REPORT PURSUANT TO SECTION 202(e) OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010

ADMINISTRATIVE OFFICE OF THE
UNITED STATES COURTS

WASHINGTON, D.C. 20544

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I. Introduction

The economic turmoil that affected the global economy and markets beginning in late 2007 is well documented. This report does not seek to restate those events or evaluate the potential causes of the resulting recession. Rather, this report is forward-looking and considers the existing statutory schemes for resolving any future distress at bank holding companies and nonbank financial institutions. Specifically, it analyzes Title 11 of the United States Code (the "Bankruptcy Code"; a list of capitalized defined terms used herein is set forth at **Appendix A**) and Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act"). The Administrative Office of the United States Courts ("AOUSC") submits this report pursuant to section 202(e) of the Act.

The report proceeds as follows:

- Part II provides an executive summary of the report's primary findings and analysis with respect to the three issues identified for study in section 202(e) of the Act.
- Part III describes the mandate for this report and the process invoked to study the relevant issues and compile the report.
- Part IV sets forth the key elements of the Bankruptcy Code, as applied to bank holding companies and nonbank financial institutions, and Title II of the Act.
- Part V discusses some common advantages and disadvantages associated with each resolution scheme for insolvent financial institutions, particularly those posing systemic risk. It also discusses the relationship between the two schemes, including certain problematic aspects (e.g., invocation of Title II of the Act after an institution has filed bankruptcy). This part draws on the vast literature and actual case studies emerging from the recent recession.
- Part VI reviews potential modifications to the resolution schemes proposed by various commentators that might serve the underlying purpose of Title II of the Act—i.e., mitigating systemic risk posed by the failure of systemically important financial institutions. It also considers how such modifications might affect the operations of healthy financial institutions and whether such modifications are appropriate for all distressed financial institutions or just those posing systemic risk.

The report concludes in Part VII by summarizing the issues relevant to, and the status of, the resolution schemes applicable to large, complex financial institutions.

II. Executive Summary

Section 202(e) of the Act directs the AOUSC to study three specific issues that primarily focus on the resolution of distressed financial institutions under the Bankruptcy Code: (1) "the effectiveness of chapter 7 or chapter 11 of the Code in facilitating the orderly liquidation or

reorganization of financial companies"; (2) "ways to make the orderly liquidation process under the Bankruptcy Code for financial companies more effective"; and (3) "ways to maximize the efficiency and effectiveness of the Court," which presumably means the United States District Court for the District of Columbia under Title II of the Act, but may mean the United States Bankruptcy Court, as discussed *infra* Part V.E.

The AOUSC determined that the best way to approach the section 202(e) study was to systematically and objectively evaluate the application of the liquidation and reorganization provisions of the Bankruptcy Code to financial institutions generally, as well as to large, complex financial institutions that might qualify as "covered financial companies" under the Act. Accordingly, Part IV of this report reviews the key provisions of the Bankruptcy Code that likely would affect the reorganization or liquidation of a financial institution. It also summarizes key provisions of Title II of the Act for purposes of comparison. Part V of the report then explains the potential advantages and disadvantages of each resolution scheme in the context of large, complex financial institutions.

The study does not draw general conclusions about the "effectiveness" of the Bankruptcy Code in facilitating the "orderly" liquidation or reorganization of distressed financial institutions. First, these terms, "effective," "effectiveness," and "orderly," are undefined and may mean different things to different people. By way of example, some may view one or more of them to mean the amount of the dividend paid in the case, others may view them in terms of the amount of time it takes to pay those dividends while still others may view these terms in the context of how quickly the debtor's business is sold or transferred to another entity that operates the debtor's business thereby preserving jobs and minimizing any potential systemic risk. Second, each bankruptcy case is unique in various respects, including the events leading to the bankruptcy filing and the operations and finances of the business. Consequently, what constitutes an effective use of the Bankruptcy Code or an orderly resolution depends on the circumstances of the particular case.

For example, as explained *infra*, CIT Group Inc. ("CIT Group") utilized chapter 11 of the Bankruptcy Code to implement a plan of reorganization that allowed the company to emerge quickly from bankruptcy intact and with a much stronger capital structure. In contrast, as discussed *infra*, Lehman Brothers Holding Inc. ("Lehman Brothers") invoked chapter 11 of the Bankruptcy Code as an option of last resort. The Lehman Brothers case facilitated the sale of the assets of the company's investment bank, however, and it remains pending in an effort to maximize recoveries for creditors through the liquidation of the company's other assets and the pursuit and resolution of claims by and against the company. Although it may be easier to characterize the Bankruptcy Code as effective and the resolution orderly in the CIT Group bankruptcy case but not in Lehman Brothers, many individuals interviewed by the AOUSC working group contended that the Bankruptcy Code also worked quite effectively in the Lehman Brothers bankruptcy case and that the case proceeded in an orderly manner given the

circumstances presented at the time by the unplanned filing of the case and the potential systemic risk.

Many individuals interviewed by the AOUSC working group emphasized the functionality and flexibility of the Bankruptcy Code as reasons why the Bankruptcy Code could adapt to resolve distressed financial institutions. Nevertheless, these individuals and the AOUSC's independent research identified certain attributes of large, complex financial institutions that may create challenges not necessarily present in other business bankruptcy cases. These attributes include the nature of covered financial companies' assets, the importance of market confidence to their business model, their funding mechanisms and relationships with other market participants and the global nature of their operations. The impact of these attributes on the resolution of distressed financial institutions is discussed *infra* Part V.

Part VI of this report reviews several of the proposals suggested by commentators for better accommodating the resolution of financial institutions under the Bankruptcy Code. These proposals generally focus on mitigating the impact of any large, complex financial institution bankruptcy filing on the global economy and markets by, among other things, encouraging prebankruptcy planning, enhancing the involvement of the Federal Deposit Insurance Corporation ("FDIC") and other governmental agencies in the bankruptcy case, streamlining certain processes and/or modifying the treatment of financial contracts in bankruptcy.

Overall, the AOUSC's research to date suggests that many of the issues that preceded the Act emerged not only because of the business attributes of large, complex financial institutions but also because of the dire economic conditions facing the United States and other countries beginning in late 2007. Accordingly, it likely was this confluence of circumstances—and not the Bankruptcy Code or any one particular issue—that created challenges for Lehman Brothers in its chapter 11 case and for the other financial institutions that failed or were resolved under the Bankruptcy Code or the Federal Deposit Insurance Act ("FDIA"). On a preliminary review, the Bankruptcy Code appears to function well to address corporate distress, including in the context of bank holding companies and nonbank financial institutions. The existing data and literature, however, do not permit any conclusive resolution of the issues presented for study.

III. Scope and Methodology of Report

The recession beginning in December 2007 and ending in June 2009 is the longest and most severe recession experienced in the United States during the post-war period (National Bureau of Economic Research 2010, Bernanke 2010, Faberman 2010, Gascon 2009). The U.S. economy shrank 4.1 percent and the unemployment rate hit a 26-year high of 10.1 percent during this period (Chandra 2010). Although the recession affected all sectors of the U.S. economy, it hit the financial services sector particularly hard (Anderson 2009; Nanto, 2009). For example, during 2007 to 2010, numerous financial institutions (primarily bank holding companies and

nonbank financial institutions, including registered brokers or dealers) filed for protection under either chapter 7 or chapter 11 of the Bankruptcy Code, and over 300 banks were closed by the FDIC (**Appendix B**). In addition, large financial institutions worldwide recorded losses of $1.5 trillion during this period—losses primarily relating to pre-2007 high-risk investments (Wilmarth 2011).

The U.S. government adopted several regulatory responses to the recession, including the Troubled Asset Relief Program and the American Recovery and Reinvestment Act of 2009 (Nanto 2009). Nevertheless, the most sweeping set of reforms is set forth in the Act, which was signed into law on July 21, 2010 (Wilmarth 2011). The Act contemplates a variety of changes in the regulation of financial institutions, financial products and services and various market participants. The Act's stated goals are "[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes" (Preamble of Act).

Several sections of the Act were adopted in response to the failures of large financial institutions including Bear Stearns, Lehman Brothers and Merrill Lynch and the near collapse of American International Group ("AIG")—all institutions dubbed "too big to fail" by some commentators and policymakers. Bear Stearns was the first of these firms to fail, being sold to JPMorgan Chase for approximately $10 per share in a transaction that had the backing of the U.S. government (Press Release, Mar. 24, 2008; Cho & Irwin, Mar. 25, 2008). Similarly, the U.S. government assisted AIG with its liquidity issues by, among other things, extending $85 billion in financing to AIG in September 2008 (Press Release, Sept. 16, 2008). Between these two events—notably, the day before the Board of Governors of the Federal Reserve System ("Federal Reserve") announced the AIG financing—Lehman Brothers filed a chapter 11 bankruptcy case, and Merrill Lynch announced that it was selling itself to Bank of America (Press Releases, Sept. 15, 2008).

Some observers point to the Lehman Brothers' chapter 11 case as exacerbating the recession and triggering the credit crisis. These commentators speculate that the interconnectedness among Lehman Brothers and other large financial institutions and the resulting systemic risk accelerated the existing instability in the financial markets. *See infra* Part V.A. Other commentators view Lehman Brothers as a victim of the turmoil in the financial markets and the unfulfilled expectations of a government "bail-out" and assert that the sale facilitated by Lehman Brothers' chapter 11 case was successful under the circumstances (Skeel 2011). As discussed at various points *infra* Part V, the assets of Lehman Brothers' broker-dealer affiliate, Lehman Brothers, Inc. ("LBI"), were sold to Barclays Capital Inc. ("Barclays") during the first week of the chapter 11 case, and Lehman Brother's Chief Restructuring Officer is liquidating its remaining assets in an orderly manner in the chapter 11 case.

In light of these financial institution failures and the Act's resulting goals of promoting financial stability and ending "too big to fail," Title I of the Act, Financial Stability, creates the Financial Stability Oversight Council ("FSOC") and requires certain bank holding companies and nonbank financial institutions to submit resolution plans to the FSOC, Federal Reserve and FDIC. Act §§ 111, 165(d). Moreover, Title II, Orderly Liquidation Authority ("OLA"), creates a regulatory process for the FDIC to liquidate certain bank holding companies and nonbank financial institutions. This Part explains the genesis of this report under Title II of the Act and the study undertaken to comply with this mandate and compile the report.

A. Scope of this Report

As described further in Part IV.B, Title II of the Act establishes an orderly liquidation process for covered financial companies subject to regulation by the FDIC under the Act. The FDIC is charged with administering the orderly liquidation process as receiver for the covered financial company. If the FDIC is acting as a receiver, the OLA is the exclusive insolvency law applicable to that covered financial company. Accordingly, the Bankruptcy Code would not govern that covered financial company, and any bankruptcy case filed for that company would terminate upon the appointment of the FDIC as receiver. *See infra* Part IV.B.

In light of the new insolvency scheme created for covered financial companies under the Act, Title II mandates various studies to consider the implications of the new scheme and the existing alternatives to that scheme. *See, e.g.*, Act §§ 202(e), (f), 215-217. This report relates to the study mandated by section 202(e) of the Act, "Study of Bankruptcy and Orderly Liquidation Process for Financial Companies."

Section 202(e)(1)(B) requires the AOUSC to study the following three issues:

1. the effectiveness of chapter 7 or chapter 11 of the Bankruptcy Code in facilitating the orderly liquidation or reorganization of financial companies;
2. ways to maximize the efficiency and effectiveness of the Court [Title II defines "Court" to mean "the United States District Court for the District of Columbia, unless the context otherwise requires"];
3. ways to make the orderly liquidation process under the Bankruptcy Code for financial companies more effective.

Section 202(e) further requires the AOUSC to submit a report summarizing the results of the study "[n]ot later than 1 year after the date of enactment" of the Act—i.e., July 21, 2011. The AOUSC must file two subsequent annual reports in July 2012 and July 2013, and then a report "every fifth year after the date of enactment." This report is the first of the three annual reports required by the Act.

B. Methodology of Report

The AOUSC implemented a systematic and extensive process to comply with its obligations under section 202(e) of the Act. The AOUSC appointed a working group to study the issues identified in section 202(e). This working group is chaired by the Honorable Stuart Bernstein, United States Bankruptcy Judge for the Southern District of New York. Other members of the working group include: Judge Sidney H. Stein, United States District Court for the Southern District of New York; Judge James O. Browning, United States District Court for the District of New Mexico; Vito Genna, Bankruptcy Court Clerk for the Southern District of New York; Professor Michelle M. Harner, University of Maryland School of Law; Amanda L. Anderson, AOUSC Chief of the Bankruptcy Judges Division; Cathy A. McCarthy, AOUSC Deputy Associate Director of the Office of Management, Planning and Assessment; Steven R. Schlesinger, AOUSC Chief of the Statistics Division; Elizabeth C. Wiggins, Senior Research Associate of the Federal Judicial Center; Vanessa A. Lantin, Attorney Advisor of the AOUSC Bankruptcy Judges Division.

The working group approached the study in three phases: identifying and reviewing the existing literature on Title II of the Act and the questions posed by section 202(e); identifying and interviewing lawyers, financial professionals, academics, judges and individuals associated with the United States bankruptcy courts who have experience with or expertise in the questions posed by section 202(e); and assessing the information gathered in the first two phases for purposes of preparing this report and considering proposals offered by various third parties with respect to certain issues raised by the section 202(e) questions.

The literature reviewed by the working group was diverse and representative of various perspectives on the relevant issues. This literature review provided the working group with necessary background on the Act and the issues relating to the liquidation or reorganization of financial institutions under the Bankruptcy Code. It also informed the working group's questions for, and discussions with, various experts in phase two of the process. Many of the articles and essays included in this literature review are set forth in the Bibliography attached to this report.

The working group conducted 20 separate teleconferences to gather information and various perspectives on the liquidation or reorganization of financial institutions under the Bankruptcy Code or Title II of the Act. The working group interviewed 46 individuals during these teleconferences. The identity of these individuals and their affiliations, as well as the identity and affiliations of individuals providing assistance with this report, are listed in **Appendix C**. These individuals included professionals who were involved in some capacity with the liquidation or crisis management of bank holding companies, registered brokers or dealers and other nonbank financial institutions both before and during the recent

recession, including AIG, Allied Financial Group, CIT Group, Colonial Bank, Enron, Lehman Brothers, Refco and Washington Mutual. They also included professionals who participated in the legislative process resulting in prior amendments to the Bankruptcy Code (including the provisions dealing with financial contracts) and academics who have analyzed these and other relevant aspects of the financial distress of financial institutions. Parts V and VI aggregate and summarize some of the comments and perspectives of the individuals interviewed during phase two of the process, but these summaries represent only the working group's synthesis of the interviews and are not attributable to any particular individual.

The AOUSC and members of the working group also participated in several meetings with other federal agencies working on reports mandated by Title II of the Act, including the U.S. Government Accountability Office ("GAO") and the Federal Reserve, to discuss relevant issues and the scope and nature of the various reports. Nevertheless, this report reflects only the views and perspectives of the AOUSC.

IV. Overview of Resolution Schemes

A basic understanding of the key elements of the Bankruptcy Code and Title II of the Act is helpful in assessing the analysis of these resolution schemes set forth in Part V and the assessment of various proposals made by commentators included in Part VI. Accordingly, this Part first describes the provisions of the Bankruptcy Code applicable to a reorganization or liquidation of a financial institution. It then describes the basic structure of Title II of the Act.

A. The Bankruptcy Code

The Bankruptcy Code is the primary insolvency scheme available to U.S. companies. It addresses both traditional bankruptcy (i.e., straight liquidation) and reorganization. Chapter 7 of the Bankruptcy Code sets forth the straight liquidation procedures, with the mandatory appointment of an independent trustee and a liquidation of all of the debtor's assets. Chapter 11 of the Bankruptcy Code sets forth the reorganization procedures, with the debtor typically staying in possession and control of its assets and the reorganization process. Nevertheless, a trustee or examiner may be appointed in a chapter 11 case. In addition, a debtor in possession may sell substantially all of its assets in a chapter 11 case. (A debtor in possession in a chapter 11 case has the same general powers and duties as a chapter 7 or chapter 11 trustee; thus, references to "trustee" herein in the chapter 11 context include the debtor in possession and vice versa, as applicable.)

This subpart explains the chapter 7 and chapter 11 processes in the context of distressed financial institutions. It also provides an overview of chapter 15 of the Bankruptcy Code, which addresses cross-border insolvency cases.

1. Policies Underlying the Bankruptcy Code

An understanding of the general policies underlying the Bankruptcy Code informs any study of the structure and mechanics of the chapter 7 and chapter 11 processes. The policy objectives are multifaceted. For example, the Bankruptcy Code strives to achieve equality of distribution among similarly-situated creditors. *See, e.g.,* Begier v. IRS, 496 U.S. 53, 58 (1990) ("Equality of distribution among creditors is a central policy of the Bankruptcy Code. According to that policy, creditors of equal priority should receive pro rata shares of the debtor's property."). Likewise, it seeks to maximize the value of the debtor's estate (i.e., the assets available for distribution to creditors) in order to increase returns to creditors. *See, e.g.,* Toibb v. Radloff, 501 U.S. 157, 163 (1991) ("[C]hapter 11 also embodies the general Code policy of maximizing the value of the bankruptcy estate."). In addition, the Bankruptcy Code reflects a general preference for rehabilitating a company rather than liquidating it. *See, e.g.,* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984) ("The fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources.").

The Bankruptcy Code offers a trustee several useful tools for achieving its primary policy objectives. These tools include, among others: the automatic stay, 11 U.S.C. § 362; ability to obtain debtor-in-possession (i.e., postpetition) financing, 11 U.S.C. § 364, and use cash collateral, 11 U.S.C. § 363; ability to sell property, often free and clear of interests, 11 U.S.C. § 363; ability to reject burdensome executory contracts and unexpired leases, 11 U.S.C. § 365; and power to avoid certain prepetition and postpetition transfers and unrecorded liens, 11 U.S.C. §§ 544, 545, 547, 548, 549, 553. These tools are each discussed further below. The process is transparent; the trustee's actions out of the ordinary course are subject to notice and a hearing and approval or disapproval by the bankruptcy court.

2. Who May Be a Debtor Under the Bankruptcy Code

In general, only an individual, partnership or corporation domiciled in the United States may be a debtor under the Bankruptcy Code. 11 U.S.C. § 109(a). This requirement is further restricted based on the chapter of the Bankruptcy Code applicable to the debtor. These restrictions apply to financial institutions as follows:

- Insurance companies and commercial banks (e.g., depository banks, savings and loan associations, etc.) may not be debtors under either chapter 7 or chapter 11 of the Bankruptcy Code. 11 U.S.C. §§ 109(b)(2) (domestic), (b)(3) (foreign insurance companies or commercial banks doing business in the United States), (d). *Note—an uninsured state member bank or a corporation organized under section 25A of the Federal Reserve Act operating as a multilateral clearing organization may be a debtor under chapter 11.* 11 U.S.C. § 109(d).

- Stockbrokers and commodity brokers may not be debtors under chapter 11 of the Bankruptcy Code. 11 U.S.C. § 109(d).

The financial distress of entities excluded from the Bankruptcy Code is resolved under the applicable state or federal nonbankruptcy law. Moreover, special provisions govern the liquidation of stockbrokers and commodity brokers under chapter 7 of the Bankruptcy Code that, among other things, permit the Securities Investor Protection Corporation ("SIPC") to seek a stay of the chapter 7 case in favor of the SIPC's liquidation of the entity under the Securities Investor Protection Act of 1970 ("SIPA"). 11 U.S.C. §§ 741-767. Nevertheless, bankruptcy courts often preside over SIPA proceedings, which can be removed to the bankruptcy court (Madoff Order, Dec. 15, 2008). 15 U.S.C. § 78eee.

3. General Provisions Applicable in Both Chapter 7 and Chapter 11 Cases

A chapter 7 or a chapter 11 case is commenced by the filing of either a voluntary bankruptcy petition by the debtor or an involuntary bankruptcy petition by generally three or more creditors against the debtor. 11 U.S.C. §§ 301, 303 (in some cases, only one creditor may be necessary to file an involuntary petition against a debtor). The case typically is filed in the United States bankruptcy court for the jurisdiction in which the debtor is incorporated, has its principal place of business or principal asset. 28 U.S.C. § 1408. In addition, a company may file in a jurisdiction in which a case is already pending concerning one of its affiliates. *Id.* Although the United States district courts have original and exclusive jurisdiction over all cases filed under the Bankruptcy Code, 28 U.S.C. § 1334, they generally refer all bankruptcy cases to the bankruptcy courts in the particular jurisdiction. *See* 28 U.S.C. § 157(a).

Immediately upon the filing of a voluntary or involuntary petition, the bankruptcy estate is created and the automatic stay takes effect. The bankruptcy estate generally includes all of the debtor's legal and equitable interests in property as of the petition date. 11 U.S.C. § 541(a). The automatic stay is an injunction that prevents creditors and others from prosecuting or collecting most prepetition claims or interfering with or attempting to gain control over property of the estate. 11 U.S.C. § 362(a).

Although both the estate and automatic stay provisions are subject to certain exceptions, these two tools are central to the bankruptcy process. The estate collects all of the debtor's assets that are available to pay creditors' claims, and it may be enlarged by the trustee through the pursuit of prepetition claims and causes of action belonging to the debtor, preference claims, fraudulent conveyance claims and other avoidance actions permitted by the Bankruptcy Code. 11 U.S.C. §§ 544, 545, 547, 548, 549, 553. The automatic stay in turn gives the trustee an opportunity to assess the debtor's financial condition, prevents creditors from prematurely or unfairly dismantling the estate and works to maximize the value of the estate and returns to creditors. Creditors subject to the automatic stay may request adequate protection of their interest during the pendency

of the stay or, alternatively, may request relief from the stay for cause or under certain other circumstances. 11 U.S.C. §§ 362(d), 361. An important exception to the automatic stay in the context of financial institutions relates to financial contracts and is discussed *infra* Part IV.A.8.

In addition, a trustee may unilaterally elect to assume, assume and assign or reject the debtor's executory contracts and unexpired leases after notice and a hearing. 11 U.S.C. § 365. This power is subject to certain exceptions, including for financial contracts that are terminated by the counterparty and financial accommodation contracts (such as a revolving loan). 11 U.S.C. § 365(c). A trustee also must generally cure or provide for cure of any existing defaults under executory contracts and unexpired leases to be assumed or assumed and assigned, and must provide adequate assurance of future performance. 11 U.S.C. § 365(b), (f).

Creditors and shareholders generally have the ability to participate in the process and have standing to be heard by the court on most issues. They may, and in some instances must, file a proof of claim or interest that sets forth the amount, nature and basis for their claims and interests against the debtor. 11 U.S.C. §§ 501, 502, 506; Fed. R. Bankr. P. 3002, 3003. The trustee or any party in interest may then object to the claim or interest generally at any time prior to the closing of the case or as otherwise ordered by the court. Fed. R. Bankr. P. 3007. If no objection is filed or the claim or interest is otherwise allowed by the court, the creditor or shareholder receives a distribution only to the extent of its allowed claim or interest and only as permitted by the applicable priority scheme, or as otherwise agreed or approved under a confirmed plan, based on the value available for distribution in the case. 11 U.S.C. §§ 502, 726, 1129.

4. General Chapter 7 Process

As noted above, an independent trustee is appointed to displace the debtor in a chapter 7 case. The trustee is charged with administering the bankruptcy estate in a manner that maximizes returns to the general unsecured creditors.

The end goal of a chapter 7 case is to liquidate all of the debtor's nonexempt assets, distribute the funds to creditors in accordance with the statutory priority scheme and discharge the individual debtor from his or her dischargeable prepetition debts. As discussed *infra* Part IV.A.7, section 363 of the Bankruptcy Code governs asset sales in bankruptcy. A trustee may sell the debtor's assets on a piecemeal or going concern basis, provided that any sale out of the ordinary course of business requires prior notice, hearing and court approval. 11 U.S.C. § 363(b).

The length of a chapter 7 case varies based on, among other things, the type of sale pursued by the trustee, the complexity and nature of the claims asserted against the estate and whether the trustee pursues any litigation on behalf of the estate. The chapter 7 case itself typically continues after the liquidation of assets to complete the claims

administration process. A business debtor, including a financial institution, does not receive a discharge in a chapter 7 case. 11 U.S.C. § 727. All costs and expenses of administering the chapter 7 case are paid by the bankruptcy estate—i.e., paid from assets otherwise available to pay creditors and shareholders. 11 U.S.C. § 507.

5. General Chapter 11 Process

As noted above, a company generally can stay in possession and control of its assets and restructuring efforts as a debtor in possession under chapter 11 of the Bankruptcy Code. 11 U.S.C. § 1107. A debtor in possession is authorized to, among other things, continue to operate its business and even may continue to sell and use assets in the ordinary course of business. 11 U.S.C. § 363(c). A debtor in possession also may obtain postpetition financing (i.e., debtor-in-possession financing) with priority senior to its existing secured creditors and use its cash collateral if certain conditions are satisfied. 11 U.S.C. § 364.

The most commonly stated end goal of a chapter 11 case is to confirm a plan of reorganization. A plan of reorganization essentially is a new contract between the debtor and its creditors regarding the repayment of the creditors' claims (and in rare cases, shareholders' interests). Traditionally, a plan of reorganization facilitated a stand-alone restructuring of the debtor, with the same basic company emerging as the reorganized debtor after the chapter 11 case. Nevertheless, a debtor also may resolve its financial distress in a chapter 11 case by selling all of its reorganized stock to a third party under a plan of reorganization or selling some or substantially all of its assets under section 363 of the Bankruptcy Code.

If a debtor in possession pursues a plan of reorganization, it receives an initial exclusivity period, which can be extended for cause, to propose and solicit acceptances of its plan from creditors and shareholders. 11 U.S.C. § 1121. After the exclusivity period expires, any creditor or party in interest may file a plan for the debtor. Creditors and shareholders whose claims or interests are impaired under the plan are entitled to vote to accept or reject the plan. 11 U.S.C. § 1126. A class of creditors or shareholders accepts the plan if two-thirds in amount and over half in number of those voting vote in favor of the plan. *Id.* A debtor or plan proponent has the ability to seek court approval of its plan so long as one impaired class of creditors or shareholders accepts the plan. 11 U.S.C. § 1129.

If a trustee pursues a sale of assets under section 363 of the Bankruptcy Code, the proceeds of the sale can be distributed to creditors either through a plan of liquidation (that follows the same approval process described *supra* for plans of reorganizations), conversion to a chapter 7 case or, in certain cases, a distribution order from the court. Sales of substantially all of a debtor's assets under section 363 in chapter 11 cases may be viewed as potential end-runs around the plan of reorganization confirmation process—e.g., the sales may be characterized as resolution plans that do not satisfy the solicitation

and confirmation requirements of the Bankruptcy Code (commonly referred to as *sub rosa* plans). Nevertheless, many chapter 11 cases involve asset sales under section 363 of the Bankruptcy Code that convert non-cash assets that may be wasting or difficult to manage into cash or more liquid assets. *See infra* Part IV.A.7. In addition, some jurisdictions have developed standards to facilitate orderly, transparent section 363 sales in appropriate circumstances in chapter 11 cases. *See, e.g.*, C.D. Ca. Bankr. L.R. 6004-1 (establishing procedures for asset sales, including sales of publicly traded assets); Del. Bankr. L.R. 6004-1 (setting forth disclosures required in sale context and procedures governing auctions); S.D.N.Y. General Order M-383 (setting forth guidelines for the conduct of asset sales).

A trustee or examiner may be appointed in a chapter 11 case under certain circumstances. 11 U.S.C. § 1104. A trustee displaces the debtor in possession. The appointment of an examiner does not displace the debtor in possession, but it may be the prelude to the appointment of a chapter 11 trustee, or it may provide a focus for an important investigation, such as into potential avoidance claims. In addition, in most large chapter 11 cases, the United States trustee (i.e., an arm of the Department of Justice that monitors bankruptcy cases in all states but North Carolina and Alabama where the Bankruptcy Administrator, who is part of the Judicial Branch, assumes the role of the U.S. trustee) appoints a statutory committee of several of the largest unsecured creditors in the chapter 11 case. 11 U.S.C. § 1102. The statutory committee acts as a fiduciary for the constituency it represents, and it can investigate and review the debtor's conduct and participate in the chapter 11 case. 11 U.S.C. § 1103. The United States trustee also can appoint other statutory committees, including a statutory committee of shareholders. Finally, groups of creditors or shareholders sometimes join together in unofficial or *ad hoc* committees to advance their interests.

The length of a debtor's chapter 11 case depends upon the extent of the debtor's pre-bankruptcy planning, the proposed course for restructuring in or exiting chapter 11 (i.e., plan of reorganization or liquidation or sale), the complexity of the debtor's business, the nature and amount of claims asserted against the debtor and any litigation pursued in connection with the case. A debtor may resolve its financial distress in a more expeditious manner in chapter 11 by using a prepackaged plan or, if warranted, a section 363 sale. A prepackaged plan is negotiated between the debtor and its key creditors and voted on by impaired classes of creditors prior to the filing of the chapter 11 case. 11 U.S.C. §§ 1125, 1126. A debtor can receive a discharge in chapter 11 if it reorganizes under its confirmed plan of reorganization and continues in business. If a plan is not confirmed, the chapter 11 case may be converted to a case under chapter 7 (either to facilitate an asset sale or to distribute the proceeds from any asset sales conducted during the chapter 11 case) or dismissed. 11 U.S.C. § 1112. Again, all costs and expenses of administering the chapter 11 case are paid by the bankruptcy estate—

i.e., paid from assets otherwise available to pay creditors and shareholders. 11 U.S.C. § 507.

6. Special Procedures for the Chapter 11 "Mega-Case"

The United States bankruptcy courts frequently handle chapter 11 cases for large, complex companies. On average, 61.3 chapter 11 mega-cases are filed annually, and these filings tend to be concentrated in the United States Bankruptcy Courts for the District of Delaware and the Southern District of New York. This average is based on the AOUSC's mega-case database (described at **Appendix D**) which reports 678 "lead" chapter 11 cases that qualify as mega-cases for the period January 1, 2000 through September 30, 2010. The AOUSC defines a "mega-case" as "an extremely large case with: (1) at least 1,000 creditors; (2) $100 million or more in assets; (3) a great amount of court activity as evidenced by a large number of docket entries; (4) a large number of attorneys who have made an appearance of record; and (5) regional and/or national media attention" (Bartell 2009). The database also includes 8,772 cases meeting the AOUSC's mega-case criteria that are associated with the 678 lead cases; this number of associated cases is conservative because the database does not include associated cases that do not meet the mega-case criteria.

As a result, the bankruptcy courts and professionals working with these companies have extensive experience with the administration of mega-cases. Moreover, various procedures and best practices have emerged that guide bankruptcy courts in administering mega-cases and provide clear guidelines to parties participating in those cases. The Federal Judicial Center ("FJC"), working with the bankruptcy courts and bankruptcy professionals, has in turn published *A Guide to the Judicial Management of Mega-Cases* (the "*Mega-Case Guide*"), which was first published in 1992 and then subsequently updated in 2009 (Bartell 2009). In addition, the Bankruptcy Rules were amended in 2007 to incorporate rules that govern certain aspects of chapter 11 mega-cases, including the filing and resolution of first-day motions, the claims resolution process and the timing of certain proceedings before the bankruptcy court (Bartell 2009). *See, e.g.*, Fed. R. Bankr. P. 3007, 4001, 6003. Likewise, several jurisdictions have adopted local rules to govern asset sales under section 363 of the Bankruptcy Code and the solicitation and confirmation of prepackaged chapter 11 plans.

The *Mega-Case Guide* explains the procedures typically invoked by the bankruptcy courts to facilitate the efficient administration of mega-cases. These procedures include expedited notice of any pleadings needing immediate attention from the bankruptcy court upon the filing of the chapter 11 case (commonly called "first-day motions"); use of a website, hotline or separate public relations firm (retained by the debtor) to handle inquiries from parties in interest; use of a core shortened notice list approved by the bankruptcy court, electronic service of notices and pleadings or a separate noticing agent

(retained by the debtor) to handle the service of notices and pleadings in the case; and special procedures or the use of a separate claims agent (retained by the debtor) to handle the filing and administration of proofs of claim, which may number in the tens of thousands (Bartell 2009). *See also* Bankruptcy Rules 2002, 9036. Bankruptcy courts also typically approve case-management orders in mega-cases addressing, among other things, the noticing procedures for the case, scheduling of omnibus and emergency hearings on motions and adversary proceedings, the setting of appropriate deadlines for major events in the case and the rules governing the appearance of counsel.

Beyond administrative matters, the *Mega-Case Guide* also explains the procedures adopted by bankruptcy courts in mega-cases to facilitate the timely and efficient resolution of complex litigation, the claims resolution process and the solicitation and confirmation of any plan of reorganization. For example, pursuant to Bankruptcy Rule 3007, a debtor may object to up to 100 individual claims in a single, "omnibus" claims objection on certain grounds, thereby streamlining the objection and resolution process. In addition, bankruptcy courts frequently approve claims resolution procedures that encourage private party negotiation in order to facilitate consensual resolution of any disputed claims issues (Bartell 2009). Many of the motions, orders and procedures used to streamline the chapter 11 process in mega-cases are now standardized in various jurisdictions and available to the parties prior to any chapter 11 filing, again increasing certainty for parties in interest.

7. Section 363 Sale Process

A trustee may sell some or substantially all of the debtor's assets in the bankruptcy case. 11 U.S.C. § 363. As noted *supra* Part IV.A.5, a sale of substantially all of a debtor's assets under section 363 in a chapter 11 case, at least where those assets are not at risk of rapidly decreasing in value, may be questioned as either short-circuiting of the chapter 11 process or, if it also involves allocation of value to various creditors, a *sub rosa* plan in violation of section 1129 of the Bankruptcy Code. Although questions linger and may warrant further study, section 363 sales currently are used in many instances to facilitate a going-concern sale or the orderly liquidation of the debtor in a chapter 11 case. *See infra* Part VII.

Section 363 and Bankruptcy Rules 2002(a) and 6004 generally require that the trustee provide reasonable notice of the sale hearing to all creditors and indenture trustees, as well as any party asserting a claim or interest in the assets being sold. Parties in interest may file objections to the proposed sale, and the trustee may sell the assets only after the court enters an order approving the sale. 11 U.S.C. § 363(b); Fed. R. Bankr. P. 6004.

Section 363 authorizes a trustee to, among other things, sell the assets "free and clear of any interest in such property of an entity other than the estate" if certain conditions

are met. 11 U.S.C. § 363(f). In many cases, a sale free and clear of claims and interests is pursued under either section 363(f)(1) ("applicable nonbankruptcy law permits sale of such property free and clear of such interest") or section 363(f)(5) ("such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest"). The interests of creditors and others in the assets being sold attach to the sale proceeds upon the closing of the sale.

Sales under section 363 often are accompanied by a bidding process and auction designed to ensure that the estate receives the highest and best offer for the assets. The terms of bidding and auction procedures vary based on the facts of the particular case, and a court may approve an asset sale without such a process if warranted under the circumstances. Fed. R. Bankr. P. 6004. Again, depending on the facts of the particular case, a section 363 sale can be completed very quickly or may take additional time. *See infra* Part V.C.

8. Financial Contracts and the Bankruptcy Code Safe Harbors

The Bankruptcy Code includes certain protections for financial contracts qualifying as a securities contract, commodities contract, forward contract, repurchase agreement, swap agreement or master netting agreement (collectively referred to as "safe harbor contracts"). 11 U.S.C. §§ 362(b)(27), 546(e)-(g), (j), 555, 556, 559, 560, 561, 562. Each of these terms is defined in the Bankruptcy Code. 11 U.S.C. §§ 101, 741. These definitions in turn are broad in scope (Lubben 2010). For example, the term "securities contract" includes:

(i) a contract for the purchase, sale, or loan of a security, a certificate of deposit, a mortgage loan, any interest in a mortgage loan, a group or index of securities, certificates of deposit, or mortgage loans or interests therein (including an interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option, and including any repurchase or reverse repurchase transaction on any such security, certificate of deposit, mortgage loan, interest, group or index, or option (whether or not such repurchase or reverse repurchase transaction is a "repurchase agreement", as defined in section 101);

(ii) any option entered into on a national securities exchange relating to foreign currencies;

(iii) the guarantee (including by novation) by or to any securities clearing agency of a settlement of cash, securities, certificates of deposit, mortgage loans or interests therein, group or index of securities, or mortgage loans or interests therein (including any interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan,

interest, group or index, or option (whether or not such settlement is in connection with any agreement or transaction referred to in clauses (i) through (xi));

(iv) any margin loan;

(v) any extension of credit for the clearance or settlement of securities transactions;

(vi) any loan transaction coupled with a securities collar transaction, any prepaid forward securities transaction, or any total return swap transaction coupled with a securities sale transaction;

(vii) any other agreement or transaction that is similar to an agreement or transaction referred to in this subparagraph;

(viii) any combination of the agreements or transactions referred to in this subparagraph;

(ix) any option to enter into any agreement or transaction referred to in this subparagraph;

(x) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), (iii), (iv), (v), (vi), (vii), (viii), or (ix), together with all supplements to any such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a securities contract under this subparagraph, except that such master agreement shall be considered to be a securities contract under this subparagraph only with respect to each agreement or transaction under such master agreement that is referred to in clause (i), (ii), (iii), (iv), (v), (vi), (vii), (viii), or (ix); or

(xi) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this subparagraph, including any guarantee or reimbursement obligation by or to a stockbroker, securities clearing agency, financial institution, or financial participant in connection with any agreement or transaction referred to in this subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562.

11 U.S.C. § 741(7). Likewise, the term swap agreement includes traditional interest rate, currency, equity, debt, total return, commodities and inflation swaps, options and futures, as well as:

(ii) any agreement or transaction that is similar to any other agreement or transaction referred to in this paragraph and that—

(I) is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap or other derivatives markets (including terms and conditions incorporated by reference therein); and

(II) is a forward, swap, future, option, or spot transaction on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value;

11 U.S.C. § 101(53B). Additional definitions of key terms relating to safe harbor contracts or their treatment under the Bankruptcy Code are set forth in 11 U.S.C. §§ 101(25), (38A), (47); 11 U.S.C. § 761(4).

The protections afforded counterparties to safe harbor contracts are found in several provisions of the Bankruptcy Code. For example, a counterparty can enforce an *ipso facto* clause and terminate the contract immediately upon the debtor's bankruptcy filing notwithstanding the general automatic stay and the unenforceable nature of *ipso facto* clauses in most executory contracts and unexpired leases. 11 U.S.C. §§ 362(b)(27), 365(e), 541(c). A counterparty can immediately close out these contracts, calculate any damages permitted by the contract, "net" or set off these damages against any amounts it owes the debtor under the contract and apply any collateral held by the counterparty to satisfy its damages claim (Baird & Morrison 2010, Roe 2009). 11 U.S.C. §§ 555, 556, 559, 560, 561, 562. Moreover, most prepetition transactions with, or actions by, a counterparty to a safe harbor contract cannot be challenged as a preference, fraudulent transfer (except for instances of actual fraud) or other avoidable transfer. 11 U.S.C. § 546(e)-(g), (j).

The safe harbor provisions of the Bankruptcy Code collectively remove safe harbor contracts from the bankruptcy process. Counterparties to safe harbor contracts are permitted to enforce their prepetition contract rights as if the bankruptcy case had not been commenced but the debtor was otherwise in default under the contracts. Most safe harbor contracts are governed by the terms of either the 1992 or 2002 Master Agreements promulgated by the International Swaps and Derivatives Association, Inc. ("ISDA"). The ISDA Master Agreements typically contain *ipso facto* clauses and broad remedy provisions for non-defaulting counterparties. Counterparties rely on the terms of the ISDA Master Agreements to close out their positions under terminated safe harbor contracts and to calculate any remaining damages claim against the debtor's estate (Mengle 2010). The safe harbor provisions are discussed further *infra* Parts V.H, VI.A.

Notably, the original safe harbors enacted in 1978 were designed specifically to prevent the spread of insolvencies among commodity brokers and forward contract merchants in the commodities markets. They were subsequently expanded to stock brokers and clearing houses (1982), repurchase agreements (1984), swap agreements (1990), and in 2005, to essentially all derivatives and master netting agreements

(Edwards & Morrison 2005, Gilbane 2010). The primary justification for safe harbors is that they reduce systemic risk and market instability—specifically, the possibility that locking the financial assets of one company in the bankruptcy will force its counterparties into bankruptcy, starting a chain reaction of insolvencies (Krimminger 2006, Mengle 2010, Peck 2011).

9. Overview of Chapter 15

Chapter 15 of the Bankruptcy Code applies to cross-border insolvency cases. Chapter 15 incorporates the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law (Adler 2011, Bufford 2009). Accordingly, application of chapter 15 in U.S. cases must generally align with the approaches of other countries adopting the Model Law.

Chapter 15 seeks to increase coordination of cross-border cases but focuses primarily on those in which the chapter 15 case is ancillary to a foreign proceeding. Under chapter 15, a representative of a foreign debtor can file a petition for recognition of the foreign proceeding. 11 U.S.C. § 1504. Upon an order of the bankruptcy court recognizing the proceeding, the foreign representative is authorized to continue to operate the debtor's business and may invoke certain provisions of the Bankruptcy Code, including the automatic stay of section 362. 11 U.S.C. § 1520. The foreign representative also obtains standing in other bankruptcy cases and the ability to seek relief for the debtor in the federal and state courts of the United States. 11 U.S.C. § 1509.

B. Title II of the Act

Title II of the Act authorizes the Secretary of the Treasury ("Secretary") to appoint the FDIC as receiver for any covered financial company. Once appointed, the FDIC is authorized to liquidate the assets of the covered financial company in a process akin to the FDIC's authority over insured depository banks under the FDIA (FDIC, Notice of Proposed Rulemaking, Jan. 2011). As described below, the OLA is an administrative process that gives the FDIC discretionary authority over many aspects of the covered financial company's liquidation and subjects the FDIC's decisions only to ex post judicial review (Baird & Morrison 2010). Title II of the Act displaces the Bankruptcy Code and any other applicable insolvency scheme with a new resolution process for those entities covered by the statute. Act § 202(c)(2). (This subpart incorporates some material from an outline of Title II of the Act prepared for the FJC (McKenzie 2011).)

1. Policies Underlying the Act

Title II of the Act reflects several policy objectives emerging from the recent recession. For example, the OLA is intended to facilitate quick, administrative liquidations of certain financial institutions without the need for taxpayer funding or a government bail-out. The process targets financial institutions that pose systemic risk in an effort to promote

greater financial stability. Title II seeks to liquidate "failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard." Act § 204(a).

2. Financial Institutions Covered by Title II of the Act

The Act does not provide a specific list of financial companies subject to OLA. Rather, it defines the term "financial company" broadly to include a bank holding company, a nonbank entity supervised by the Federal Reserve, an entity "predominantly engaged in activities that the [Federal Reserve] has determined are financial in nature or incidental thereto" under the Bank Holding Company Act, and certain subsidiaries of any of these. Act § 201(a)(11). The government-sponsored enterprises Fannie Mae and Freddie Mac are excluded, as are entities chartered under the Farm Credit Act. In addition, the term "financial company" does not include an entity "if the consolidated revenues of such company from such activities constitute less than 85 percent of the total consolidated revenues of such company, as the Corporation, in consultation with the Secretary, shall establish by regulation." Act § 201(b).

A "covered financial company" is "a financial company for which a determination has been made under section 203(b)." Act § 201(a)(8). Section 203(b) in turn gives the Secretary, in consultation with the President, the power to determine that a financial company should be subject to OLA based on the following factors:

1. the financial company is in default or in danger of default;
2. the failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States;
3. no viable private sector alternative is available to prevent the default of the financial company;
4. any effect on the claims or interests of creditors, counterparties, and shareholders of the financial company and other market participants as a result of actions to be taken under this title is appropriate, given the impact that any action taken under this title would have on financial stability in the United States;
5. [an orderly liquidation under the Act] would avoid or mitigate such adverse effects, taking into consideration the effectiveness of the action in mitigating potential adverse effects on the financial system, the cost to the general fund of the Treasury, and the potential to increase excessive risk taking on the part of creditors, counterparties, and shareholders in the financial company;
6. a Federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to the regulatory order; and

7. the company satisfies the definition of a financial company under section 201.

The *ad hoc* nature of determining whether a financial institution qualifies as a "covered financial company" subject to the OLA creates some uncertainty for financial institutions and the markets generally. It also presents challenges in evaluating the provisions of the Bankruptcy Code and Title II of the Act in the context of these companies. *See infra* Part V.

3. Commencement and Judicial Review

The Title II process begins with a recommendation by the Secretary, two-thirds of the FDIC and two-thirds of the Federal Reserve that the FDIC be appointed as receiver for a covered financial company. Act §203(a)(1)(A). The Secretary then must commence the OLA proceeding for the covered financial company if, in consultation with the President, it is determined appropriate under section 203(b) of the Act (Skeel 2010). Once the decision is made, the Secretary notifies the covered financial company and, upon consent by the company, appoints the FDIC as receiver for the company.

If the board of directors of a covered financial company does not consent to the appointment of the FDIC as receiver, the Secretary must file a petition to take over the covered financial company and to appoint the FDIC as receiver in the United States District Court for the District of Columbia. Act § 202(a)(1)(A)(i). The Act directs the Secretary to file the OLA petition under seal, and no party is permitted to disclose the existence of the proceeding. Act §202(a)(1)(A), (C).

Judicial review by the district court is limited to "whether the determination of the Secretary that the covered financial company is in default or in danger of default and satisfies the definition of a financial company … is arbitrary and capricious." Act § 202(a)(1)(A)(iii). The district court's determination must be made "[o]n a strictly confidential basis, and without any prior public disclosure." Act § 202(a)(1)(A)(iii). Moreover, if the district court does not make a determination within 24 hours, the Secretary's petition will be granted by operation of law permitting the Secretary to immediately appoint the FDIC as receiver. Act § 202(a)(1)(A)(v).

An expedited appeal may be taken to the United States Court of Appeals for the District of Columbia and then (via certiorari) to the United States Supreme Court. Nevertheless, review by both courts is limited to the grounds for decision available to the district court. Act § 202(a)(2). In addition, no stay may be issued during the pendency of any appeal. Act § 202(a)(1)(B).

If a covered financial company is a registered broker or dealer, the FDIC "shall appoint" the SIPC to act as trustee. Act §§ 201(a)(7), 205(a)(1). Upon appointment as trustee, the SIPC "shall promptly file" an application for a protective decree under the SIPA in any district court of competent jurisdiction. "Except as otherwise provided in this

title, no court may take any action, including any action pursuant to the [SIPA] or the Bankruptcy Code, to restrain or affect the exercise of powers or functions of the [FDIC] as receiver for a covered broker or dealer." Act § 205(c).

The commencement of an orderly liquidation under the Act terminates any pending bankruptcy (or other receivership or liquidation proceeding) and revests assets in the covered financial company—even if such assets have been transferred during bankruptcy (or other receivership or liquidation proceedings) to another entity. Act § 208(a), (b). Nevertheless, the OLA remains subject to "any order entered or other relief granted by a bankruptcy court prior to the date of appointment of the [FDIC] as receiver." Act § 208(c).

4. General Process Under Title II of the Act

The Act requires the FDIC to promulgate rules and regulations in keeping with the law that would otherwise apply to the insolvency of a covered financial company: "To the extent possible, the [FDIC] shall seek to harmonize applicable rules and regulations promulgated under this section with the insolvency laws that would otherwise apply to a covered financial company." Act § 209. The FDIC's powers and responsibilities under the Act are, in some respects, similar to those granted to a trustee under the Bankruptcy Code and are, in other respects, very different (Adler 2010). The following highlights some of these key provisions:

- Similar to a bankruptcy trustee, the FDIC has broad authority to take over the covered financial company, operate the company to the extent necessary and sell the company's assets in a piecemeal or going concern basis and obtain financing to facilitate the resolution. Nevertheless, unlike the Bankruptcy Code, the Act directs the FDIC to remove management and members of the board of directors "responsible for the failed condition of the covered financial company." Act §§ 210(a), 206(4), (5).
- In pursuing a sale of a covered financial company, the FDIC has broad authority to sell substantially all of the institution's assets to another company, "without obtaining any approval, assignment, or consent with respect to such transfer," unless the sale raises antitrust or related concerns. Act § 210(a)(1)(G). In addition, the FDIC has authority to create and operate a temporary financial institution—i.e., a bridge financial company—to facilitate the sale, assignment or continued operation of the covered financial company's business (Baird & Morrison 2010). Act § 210(h)(1)(B). These powers essentially allow the FDIC to liquidate the covered financial company on a piecemeal or going concern basis with the latter being accomplished either through the transfer to a third party or a bridge financial company, which the FDIC can fund through a mechanism similar to debtor-in-possession financing for up to five years (Baird & Morrison 2010). Act § 210(h)(12).

- The Act authorizes the FDIC to fund the resolution of the covered financial company. The FDIC's funding authority is extensive and provides it with more funding options and flexibility in this respect than that available to debtors in possession or trustees in bankruptcy cases. For example, the FDIC can issue treasury obligations up to 10% of value of pre-resolution consolidated assets during the first 30 days of the case and up to 90% of the value in resolution thereafter. Act § 210(n)(6).
- Although Title II of the Act does not impose an automatic stay akin to section 362 of the Bankruptcy Code, it does limit the rights of creditors and shareholders to "their right to payment, resolution, or other satisfaction of their claims." Act §210(a)(1)(M). It further restricts the ability of courts to enter orders affecting assets subject to the OLA. Act § 201(a)(9)(C). Nevertheless, the FDIC must affirmatively request a stay in any judicial action or proceeding in which the covered financial company "is or becomes a party, for a period of not to exceed 90 days." Act § 210(a)(8)(A). Upon receipt of the request, "the court shall grant such stay as to all parties." Act § 210(a)(8)(B).
- The claims review process under the Act is similar to that set forth under the Bankruptcy Code, except that the deadlines are shorter and creditors and shareholders are limited to ex post review of the FDIC's decision. For example, the FDIC must allow or disallow claims by creditors of a covered financial company within 180 days (with the possibility of expedited review for claims by secured creditors who allege irreparable harm). Act § 210(a)(3)(A)(i), (5)(A). A claim may be disallowed in whole or in part if it is "not proved to the satisfaction of the [FDIC]." Act § 210(a)(3)(D)(i). Moreover, if the FDIC disallows a claim, the claimant may bring suit within 60 days (or continue an action commenced before the date of appointment of the FDIC as receiver) "in the district or territorial court of the United States for the district within which the principal place of business of the covered financial company is located." Act § 210(a)(4)(A).
- The Act contains a priority scheme for the payment of unsecured claims that is slightly different than that set forth in the Bankruptcy Code: (1) administrative expenses, (2) amounts owed to the United States, (3) limited wage and employee benefit plan claims, and (4) general unsecured claims. Claims for wages, salaries, or commissions, including severance, by senior executives and directors of the covered financial company are subordinated, as are obligations to shareholders. Act § 210(b)(1). Nevertheless, contrary to the Bankruptcy Code, the FDIC may favor certain creditors in the payment scheme, providing for unequal payment to and treatment of similarly-situated creditors, under certain circumstances. Act § 210(b)(4).
- As receiver, the FDIC may pursue actions to avoid preferences and fraudulent transfers. Act § 210(a)(11). The language of the Act for these

provisions largely tracks sections 547 and 548 of the Bankruptcy Code and incorporates by reference terms from the Bankruptcy Code. Act § 210(a)(11).

- The Act abrogates the statute of limitations for claims brought by the FDIC as receiver and imposes minimum limitations periods, unless state law would be more generous. Act § 210(a)(10)(A). For tort claims involving "fraud, intentional misconduct resulting in unjust enrichment, or intentional misconduct resulting in substantial loss to the covered financial company," the Act revives otherwise time-barred claims by the FDIC, so long as the statute of limitations has not expired more than five years before the FDIC's appointment as receiver. Act § 210(a)(10)(C).
- The FDIC is given the power to "disaffirm or repudiate" any contract or lease the agency determines to be burdensome, if doing so "will promote the orderly administration of the affairs of the covered financial company." Act § 210(c)(1). Counterparties to such contracts are limited to claims for "actual direct compensatory damages" from the breach. Act § 210(c)(3).

The FDIC is in the process of proposing and adopting rules to govern the OLA process under Title II of the Act (Bair Statement, May 12, 2011). For example, the FDIC approved "an interim final rule clarifying how the agency will treat certain creditor claims under the new orderly liquidation authority" in January 2011 and issued a second related notice of proposed rulemaking with respect to section 209 of the Act in March 2011 (Press Release, Jan. 18, 2011; Notice of Proposed Rulemaking, Mar. 15, 2011). The FDIC and the Federal Reserve also issued a joint notice of proposed rulemaking with respect to resolution plans under Title I of the Act in March 2011 (Notice of Proposed Rulemaking, Mar. 29, 2011).

5. Financial Contracts Under Title II of the Act

Section 210(c)(8)(D) of the Act identifies certain types of financial contracts as "qualified financial contracts." Qualified financial contracts include securities contracts, commodities contracts, forward contracts, repurchase agreements, swap agreements or master netting agreements, and the definitions of those contracts largely track the definitions provided for safe harbor contracts under the Bankruptcy Code. Nevertheless, the rights of counterparties to qualified financial contracts are slightly more restricted than the rights of counterparties under the Bankruptcy Code.

A key difference in treatment relates to a short automatic stay under the Act that prohibits counterparties to qualified financial contracts from enforcing an *ipso facto* clause to terminate the contract or invoking a walk-away clause. This stay extends until "5:00 p.m. (eastern time) on the business day following the date of appointment" of the FDIC as receiver or after the counterparty receives notice of a transfer of the contract in accordance with the Act. Act §§ 210(c)(10)(B), 210(c)(8)(F). Nevertheless, the counterparties' other rights and remedies under the qualified financial contract remain

enforceable notwithstanding the temporary stay (Baird & Morrison 2010). Act § 210(c)(8)(A).

The short stay on counterparties' rights incorporated into Title II potentially presents an issue for covered financial companies that file a bankruptcy case before being placed into the OLA under Title II of the Act. The bankruptcy filing will allow counterparties to terminate financial contracts immediately because of the lack of any stay in that context. *See supra* Part IV.A.8. Section 208(b) of the Act arguably voids any transfers occurring prior to the OLA in any bankruptcy case, but the termination and netting of financial contracts may prove difficult to unwind and resurrect in the subsequent OLA. Act § 208(b). As a result, the short stay under the OLA may hold little value for that particular covered financial company.

The Act authorizes the FDIC to transfer qualified financial contracts to a third party or bridge financial company. In so doing, the FDIC must transfer all contracts and claims held by a counterparty and any of its affiliates or transfer none. Act § 210(c)(9). This requirement prevents the FDIC from cherry-picking contracts and thereby protects counterparties (Baird & Morrison 2010).

Similar to the Bankruptcy Code, the Act also protects counterparties from preference and fraudulent conveyance claims relating to transfers made in connection with qualified financial contracts (other than claims of actual fraud). Act § 210(c)(8)(C).

V. Analysis of Resolution Schemes

Section 202(e) of the Act requires the AOUSC to study the effectiveness of chapter 7 and chapter 11 of the Bankruptcy Code for liquidating or reorganizing financial institutions. Notably, section 202(e) does not limit the study to "covered financial companies" or financial companies posing a systemic risk. Nevertheless, in preparing this study, this distinction emerged as a relevant factor that should be considered in assessing the resolution schemes and whether potential issues under or proposed changes to the Bankruptcy Code should relate solely to financial institutions that would qualify as "covered financial companies" under the Act, all financial institutions or all business debtors. Accordingly, the factors classifying a financial institution as a "covered financial institution" and whether that classification impacts the effectiveness of the resolution scheme are questions that remain uncertain under the existing data and literature.

This Part builds on the background information set forth in Part IV and examines the two different resolution schemes applicable to covered financial companies. It focuses primarily on the aspects of these schemes that affect covered financial institutions, including the role of the bankruptcy courts under the Bankruptcy Code and the United States District Court for the District of Columbia in the OLA process. Again, it is important to note that this analysis, as well

as the third-party proposals discussed *infra* Part VI, should not be read in a vacuum and must consider the implications for all financial institutions and other business debtors.

A. Challenges in the Resolution of Covered Financial Companies

To assess whether a particular resolution scheme is effective, it is first necessary to understand the attributes of covered financial companies that arguably distinguish them from other types of companies commonly liquidated or reorganized under chapter 7 and chapter 11 of the Bankruptcy Code. These attributes include the nature of covered financial companies' assets, the importance of market confidence to their business model, their funding mechanisms and relationships with other market participants and the global nature of their operations.

The majority of a financial company's assets are cash, securities and other financial products. The value of these assets (other than cash) fluctuates greatly depending on the nature of the product and market conditions. The value also can dissipate quickly when the markets experience a "crisis in confidence." Market confidence appears to play a critical role in the value and success of covered financial companies (Cohen & Goldstein 2009). For example, Lehman Brothers's lead bankruptcy lawyer posits that Lehman's "broker-dealer and fixed-income business were among Lehman's most valuable assets. Nonetheless, [their] value depended on Lehman's ability to assure its clients and customers of its financial and operational integrity. In the circumstances surrounding Lehman's bankruptcy, it could not instill that assurance in its clients and customers" (Miller 2009).

Notably, market confidence (or a lack thereof) can be based on perceptions that may or may not be accurate (Ayotte & Skeel 2010). A perceived but not necessarily real liquidity issue at a covered financial company—or one created by market participants—can lead to a crisis in confidence that in turn causes the covered financial company's failure. Consequently, "[t]he general 'crisis of confidence' effects that follow from the bankruptcy filing of a major financial institution … cannot be discounted entirely, even if they flow purely from a self-fulfilling prophecy rather than from fundamentals" (Ayotte & Skeel 2010). The concept of market confidence also is expressed as "the run on the bank" that can occur with rumors of a bank's financial distress.

The nature of covered financial company's assets and the role of market confidence also impact their funding capacity. Most covered financial companies utilize only a small percentage of long-term financing in their capital structures. The majority of their funding flows from short-term, even overnight, lending arrangements typically in the form of repurchase agreements, commercial paper and derivatives. These short-term arrangements can be terminated quickly in that the lender is under no obligation to roll over or continue the original commitment. As one commentator observed, "When it failed, Lehman had sold $4.8 billion of its commercial paper. The unwillingness of the commercial

paper market to roll over Lehman's obligations was a proximate cause of Lehman's failure" (Roe 2011).

Accordingly, if the markets suspect financial distress at a covered financial company, short-term lenders and counterparties may terminate their arrangements, leaving the covered financial company with a significant financing gap (Cohen & Goldstein 2009). At that point, the covered financial company may be unable to cover margin or collateral calls required under its other financial contracts. Likewise, the covered financial company may be unable to provide clearing or other similar services to counterparties or other market participants. Those potential defaults by the covered financial company are said to lead to a possible chain reaction—counterparties or those relying on the covered financial companies for services are unable to meet their obligations which in turn causes additional failures and a credit freeze in the markets generally. This type of systemic risk is at the core of the Act.

In addition, covered financial companies may indeed be a collection of corporate entities that on paper are separate but collectively have operations and do business in multiple jurisdictions around the world as if they were one entity. Nevertheless, the reality of the corporate operations structure often is integrated in several important respects, including their data and information systems, contract arrangements and funding sources. As such, the failure of the covered financial company can significantly disrupt the company's operations as different jurisdictions react in different ways to the failure of the overall structure or any given subsidiary thereof. *See infra* Part V.I.

Although other types of companies may face similar challenges in times of distress, covered financial companies are said to be particularly vulnerable to these challenges. Consequently, the following subparts consider, among other things, these attributes of covered financial companies in the context of the two resolution schemes.

B. Focus of Process

A critique of the Bankruptcy Code for resolving distressed covered financial companies is the underlying focus and policy of the Bankruptcy Code itself. As noted above, with the exception of its safe harbors, the Bankruptcy Code is focused almost exclusively on the interests of the debtors' creditors, with little directed focus on systemic effects. Some commentators view this focus as a significant weakness in the Bankruptcy Code as it applies to covered financial companies. These commentators believe that any effective resolution scheme for covered financial companies must instead focus on externalities and "systemic" effects (Cohen & Goldstein 2009, Bair Statement 2009).

This sentiment also is reflected in the focus of Title II of the Act. As noted above, Title II is focused almost exclusively on externalities and systemic risk. The FDIC has broad discretion to act without regard to the rights of the company itself, its creditors or its shareholders if the act promotes stability in the U.S. economy. Commentary explaining the OLA has stressed

that it "is a liquidation of the company that imposes the losses on its creditors and shareholders" (FDIC, Notice of Proposed Rulemaking, Jan. 2011).

Certainly the stated objective of a resolution scheme can influence its implementation, but it is not clear that the Bankruptcy Code precludes consideration of systemic risk. Bankruptcy courts can and do consider the effect of a proposed course of action in a bankruptcy case on the debtor, its employees, the community and other stakeholders. For example, in his order approving the sale of substantially all of the assets of General Motors, Judge Robert E. Gerber observed:

> As nobody can seriously dispute, the only alternative to an immediate sale is liquidation — a disastrous result for G.M.'s creditors, its employees, the suppliers who depend on G.M. for their own existence, and the communities in which G.M. operates. In the event of a liquidation, creditors now trying to increase their incremental recoveries would get nothing. (General Motors Memorandum Decision, July 5, 2009)

Likewise, in his order rejecting a challenge to the sale of LBI's assets to Barclays, Judge James M. Peck observed:

> The Court placed considerable reliance on the offers of proof and testimony that supported approval of the sale and the emphatic endorsements of the transaction made in open court by representatives of the federal regulators. These representatives of the regulators were unanimous and unqualified in their support, and the unmistakeable impression was that approval of the [Asset Purchase Agreement] with Barclays most definitely was in the public interest and was needed to contain incremental systemic risk and to protect customers and creditors alike. (Lehman Memorandum Decision, Feb. 22, 2011)

Although the interests of creditors remain paramount, those interests do not always conflict with third-party considerations or preclude the court from approving an action that also benefits other interests.

C. Length of Process

Given the nature of covered financial companies' assets and the issue of market confidence, most commentators agree that an expeditious resolution of the company's distress is necessary to preserve value and prevent systemic risk. Some commentators raise concerns regarding the Bankruptcy Code because it may produce a slow process, often delayed by notice and hearing requirements and the judicial process generally (Morrison 2009, Jackson 2009). As discussed *infra* Part IV.A.3, 7, any sale of a debtor's assets under section 363 of the Bankruptcy Code or any assumption and assignment of a debtor's executory contracts and leases require notice and a hearing. In a typical case, an asset sale requires 21 days' notice.

Fed. R. Bank. P. 2002(a), 6003. An appeal of the bankruptcy court's order also can delay the process.

In addition, to the extent a covered financial company invokes the plan of reorganization process under chapter 11, the Bankruptcy Code requires solicitation of votes on the plan from creditors and perhaps shareholders and a subsequent hearing for the bankruptcy court to consider and approve the plan (Cohen & Goldstein 2009). Although prepackaged plans can move through the bankruptcy approval process on an expedited basis, they still require time for negotiation and solicitation of votes on the plan prior to the commencement of the chapter 11 case. Given the structure of the plan approval process and the nature of a covered financial company's assets, many commentators assert that a chapter 11 plan of reorganization is not a viable resolution alternative for covered financial companies.

Nevertheless, certain financial institutions have successfully reorganized under chapter 11 plans, including CIT Group, which filed and confirmed a prepackaged plan of reorganization in approximately 40 days. Notably, CIT Group, a bank holding company, was able to implement a debt-for-equity (or new debt) exchange through a prepackaged plan of reorganization that eliminated approximately $10.5 billion of debt from its balance sheet and significantly enhanced CIT Group's post-confirmation liquidity (Press Release, Dec. 10, 2009; CIT Affidavit, Nov. 1, 2009). CIT Group also received approval from the bankruptcy court to continue to honor and perform under prepetition Cease and Desist Orders issued by the regulators of its depository banks, the FDIC and the Utah Department of Financial Institutions (Cease and Desist Order, Nov. 23, 2009). Neither regulator objected to CIT's plan or took further action against CIT's depository banks (CIT Plan Memorandum, Dec. 7, 2009; Marcinek, Apr. 20, 2011).

Proponents of Title II of the Act emphasize the administrative nature of the OLA, which allows the FDIC as receiver to act quickly. They suggest that the FDIC's ability to fund the covered financial company or transfer its good assets to a bridge financial company likely will facilitate timely resolution to the immediate liquidity crisis and loss of value facing the covered financial company. This approach is similar to that taken by the FDIC under the FDIA, in which the FDIC can close and transfer the assets of an insured depository bank in a matter of days (Walter 2004). On the other hand, the Bankruptcy Code permits emergency financing and emergency sales on extremely short notice, and both have occurred on very short notice in, for example, the Lehman Brothers and Refco cases (sales) and the CIT case (financing).

Although the Bankruptcy Code has procedural requirements that may slow down a process and Title II does not, questions remain regarding the benefits of each scheme in the context of covered financial companies. For example, covered financial companies typically hold thousands of very complex financial products that are vulnerable to market movements and often difficult to assess. *See supra* Part V.A. These companies are in many

respects very different from insured depository institutions (Skeel, 2009). Accordingly, even if the FDIC immediately funds the company or creates a bridge financial company, it is unclear whether the FDIC can make meaningful decisions regarding the treatment of the company's qualified financial contracts and other operations in one business day or quickly assess what the "good" assets are.

The resolution plan required by Title I of the Act may help the FDIC prepare in advance for the OLA, provided that the resolution plan reflects timely information that the FDIC has had an opportunity to dissect. Some commentators place great weight on the role of resolution plans in managing any future distress at a covered financial company; other commentators question the feasibility of such plans, particularly given their static nature and the rapid speed at which the financial industry and markets often move, and the distinct possibility that the "run" may be caused by the disclosure of fraud. The quality and effectiveness of resolution plans remain untested (Bleier & Oesterle 2011). Moreover, if a resolution plan proposes a viable resolution structure that contemplates a reorganization, as opposed to liquidation, of the covered financial company, chapter 11 of the Bankruptcy Code may be a more appropriate vehicle for addressing any financial distress (Bliss & Kaufman 2011). Although the FDIC appears to have the discretion to allow the company to file for bankruptcy, absent clear direction from the FDIC to that effect, a covered financial company may be reluctant to file the necessary bankruptcy case given the FDIC's ability to terminate the bankruptcy and replace management under the Act. *See supra* Part IV.B; Act § 208(a). Similarly, potential purchasers and key creditors may be reluctant to deal with the company, believing, unless otherwise credibly assured, that their agreements may be second-guessed by the FDIC.

Despite its procedural requirements, the bankruptcy system has proven very nimble in times of crisis and in the context of large, complex distressed companies. As discussed *supra* Part IV.A.6, numerous bankruptcy courts have significant experience with chapter 11 mega-cases and have tested procedures in place to facilitate the efficient administration of such cases. In addition, the Bankruptcy Code and the Bankruptcy Rules often permit bankruptcy judges to exercise judicial discretion and adopt expedited or streamlined procedures for particular matters. For example, Bankruptcy Rule 6004(c) allows the bankruptcy judge, "for cause shown," to reduce on a discretionary basis the standard 21 days' notice period required for sale motions. Fed. R. Bankr. P. 2002(c). Several bankruptcy judges have used this discretion to hold expedited hearings on proposed asset sales involving financial institutions and other large, complex distressed companies.

For example, in the Lehman Brothers' chapter 11 case, the bankruptcy court held a sale hearing and approved the proposed sale of LBI's assets to Barclays just five days after the filing of the chapter 11 case and one day after the SIPC commenced a SIPA proceeding against LBI (Rosenberg et al. 2009). Notice of the proposed sale and the sale hearing was

provided "by e-mail, facsimile, federal express or other overnight delivery service" to all parties in interest; the hearing on the proposed sale began on September 19, 2008, and was completed during the early morning hours of September 20, 2008 (Lehman Sale Notice Order, Sept. 17, 2008; Lehman Transcript, Sept. 19, 2008). In approving the proposed sale to Barclays at the hearing, Judge Peck commented:

> This is really not a question of due process being denied. This is a question of due process being pursued in good faith by all parties to the transaction, even the objectors…. I am completely satisfied that I am fulfilling my duty as a United States bankruptcy judge in approving this transaction and in finding that there is no better or alternative transaction for these assets, that the consequences of not approving a transaction could prove to be truly disastrous. And those adverse consequences are meaningful to me as I exercise this discretion. The harm to the debtor, its estates, the customers, creditors, generally, the national economy and the global economy could prove to be incalculable.... [T]his is not bad precedent. To the contrary, it's an extraordinary example of the flexibility that bankruptcy affords under circumstances such as this. (Lehman Transcript, Sept. 19, 2008)

Likewise, section 363 sales of substantially all of the assets of General Motors and Chrysler were approved by the bankruptcy court in approximately 30 days (Rosenberg et al. 2009).

D. Rights of Parties in Interest

The different policy objectives of the two resolution schemes and their different procedural requirements may place creditors, shareholders and counterparties of covered financial companies in different positions.

Under the Bankruptcy Code, parties in interest understand the process and their rights under that process. They know that they can be heard on any issue before the bankruptcy court and that courts strive to provide this opportunity even when matters are heard on an expedited basis. *See supra* Part V.C. They also know that the debtor will be required to make extensive public disclosures about any proposed transaction so that there is transparency in the process. Moreover, they understand the bankruptcy claims resolution process, which is systematic, public, and fairly predictable from a process perspective.

