

REPORT TO THE PRESIDENT OF THE UNITED STATES  
Pursuant to the Presidential Memorandum Issued April 21, 2017

# Orderly Liquidation Authority and Bankruptcy Reform

FEBRUARY 21, 2018





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## EXECUTIVE SUMMARY

On February 3, 2017, President Donald J. Trump issued an Executive Order prescribing seven “Core Principles” to guide reform of the U.S. financial regulatory system. Those principles include the prevention of taxpayer-funded bailouts and moral hazard, promotion of economic growth, and enabling American businesses to compete effectively with their foreign counterparts at home and abroad.<sup>1</sup> On April 21, 2017, the President issued a memorandum directing the Secretary of the Treasury to examine the Orderly Liquidation Authority (OLA)—the resolution regime created by Title II of the Dodd-Frank Act<sup>2</sup>—to propose recommendations for reform of OLA guided by the Core Principles and to examine whether a new chapter of the Bankruptcy Code should be adopted for the resolution of financial companies.<sup>3</sup>

Title II permits the Secretary of the Treasury, in consultation with the President, to appoint the Federal Deposit Insurance Corporation (FDIC) as receiver of a severely distressed financial company. A supermajority of the Board of Governors of the Federal Reserve System (Federal Reserve) and, in most cases, the board of directors of the FDIC must vote to recommend that the Secretary invoke OLA based on eight statutory criteria, and the Secretary must conclude that the company’s bankruptcy would have serious adverse effects on U.S. financial stability and that there is no private sector alternative to prevent default, among other required determinations. The decision to invoke OLA is subject to limited, expedited judicial review. Once appointed as receiver, the FDIC assumes broad statutory authority to wind down and sell off the financial company immediately or after transferring its assets to a new bridge company. The Dodd-Frank Act establishes an Orderly Liquidation Fund (OLF) at Treasury as a liquidity facility that the FDIC may draw upon, subject to terms set by Treasury, to lend to the financial company in receivership.

Treasury shares many of the concerns raised by critics of OLA. Title II, as enacted, creates a resolution authority that confers far too much unchecked administrative discretion, could be misused to bail out creditors, and runs the risk of weakening market discipline. Since the enactment of the Dodd-Frank Act, the FDIC has taken several critical steps to address these concerns, including through the development of a single point of entry (SPOE) strