, but most of us grew up handling smaller cases and handling cases in the market that really cannot afford to seek protection any longer and there's something wrong with that system." (Jeffrey Wurst, Statement to the Commission, Hearing, June 4, 2013 (ABI NYIC Transcript Pg 28), *available at* http://commission.abi.org)
- Results of survey of members of the "Section regarding Chapter 11 practice and experience" of the "Bankruptcy Law Section of the State Bar of Texas": "88% of those responding felt that Chapter 11 is not utilized as much as in years past because it has become too expensive (and 98% of respondents agreed that Chapter 11 is more expensive now than 10 years ago)." (as reported by William Greendyke, Written Statement to the Commission, November 22, 2013, *available at* http://commission.abi.org)

The ABI Commission has not yet determined the best means for controlling costs and making chapter 11 more accessible and effective for all companies. It is, however, thoroughly studying these issues and is very mindful of the need to address the cost factor associated with the chapter 11 process.

Question No. 8:

You note in your written testimony that the consensus among small and middle-market companies was that chapter 11 no longer works for these companies as a result of barriers like cost and procedural obstacles.

Please describe some of these procedural obstacles.

Response No. 8:

Please see responses to questions numbers 2 and 7 above.

Responses of Prof. Michelle M. Harner (cont.)

Question No. 9:

Would the judicial system be better equipped to deal with the resolution of a systemically important financial institution than a federal regulatory agency such as the FDIC?

Response No. 9:

The ABI Commission has not yet focused on the utility of the Bankruptcy Code for resolving systemically important financial institutions. To date, the ABI Commission and its advisory committees have concentrated on issues that affect distressed companies in chapter 11 across the board. It does, however, intend to study the ability of chapter 11 to resolve distressed systemically important financial institutions in connection with issuing its final report.

Responses of Prof. Michelle M. Harner (cont.)

Appendix A

Financial Contracts, Derivatives, and Safe Harbors Advisory Committee

Lawrence Brandman, LAMCO, LLC (New York)
Mark C. Ellenberg, Cadwalader Wickersham & Taft LLP (Washington)
Seth Grosshandler, Cleary Gottlieb (New York)
Prof. Stephen Lubben, Seton Hall University School of Law (Newark)
Prof. Edward Morrison, University of Chicago Law School
Judge James G. Peck, U.S. Bankruptcy Court (S.D.N.Y.)
Judge Christopher S. Sontchi, U.S. Bankruptcy Court (D. Del)
Kimberly Summe, Partner Fund Management (San Francisco, CA)
Shmuel Vasser, Dechert LLP (New York)
Prof. Mark Roe, Harvard Law School (Cambridge)
Eric Waxman, Westerman Ball (Uniondale, NY)

Committee Co-chairs: Judge James G. Peck and Seth Grosshandler
Reporter: Prof. Edward Morrison and Eric Waxman