The Bankruptcy Code's treatment of parties in interest stems in part from its focus on creating a level playing field for, and maximizing returns to, creditors. As discussed above, this treatment may cause delay and may undervalue externalities and systemic risk. Nevertheless, it values the prepetition contract and legal rights of creditors and works to ensure that all similarly-situated creditors bear losses from the debtor's failure equally.

Under Title II of the Act, parties in interest have no standing to challenge the FDIC's

course of action ex ante and are generally limited in their ex post objections to the treatment of their claims or interests (Baird & Morrison 2010). The FDIC is not required to share information with parties in interest or otherwise explain its actions to them. Thus, the FDIC's unilateral discretion likely will facilitate quick resolutions, but there is no certainty that it will achieve the best resolutions. Moreover, the lack of transparency and resulting uncertainty in the OLA process may have systemic effects that do not emerge in the liquidation of a typical depository bank under the FDIA. For example, the nature and extent of potential claims against a covered financial company (e.g., derivatives counterparty claims) are very different than those against a depository bank (Summe 2009, Skeel Statement 2009); the uncertainty and potential disparity in treatment under the OLA may cause counterparties to terminate financial contracts or service agreements earlier, thereby accelerating the decline of the covered financial company. The FDIC has tried to address these concerns through notices of proposed rulemakings and public comments (FDIC Rebuttal, Apr. 8, 2010). *See supra* Part IV.B.4.

E. Expertise of Party Overseeing Process

A covered financial company likely would have several U.S. jurisdictions in which it could commence a chapter 7 or a chapter 11 case. As noted above, the company can file in any jurisdiction in which it is incorporated, has its principal place of business or principal asset or an affiliate's case is pending. Moreover, in jurisdictions with more than one bankruptcy judge, judges typically are randomly assigned to cases filed in that jurisdiction. Some commentators have suggested that this process can lead to the assignment of a bankruptcy case for a covered financial company to a bankruptcy judge with little expertise in financial matters or other relevant issues (Morrison 2009, Jackson 2009). Nevertheless, the AOUSC's mega-case database and general experience suggest that mega-cases typically are filed in jurisdictions with extensive experience in administering and resolving large, complex chapter 7 and chapter 11 business cases (Wallison 2009).

The role of the FDIC under Title II of the Act may provide more consistency in resolutions depending on the standards and procedures developed by the FDIC and exactly how those procedures are implemented. The FDIC is the primary monitor and decision maker with respect to the resolution of covered financial companies under Title II (the role of other regulators under Title II is discussed *infra* Part IV.F). The FDIC has experience in regulating and liquidating depository institutions under the FDIA and has used a structure similar to a bridge financial company to resolve at least one such depository bank, IndyMac Bank (FDIC Quarterly 2011). Accordingly, some commentators suggest that the FDIC may be better equipped to handle a covered financial company resolution (Morrison 2009). In addition, judicial review of the Secretary's decision to commence an OLA proceeding if the financial institution objects rests with the United States District Court for the District of Columbia, and other potential disputes relating to the OLA arguably would be heard on an ex post basis

by that court or, in the claims resolution context, in the United States District Court for the district in which the claimant resides. *See supra* Part IV.B.3. This approach may concentrate judicial disputes concerning covered financial companies in one or a few districts and allow those district courts to develop an expertise in the process. It may, however, also increase inefficiency at least in the claims process to the extent that claims disputes are filed in multiple jurisdictions.

Section 202(e)(1)(B)(ii) of the Act directs the AOUSC to consider "ways to maximize the efficiency and effectiveness of the Court." Title II defines "Court" to mean "the United States District Court for the District of Columbia, unless the context otherwise requires." Accordingly, it is unclear whether the reference to "Court" in section 202(e)(1)(B)(ii) refers to the District Court for the District Court of Columbia or the bankruptcy courts in the context of the AOUSC's consideration of chapter 7 and chapter 11 of the Bankruptcy Code under section 202(e)(1)(B)(i) and (iii) of the Act. To the extent the reference is to the United States District Court for the District of Columbia, the AOUSC understands that the district court adopted Local Rule 85 to govern OLA-related cases. Local Rule 85 specifies the procedure for filing a petition to appoint the FDIC as trustee; explains the consequences of the district court's action or inaction with respect to a petition; and requires the Secretary to provide at least 48 hours notice to the district court (under seal) that a petition likely will be filed. This new rule and its proposed procedures have yet to be invoked and tested. To the extent the reference is to the bankruptcy courts, those issues are addressed throughout the body of this report.

F. Fragmented Process

The resolution of a covered financial company under the Bankruptcy Code may result in a fragmented resolution procedure because affiliates of the company may be ineligible for bankruptcy protection (Cohen & Goldstein 2009). *See supra* Part IV.A.2. For example, a bank holding company may be a debtor in bankruptcy but its affiliated insured depository bank may not. Rather, the FDIC likely will take over the insured depository bank and control the claims resolution process for that bank. Likewise, the debtor or one of its affiliates may be a registered broker or dealer that the SIPC elects to resolve under the SIPA. In either scenario, the bankruptcy court has no jurisdiction over the non-debtors and little ability to control aspects of the debtor's bankruptcy case related to the FDIC or the SIPC procedures. A fragmented procedure may cause unnecessary delay and cost.

Under Title II of the Act, the FDIC would act as receiver for both the covered financial company and any insured depository bank. If the covered financial company is, or has an affiliate that is, a registered broker or dealer or an insurance company, however, aspects of a fragmented procedure may emerge. Section 205(a) of the Act directs the FDIC to appoint the SIPC "to act as trustee for the liquidation under the [SIPA] of the covered broker or dealer."

Notably, the FDIC's appointment authority under this section does not require any court approval, and section 205(c) provides that "no court may take any action, including any action pursuant to the [SIPA] or the Bankruptcy Code, to restrain or affect the exercise of powers or functions of the [FDIC] as receiver for a covered broker or dealer." Moreover, the SIPC's authority is subject to certain of the FDIC's powers and duties under Title II, including the FDIC's power to transfer assets to a bridge finance company and determine any resulting claims against the FDIC. Act § 205. The FDIC's resolution of claims in this context is subject to ex post review by the relevant district court under section 210(a)(2) of the Act. Accordingly, the potential disruption to the liquidation of a covered financial company as the result of fragmented procedures may be mitigated by the ultimate control retained by the FDIC as receiver and the limited court review.

Section 203(e) of the Act provides that any covered financial company that is an insurance company or any of its affiliates that are insurance companies shall be liquidated in accordance with applicable state law. Although not explicitly stated, section 203(e) appears to leave the liquidation of any insurance company to the discretion of the prudential regulator with little involvement from the FDIC. Section 203(e)(3) does, however, give the FDIC authority to commence the appropriate state proceeding if the prudential regulator does not take the necessary action within 60 days of the determination that the insurance company is a covered financial company subject to the OLA under section 202(a) of the Act. Consequently, little difference appears to exist in the treatment of insurance companies under the Bankruptcy Code, which excludes such companies from being chapter 7 or 11 debtors, and under Title II of the Act.

G. Timing of Initiation of Process

One challenge facing most debtors—whether or not a covered financial company—is acknowledging the need for a bankruptcy filing in a timely manner. Companies sometimes ignore signs of financial distress or analyze the problem through rose-colored glasses, so that little serious consideration is given to the utility of a bankruptcy filing until it is too late. Lack of adequate prebankruptcy planning can preclude the company from achieving a prepackaged plan of reorganization, securing necessary postpetition financing or otherwise acting to preserve the value of its assets in any chapter 7 or chapter 11 case (Morrison 2009, Cohen & Goldstein 2009). Covered financial companies could face these same issues (Bliss & Kaufman 2011). In fact, covered financial companies may be more likely to delay any necessary bankruptcy filing because of the severe loss of value that may flow from the termination of their safe harbor contracts (Ayotte & Skeel 2010, Lubben 2010).

The Act recognizes the value of prebankruptcy planning by incorporating the requirement of the Title I resolution plans. Under the Act, covered financial companies must consider their alternatives for resolving any future financial distress and explain their action

plans for resolving any such distress. In concept, resolution plans should assist both the company and the FDIC in recognizing and timely addressing distressed situations. In practice, however, the effectiveness of the concept will turn largely on the quality of the information contained in the plan, the frequency with which it is updated and the extent of the FDIC's involvement in that process. *See supra* Part V.C. The utility of resolution plans also may be limited by the fact that unforeseen circumstances, such as fraud, may catch parties by surprise. Moreover, because resolution plans are not publicly available, creditors and markets generally will not be able to use that information to help discipline the covered financial company or otherwise help foster a timely resolution of any financial distress.

H. Treatment of Financial Contracts

Most commentators agree that the treatment of safe harbor contracts under the Bankruptcy Code is problematic (Peck 2011, Summe 2009). As explained *supra* Part IV.A.8, counterparties to safe harbor contracts can terminate their contracts with a debtor immediately upon the bankruptcy filing, set off and net any amounts due and owing between the parties (including application of any collateral pledged to the counterparty) and avoid any fraudulent conveyance or preference challenge to prepetition transfers received in connection with the contracts. Such counterparty actions have several significant consequences for the debtor's bankruptcy case, including value destruction created by unilateral and potentially opportunistic or even abusive termination of valuable ("in the money") contracts; the debtor's lost opportunity to transfer contracts to qualified counterparties, thereby mitigating any resulting damages; and valuation disputes (Vasser 2005). In addition, the protection provided for prepetition transfers to counterparties may increase moral hazard by reducing counterparties' incentives to monitor the debtor's financial state and their own risk profiles (Ayotte & Skeel 2010).

For example, a counterparty can terminate a safe harbor contract even if the debtor is "in the money" under the contract—i.e., the counterparty owes the debtor money under the contract and the contract itself may hold long-term value for the estate. The simple act of filing the bankruptcy case typically justifies the termination or may trigger automatic termination under the ISDA Master Agreement. (As explained *supra* Part IV.A.8, these types of *ipso facto* clauses are unenforceable in most other types of executory contracts.) Although the counterparty under these contracts should still pay the debtor any amounts owed under the contracts, those payments may not necessarily be forthcoming or the counterparty may attempt to value those payments in a commercially reasonable manner (Marchette 2010). Moreover, some safe harbor contracts contain "walk-away" clauses that permit the non-defaulting party to terminate and walk away from the contract without paying any damages claim to the debtor.

The ability to terminate safe harbor contracts also eliminates any potential for the debtor

to transfer the contracts to qualified counterparties. Outside of bankruptcy, these types of financial contracts typically permit transfers to third parties upon the written consent of the counterparty (ISDA Master Agreement § 7). A transfer to a qualified counterparty benefits both parties by allowing the transferor to avoid defaults and resulting damages under the contract and providing the promised performance to the counterparty through the transferee. Nevertheless, a debtor typically cannot invoke such transfer rights in bankruptcy because the contracts are terminated before the debtor can arrange any transfer. In the Lehman Brothers' chapter 11 case, approximately 733,000 safe harbor contracts purportedly were terminated on or shortly after the petition date (Lehman Assignment Motion, Nov. 13, 2008).

Whether a contract is "in the money" or "out of the money" from the debtor's perspective, valuation of the parties' respective obligations under the financial contract can pose significant challenges for the bankruptcy estate. For example, the 2002 ISDA Master Agreement allows the non-defaulting party to calculate its damages claim based on a "Close-out Amount methodology," which is commonly defined as the replacement value of the contract plus transaction costs (i.e., the bid-ask spread) (ISDA Close-out Amount Protocol, Feb. 27, 2009; Wehner, Sept. 22, 2008). The replacement value is determined by the amount paid by the non-defaulting party to replace the contract or, if no replacement is sought, by reference to market data for similar transactions. In addition, because replacing a contract entails transaction costs, the non-defaulting party also is permitted to add the bid-ask spread (the difference between the price at which entities are willing to buy and sell the underlying asset) to the damages calculation. The 2002 ISDA Master Agreement requires that the Close-out Amount be determined in good faith and in a commercially reasonable manner, but questions still arise under this process (ISDA Close-out Amount Protocol, Feb. 27, 2009).

Commentators argue that use of the Close-out Amount methodology may be problematic under certain circumstances. For example, basing the replacement value or bid-ask spread on market data in a volatile market may inflate the claim and contribute to a depressed valuation of the underlying asset. Similarly, adding transaction costs when no replacement transactions are pursued arguably overcompensates the non-defaulting party. These and other valuation issues arose in the Lehman Brothers' cases, with the chapter 11 trustee disputing over $45 billion in damages claims relating to safe harbor contracts (Cameron, Mar. 2, 2011). The Chief Restructuring Officer for Lehman Brothers presented, and several key counterparties have agreed to, a claims settlement framework that, among other things, proposes to calculate close-out damages for a risk-netted portfolio based on the end-of-the-day midmarket price (i.e., the price point in between that which entities are willing to buy and sell the asset at the end of the day), plus or minus a uniform set of transaction costs (Press Release, July 1, 2011). One source estimated that this type of adjustment to the Close-out Amount methodology might reduce the damages claims by $5 billion to $10 billion

(Cameron, Mar. 2, 2011).

In addition to valuation issues, other practices involving safe harbor contracts may create issues in calculating damages claims. For example, counterparties may try to invoke cross-product netting or setoff rights to allocate claims or collateral among not only financial contracts subject to the same master netting agreement but also other arrangements among the parties (Gilbane 2010; Sandler, Mar. 1, 2011; Lehman Operating Report, Jan. 21, 2011). Likewise, a safe harbor contract may allow triangular or cross-affiliate netting and setoffs, where a counterparty and its affiliates may aggregate all claims under all contracts with the debtor and its affiliates (Gilbane 2010). This type of triangular setoff generally is not permitted under the Bankruptcy Code, and some courts have disapproved of the practice in the safe harbor context (Lehman Swedbank Order, Jan. 28, 2011).

Moreover, the protection for most prepetition transfers to counterparties under section 546 of the Bankruptcy Code allows counterparties to continue their business relationships with the debtor without instilling any discipline over the debtor through active monitoring or over the counterparties themselves through active mitigation of their risk portfolios (Roe 2010). For example, with the section 546 protections, a counterparty can continue to demand collateral and payments from the debtor with impunity up until the debtor files for bankruptcy. Likewise, when combined with the enforceability of *ipso facto* clauses, a counterparty has little incentive to terminate safe harbor contracts prior to the bankruptcy because it has little downside risk to stringing out the financial relationship (Roe 2010, Ayotte & Skeel 2010). From the debtor's perspective, however, these ongoing relationships may strain a debtor's already precarious financial condition as it responds to ever-increasing collateral demands and services contracts that are no longer financially viable for the debtor.

Notably, Title II of the Act addresses certain of these issues by providing a short stay of *ipso facto* and walk-away clauses in qualified financial contracts and permitting the transfer of these contracts during that grace period. As noted *supra* Part IV.B.5, however, whether Title II provides sufficient time to arrange and consummate a transfer of qualified contracts remains to be seen and may turn on the quality of the resolution plans and the use of bridge financial companies. Title II also does not address the demands on a covered financial company's assets by collateral calls and the like prior to the commencement of the OLA process because, like the Bankruptcy Code, it protects these transfers (except for intentional fraud) from avoidance.

Some commentators argue that any stay on the enforcement of *ipso facto* clauses beyond a very short one like that invoked under Title II would increase systemic risk. This argument posits that counterparties' inability to terminate and close out financial contracts with the debtor would prevent those counterparties from fulfilling their obligations with other market participants, thereby increasing liquidity issues throughout the markets. Other

commentators argue, however, that this concern is illusory and that counterparties' immediate termination of financial contracts actually may increase market instability and have systemic effects (Roe 2010, Lubben 2010). There is little tangible evidence to support either proposition. The various proposals made by commentators to address financial contracts in the insolvency context are explained *infra* Part VI.A.

I. International Issues Relating to Process

Most large, complex financial institutions have operations in multiple jurisdictions around the world. Each of these jurisdictions has its own insolvency systems and banking regulations. Often the laws of these jurisdictions may conflict and complicate the resolution of the financial institution or affiliate in any one jurisdiction.

Lehman Brothers encountered multiple challenges relating to the global nature of its business structure, which included its main headquarters in New York; regional headquarters in London and Tokyo; and other offices throughout North America, Europe, Asia, the Middle East and South America. Lehman Brothers controlled most of the cash resources for all companies within its corporate group and, consequently, its liquidity issues and bankruptcy filing prevented it from meeting the funding needs of its affiliates. This shortfall in turn caused Lehman Brothers' affiliates in various jurisdictions to seek protection under that jurisdiction's insolvency laws. This multiple-jurisdiction resolution created numerous issues that presented themselves early in Lehman Brothers' chapter 11 case.

For example, Lehman Brothers' affiliate in the United Kingdom, Lehman Brothers International (Europe) ("LBIE"), filed for administration under the U.K. insolvency laws on the same day as the U.S. chapter 11 filing. Joint administrators were appointed to take over LBIE and oversee its administration proceeding. Administrators also were appointed in numerous other jurisdictions (International Protocol Proposal Presentation, Feb. 9, 2009). Lehman Brothers's information technology systems, similar to its cash management systems, were integrated, with the majority of its data stored in, and subject to the different insolvency laws of, five different jurisdictions (New York, London, Tokyo, Hong Kong, Mumbai) (Operational Issues & Challenges Presentation, Nov. 3, 2008). Consequently, the multiple, worldwide insolvency filings by Lehman Brothers and its affiliates caused significant disruptions in access to critical company data, including trading information, necessary to address the financial issues facing the company (International Protocol Proposal Presentation, Feb. 9, 2009; Operational Issues & Challenges Presentation, Nov. 3, 2008).

Ultimately, Lehman Brothers entered into a cross-border protocol designed to increase coordination and cooperation among the various jurisdictions involved in the company's insolvency (Lehman Cross-Border Protocol Report, Feb. 2, 2010). Nevertheless, this

protocol—like all cross-border protocols—is voluntary and non-binding. No particular jurisdiction is required to become a signatory, and there is no meaningful remedy if a jurisdiction fails to comply with the protocol. Cross-border protocols also do not address basic challenges such as legal requirements that a particular entity's assets be made available solely to that entity's creditors. Lehman Brothers and its foreign affiliates continue to work through these challenging issues.

In the chapter 11 context, a debtor in possession may continue intercompany funding and business transactions with appropriate bankruptcy court approval, typically sought as part of the first-day motions package. *See supra* Part IV.A.6. A debtor in possession needs access to postpetition financing, however, to continue these operations as usual and provide adequate assurance to creditors that such funding will not deplete assets otherwise available to pay their claims. Other than what amounted to a "bridge loan" from Barclays pending the sale of LBI's assets to Barclays, Lehman Brothers did not have access to postpetition financing, most likely because of the unexpected nature of its chapter 11 filing and insufficient time to arrange financing.

To that end, quality resolution plans may help covered financial companies identify weaknesses in the corporate structure in the context of international insolvency issues. They also may outline postpetition financing options and provide potential lenders with adequate information on which to perform due diligence and make financing decisions quickly. As noted above, the quality and effectiveness of Title I resolution plans remains to be seen. *See supra* Part V.C. Title II of the Act does not address the international issues posed by the insolvency of a covered financial company. Rather, it mandates a study of these issues by the GAO and the Federal Reserve.

VI. Assessment of Proposals Made by Commentators to Modify Resolution Schemes

Many of the issues identified in Part V are related not only to the nature and business of large, complex financial institutions but also to the dire economic conditions facing the United States and other countries beginning in late 2007. Accordingly, it likely was this confluence of circumstances—and not the Bankruptcy Code or any one particular issue—that created challenges for Lehman Brothers in its chapter 11 case and for the other financial institutions that failed or were resolved under the Bankruptcy Code or the FDIA. On a preliminary review, the Bankruptcy Code appears to function well to address corporate distress, including in the context of bank holding companies and nonbank financial institutions. *See supra* Part V. Among other things, the claims process under the Bankruptcy Code appears well equipped to handle the quantity and complexity of the types of claims frequently asserted against financial companies, including covered financial companies. *See supra* Part V.D.

Nevertheless, given the attributes of large, complex financial institutions and the general desire to mitigate the consequences of any future economic downturns, this Part considers potential responses to some of the issues identified in Part V. Specifically, it reviews several proposals introduced by commentators for improving the resolution of large, complex financial institutions. These proposals primarily focus on financial institutions that likely would qualify as "covered financial companies" but also need to be considered in light of other financial institutions and business debtors.

A. How to Treat Financial Contracts

Many proposals discussing the resolution of distressed financial institutions focus on the treatment of financial contracts under the Bankruptcy Code. *See supra* Part IV.A.8. The proposals range from a complete revocation of the safe harbor protections for all financial contracts to more targeted refinements of those provisions to calls to leave the provisions in their current form. This subpart discusses these proposals, as does the explanation of the proposed chapter 14 *infra* Part VI.C.

1. Whether to Reinstate the Automatic Stay

Some commentators suggest eliminating the exception to the automatic stay for safe harbor contracts set forth in section 362(b) of the Bankruptcy Code (Lubben 2010, Miller 2009). This change would enjoin any action by a counterparty to terminate its financial contract with the debtor, exercise any setoff or netting rights, apply collateral or otherwise affect the debtor's interest in the contract without first obtaining relief from the automatic stay from the bankruptcy court. Accordingly, this change would treat financial contracts like any other executory contract to which the debtor is a party.

Other commentators suggest that precluding all counterparties from exercising all rights under the financial contracts with a debtor would increase systemic risk (Baird & Morrison 2010). Commentators also suggest that it would give debtors an unfair advantage and increase transaction costs, as debtors could "cherry-pick" valuable contracts while rejecting burdensome ones (ISDA Research Notes 2009, Baird & Morrison 2010). Although debtors have the ability to cherry-pick other types of executory contracts, commentators suggest that the interconnectedness of financial markets and the nature of financial contracts warrant different treatment.

Given these concerns, some commentators have offered more targeted proposals, including:

- imposing a short stay on counterparties' rights—similar to that used under Title II of the Act—to restrict the counterparties' conduct for one or a few days after the bankruptcy filing (Ayotte & Skeel 2010, Morrison 2009);

- imposing a stay only on counterparties to certain types of financial contracts—e.g., repurchase agreements and other financial contracts that resemble more traditional secured lending arrangements (Ayotte & Skeel 2010, Partnoy & Skeel 2007);
- requiring the debtor to provide adequate protection to counterparties during any stay on the enforcement of their rights under financial contracts (Lubben 2010, Bliss & Kaufman 2011);
- limiting the stay to enforcement of *ipso facto* clauses only, which would prevent termination of the contract solely because of the bankruptcy filing, the debtor's financial condition or similar economic factors (but arguably would allow termination for failure to meet a collateral or margin call, etc.) (Roe 2010, Ayotte & Skeel 2010); and
- limiting netting to economically-related contracts (Roe 2010).

2. Whether to Revoke the Section 546 Protections

Some commentators question the value of the protections against avoidance actions afforded counterparties to financial contracts. As explained *supra* Part IV.A.8, section 546 of the Bankruptcy Code protects most forms of margin payments and transfers under master netting agreements in connection with financial contracts. 11 U.S.C. § 546(e)-(g), (j). This protection allows counterparties to continue prepetition collateral and margin calls and the netting of payments due under contracts subject to a master netting agreement without much analysis or concern for future liability to the debtor's estate or creditors (Roe 2010).

In light of these concerns, some commentators have proposed eliminating the section 546 protections for counterparties (Roe 2010, Lubben 2010). This change would subject transfers of cash and other collateral by the debtor to the counterparty, as well as the exercise of netting or setoff rights by the counterparty, during the 90 days before the bankruptcy filing to avoidance as a preference under section 547 of the Bankruptcy Code. Similarly, these types of transfers (even outside of the 90-day period) might be challenged as fraudulent conveyances under section 544 or 548 of the Bankruptcy Code.

3. Whether to Maintain the Status Quo

Still other commentators argue that the potential for systemic effects flowing from a stay on counterparties' rights requires the maintenance of the safe harbors in their current form (Krimminger 2009, Mengle 2010). These commentators emphasize the interconnectedness of the financial markets, the related cross-border issues and the potential domino effect flowing from the likely multiple defaults relating to counterparties' inability to balance their trading books and cover their unhedged positions. Nevertheless, the FDIC and some commentators distinguish covered financial companies and support the short stay on enforcement in that limited context. The FDIC commented:

> The exemption from the automatic stay under the Bankruptcy Code in the case of qualified financial contracts generally works well in most cases. However, for systemically important financial institutions, in which the sudden termination and netting of a derivatives portfolio could have an adverse impact on U.S. financial stability, the nullification of the *ipso facto* clause is needed. (FDIC Quarterly, 2011)

4. Synthesis of Proposals

As noted *supra* Part V.H, neither proponents of maintaining the status quo nor those in favor of revoking the safe harbor protections have significant, tangible evidence to support the predicted effect of their respective positions on systemic risk. Rather, each side theorizes as to the effects and, as with most debates, there likely is some validity to each side's arguments. That being said, the treatment of financial contracts under the Bankruptcy Code and Title II of the Act is critical to the successful resolution of large, complex financial institutions in distress.

B. Role of Governmental Entities

As discussed *supra* Part V.G, the fragmented corporate structure of many large, complex financial institutions raises certain challenges for these entities in insolvency proceedings. For example, a financial institution may include a registered broker or dealer, a depository bank or an insurance company, each of which invokes special insolvency rules. The registered broker or dealer is subject to resolution by the SIPC under the SIPA and perhaps the Bankruptcy Code, the depository bank is subject to resolution by the FDIC under the FDIA and the insurance company is subject to resolution by its prudential regulator under applicable nonbankruptcy law.

To ease coordination among the various regulators and the bankruptcy court, some commentators propose allowing the regulator by itself to commence an involuntary bankruptcy case against the financial institution and providing the regulators a more prominent role in the bankruptcy case (Morrison 2009, Bliss & Kaufman 2011). As discussed, *infra* Part VI.C, some commentators even propose modifying the debtor qualifications under section 109 of the Bankruptcy Code to allow registered brokers or dealers and insurance companies to be debtors under either chapter 7 or chapter 11 of the Bankruptcy Code. This type of change would leave only depository banks outside of the bankruptcy system.

Although providing additional clarity regarding the role of regulators in the bankruptcy cases of financial institutions and their affiliates may be welcome by the regulators, regulators already have standing to appear and be heard in most cases under section 1109 of the Bankruptcy Code. In fact, the FDIC and the SIPC frequently do appear in cases involving bank holding companies and registered brokers or dealers, respectively. Likewise,

granting these regulators the authority to commence involuntary cases against financial institutions may be feasible, but it likely would be of limited utility. To the extent that the SIPC can currently take over a registered broker or dealer under the SIPA and the FDIC can currently take over a depository institution under the FDIA and covered financial companies under the OLA, these regulators likely would have little incentive to invoke that authority.

The most significant proposed change appears to be modifying the qualifications for a debtor under section 109 of the Bankruptcy Code to allow registered brokers or dealers and insurance companies to be debtors under chapters 7 and 11 of the Bankruptcy Code. *See infra* Part VI.C. This change would bring the resolution of the financial institution and most of its affiliates into one forum. Nevertheless, to have a meaningful impact on the process, the roles of the regulators would need to be modified to permit the bankruptcy court, as opposed to the SIPC or prudential regulator, to be the primary authority overseeing the resolution. As in the context of depository banks and the role of the FDIC, it is unclear that such changes are feasible.

C. Whether to Add a New Chapter to the Bankruptcy Code

Stanford University's Hoover Institution Working Group on Economic Policy proposed adding a new chapter to the Bankruptcy Code—chapter 14—to address financial distress at large, complex financial institutions (Jackson et al., Apr. 25, 2011). The proposed chapter 14 would apply to all financial institutions with more than $100 billion in assets and their subsidiaries, including stockbrokers, commodity brokers and insurance companies. The proposal would amend section 109 of the Bankruptcy Code to allow stockbrokers and commodity brokers to qualify as debtors in chapter 11 cases, as well as chapter 7 cases without most of the special provisions currently applicable to stockbrokers and commodity brokers under chapter 7.

The proposed chapter 14 would be filed in connection with a traditional chapter 7 or chapter 11 case but would proceed before certain, predesignated judges in the United States District Courts for the Second Circuit and the District of Columbia. These district court judges could not delegate the chapter 14 cases to bankruptcy judges but could use a special master (similar to a court-appointed expert) to assist with the administration of the case. The proposed chapter 14 also would allow the institution's primary regulator, including the FDIC, SIPC and CFTC, to commence an involuntary case against the institution.

In addition to authority to file involuntary cases, the primary regulators would have an increased presence in chapter 14 cases. For example, the primary regulator could file a motion to sell some or all of the institution's assets under section 363 and file a plan of reorganization for the institution under section 1129, notwithstanding the debtor in possession's exclusive period to file a plan under section 1121. In addition, the primary regulator could seek approval of postpetition financing under section 364 of the Bankruptcy

Code to make payments to prepetition creditors, particularly payment to counterparties under financial contracts. The proposed revisions to section 364 would include a clawback provision to the extent that the payments to prepetition creditors allow them to recover more than other similarly-situated creditors and would allow the primary regulator to be the source of the funding under certain circumstances.

The proposed chapter 14 also would amend the safe harbor provisions of the Bankruptcy Code, at least as they apply to financial institutions covered by chapter 14. The proposed amendments would treat repurchase agreements similar to other types of secured lending arrangements in that the agreement would terminate automatically upon the bankruptcy filing (similar to other financial accommodation contracts) and the counterparty would need relief from the automatic stay to sell collateral, other than cash or cash-like collateral. Other types of financial contracts, including swaps, would be treated similar to other executory contracts, but the automatic stay would only apply to the contracts and counterparties for three days after the bankruptcy filing or the rejection of the contract pursuant to section 365 of the Bankruptcy Code, whichever occured first. In addition, the proposed chapter 14 would eliminate the protection against avoidance actions provided by sections 546(f), (g) and (j), but would offer a defense to any such preference actions by amending section 547(c)(5) to permit counterparties to invoke that section's two-point improvement test when the counterparty's collateral could be defined as a pool.

The chapter 14 proposal attempts to address several of the issues identified by the Hoover Institution Working Group's research, including the potentially fragmented nature of financial institution insolvency proceedings, the funding and liquidity needs of these institutions and the Bankruptcy Code safe harbors. It also provides several interesting approaches for policymakers to consider. Nevertheless, it is not clear that a new chapter is necessary to implement some of those approaches. Some of the approaches may underutilize strengths of the bankruptcy system, such as the insolvency expertise of the bankruptcy judges.

D. Whether to Make Other Refinements to theBankruptcy Code

During the working group's interviews described *supra* Part III, participants identified and discussed several of the issues and proposals set forth in Parts V and VI.A-C, as well other important aspects relating to the resolution of distressed financial institutions. This subpart discusses some of the additional proposals identified during these interviews and the working group's research and preparation of this report. It should be noted that, as with the proposals discussed above, participants often debated or disagreed about the merits of the various proposals.

Many participants discussed the use of the section 363 sale process in cases like Lehman Brothers, General Motors and Chrysler, emphasizing the Bankruptcy Code's and bankruptcy

courts' ability to respond quickly to those types of emergency circumstances. Nevertheless, recognizing the *ad hoc* nature of these sales and the venue of the cases—i.e., the Southern District of New York—some participants suggested creating more standardization of the sale process for large, complex financial institutions. Similarly, a few participants raised the potential of requiring bankruptcy cases for large, complex financial institutions to be filed in certain predesignated jurisdictions such as the Southern District of New York or the District of Delaware.

Other issues raised in this context included the focus of the proceedings and the role of regulators. Some participants suggested amending the Bankruptcy Code to explicitly allow bankruptcy judges to consider potential systemic effects, in addition to the interests of creditors and other stakeholders, in their analysis of any proposed transaction. The Bankruptcy Code similarly could be amended to explicitly allow regulators to introduce evidence on those issues and perhaps even initiate the proposed transaction by commencing the bankruptcy case or filing the relevant motion.

Some participants discussed the value of retaining at least certain members of a financial institution's management team to assist with the bankruptcy case, which currently is permitted under the Bankruptcy Code (but may not be the case under Title II). Other participants noted, however, that the bankruptcy court may need to retain its own expert to evaluate certain financial issues or systemic concerns raised by regulators or counterparties. This proposal is similar to the special master aspect of the chapter 14 proposal discussed *supra* but relies on the procedures for court-appointed experts instead of special masters. (Bankruptcy Rule 9031 does not permit the appointment of special masters in bankruptcy cases.) In addition, some participants suggested that a special panel of chapter 7 trustees with expertise in financial matters may prove beneficial in instances where financial institutions file chapter 7 cases.

Although most of the specific amendments to the Bankruptcy Code discussed during the interviews revolved around the safe harbor provision, section 365(o) also was identified as an area of potential confusion in the context of bank holding company bankruptcy cases. Section 365(o) provides that a trustee in a chapter 11 case shall be deemed to assume and "shall immediately cure any deficit under, any commitment by the debtor to a Federal depository institutions regulatory agency (or predecessor to such an agency) to maintain the capital of an insured depository institution." Participants noted that uncertainty exists regarding the extent of this obligation when the depository bank and the related capital requirements have been transferred to another financial institution under the FDIA or when the chapter 11 estate does not have the liquidity to satisfy its section 365(o) obligations.

In the context of the Bankruptcy Code safe harbor provisions, participants discussed the proposals identified *supra* Part VI.A. Many participants suggested that some short stay of counterparties' rights that gave the debtor in possession an opportunity to assume and

assign these contracts to qualified transferees would be beneficial. These participants generally did, however, recognize the need to balance the interests of the estate with the potential systemic effects that might flow from any greater interruption in the counterparties' ability to terminate financial contracts. Participants also suggested a need to clarify valuation and damages calculations in situations where the financial contracts are terminated by the counterparties or rejected by the debtor. Notably, many participants suggested that modifications to the Bankruptcy Code safe harbors, including eliminating the section 546 protections, should apply in all bankruptcy cases, not just those involving large, complex financial institutions.

VII. Conclusion

The process undertaken by the AOUSC and its working group to research and prepare this report identified several significant issues that relate directly to the questions presented for study by section 202(e) of the Act. As a general matter, resolving distressed financial institutions, including those qualifying as covered financial companies under the Act, raises issues addressed on a regular basis by U.S. bankruptcy courts in the context of chapter 11 mega-cases. *See supra* Part IV.A.6. The Bankruptcy Code and the bankruptcy courts appear well equipped to administer these cases in an orderly manner. Nevertheless, the business models of at least some financial institutions may pose different challenges in any resolution, including assets that dissipate quickly or fluctuate greatly in value; reliance on market confidence and potential "runs on the bank" when that confidence weakens; use of complex financial contracts and short-term funding mechanisms; and integrated and global operations and infrastructures that are difficult to unwind. *See supra* Part V.A.

These distinguishing attributes of financial institutions should be considered in assessing any resolution scheme applicable to financial institutions. In this context, as explained *supra* Part V, some commentators suggest that speed and flexibility in resolution, certainty for creditors and other parties in interest, considerations of externalities and systemic risk, pre-bankruptcy planning and the treatment of financial contracts are among the issues to weigh under both the Bankruptcy Code and Title II of the Act. The AOUSC believes that this report provides a thorough analysis of the issues and the current status of the resolution schemes applicable to large, complex financial institutions. Some identified issues are not, however, subject to final resolution under the existing data and literature.

Appendix A: Capitalized Defined Terms

Defined Term	Definition
Act	Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
AIG	American International Group
AOUSC	Administrative Office of the United States Courts
Bankruptcy Code	Title 11 of the United States Code
Barclays	Barclays Capital Inc.
CIT Group	CIT Group Inc.
FDIA	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	Board of Governors of the Federal Reserve System
FJC	Federal Judicial Center
FSOC	Financial Stability Oversight Council
GAO	Government Accountability Office
ISDA	International Swaps and Derivatives Association, Inc.
LBI	Lehman Brothers, Inc.
LBIE	Lehman Brothers International (Europe)
Lehman Brothers	Lehman Brothers Holding Inc.
Mega-Case Guide	A Guide to the Judicial Management of Mega-Cases
OLA	Orderly Liquidation Authority
Secretary	Secretary of the Treasury
SIPA	Securities Investor Protection Act of 1970
SIPC	Securities Investor Protection Corporation

Appendix B: Sources for Bank Holding Companies and Nonbank Financial Institutions Bankruptcy Cases and FDIC Failed Bank List

Neither the AOUSC nor the FJC has tracked bankruptcy filings by industry in manner that easily identifies bank holding companies or nonbank financial institutions. Other than registered brokers and dealers, which often involve related SIPA procedures, these types of financial institutions have been treated like other business debtors under the Bankruptcy Code and, thus, previously did not require special tracking. Nevertheless, the AOUSC working group searched various online public filing databases to obtain a preliminary indication of the number of bank holding company and nonbank financial institution bankruptcy filings during 2007 to 2010.

In addition, the FDIC maintains a list of failed insured depository banks in which the FDIC has been appointed as receiver under the FDIA. This list is available at the FDIC's website, http://www.fdic.gov/bank/individual/failed/banklist.html.

Appendix C: Individuals Interviewed for Report

United States Bankruptcy Judges

Hon. Kevin J. Carey	Chief U.S. Bankruptcy Judge, District of Delaware
Hon. Robert D. Drain	U.S. Bankruptcy Judge, Southern District of New York
Hon. Robert E. Gerber	U.S. Bankruptcy Judge, Southern District of New York
Hon. Martin Glenn	U.S. Bankruptcy Judge, Southern District of New York
Hon. Arthur J. Gonzalez	Chief U.S. Bankruptcy Judge, Southern District of New York
Hon. Allan L. Gropper	U.S. Bankruptcy Judge, Southern District of New York
Hon. Barbara J. Houser	Chief U.S. Bankruptcy Judge, Northern District of Texas
Hon. James M. Peck	U.S. Bankruptcy Judge, Southern District of New York
Hon. Mary Walrath	U.S. Bankruptcy Judge, District of Delaware
Hon. Dwight H. Williams	Chief U.S. Bankruptcy Judge, Middle District of Alabama

United States Bankruptcy Clerks of Court

David D. Bird	U.S. Bankruptcy Clerk of Court, District of Delaware
Vito Genna	U.S. Bankruptcy Clerk of Court, Southern District of New York
Juan-Carlos Guerrero	U.S. Bankruptcy Clerk of Court, Middle District of Alabama

United States District Judge

Hon. Laura Taylor Swain	U.S. District Judge, Southern District of New York

Attorneys

John J. Clarke, Jr.	DLA Piper, New York
Matthew A. Feldman	Willkie Farr & Gallagher, New York
Evan D. Flaschen	Bracewell & Giuliani, Connecticut
Maurice Horwitz	Weil, Gotshal & Manges, New York

Christopher K. Kiplok	Hughes Hubbard & Reed, New York
Alan W. Kornberg	Paul, Weiss, Rifkind, Wharton & Garrison, New York
Richard Levin	Cravath, Swaine & Moore, New York
Harvey R. Miller	Weil, Gotshal & Manges, New York
David R. Seligman	Kirkland & Ellis, Chicago, Illinois

Financial Professionals

Lawrence Brandman	Lehman Brothers Holdings Inc., New York
Kenneth A. Buckfire	Miller Buckfire, New York
William Q. Derrough	Moelis & Company, New York
Daniel J. Ehrmann	Alvarez & Marsal, New York
Melissa Kibler Knoll	Mesirow Financial Consulting, Chicago, Illinois
Michael Krimminger	General Counsel, Federal Deposit Insurance Corporation
Bryan Marsal	Alvarez & Marsal, New York
Locke R. McMurray	Lehman Brothers Holdings Inc., New York
Jim Millstein	Former Chief Restructuring Officer, U.S. Department of Treasury
Christopher M. O'Meara	Lehman Brothers Holdings Inc., New York
Mark Shapiro	Barclays
Bettina Whyte	Alvarez & Marsal, New York

Academics

Kenneth M. Ayotte	Northwestern Law School
Douglas G. Baird	University of Chicago Law School
Erik K. Gerding	University of New Mexico School of Law
Steven L. Heston	Robert H. Smith School of Business, University of Maryland
Thomas H. Jackson	Hoover Institution, Stanford University
Kimberly D. Krawiec	Duke University School of Law
Stephen J. Lubben	Seton Hall Law

Troy McKenzie	New York University School of Law
Kenneth E. Scott	Hoover Institution, Stanford University
Kimberly Anne Summe	Hoover Institution, Stanford University
John B. Taylor	Hoover Institution, Stanford University
Frederick Tung	Boston University School of Law

Law Clerks/Interns

Tracy Leyba	Law Student Intern, Federal Judicial Center
Brian Wells	Law Clerk to Bankruptcy Judge Stuart Bernstein (NY-S)

Appendix D: Description of Bankruptcy Databases

AOUSC Mega-Case Database

The Statistics Division of the Administrative Office of the U.S. Courts (AO) first identified all chapter 11 business bankruptcies filed between January 1, 2000, and September 30, 2010. From that population, the AO used data provided by debtors at filing to identify those cases where the debtor reported more than $100 million in assets and more than 1,000 creditors, the criteria identified by the Federal Judicial Center as "mega" chapter 11 bankruptcy cases. Cases filed under chapter 11 may involve several separate filings of different business entities affiliated with the same corporate parent. In order to identify which cases are jointly administered, and which case is the lead case on which activity in the case is docketed, Statistics Division staff turned to each court's ECF system to identify cases that were jointly administered and, in such situations, which case was the lead case for purposes of docketing. The Statistics Division query of its data indicated 109,967 cases filed under chapter 11 between January 1, 2000, and September 30, 2010. Of those cases, 9,450 met the assets and creditors criteria of a mega filing. Analysis of CM/ECF records reduced those 9,450 cases to 678 lead cases. The bankruptcy filing with the greatest number of cases was the 2004 filing of Footstar, Inc. in the Southern District of New York, which involved 2,398 filings that met the definition of mega filing (and may have generated additional filings where the debtor did not indicate assets and creditors sufficient to qualify as a mega filing).

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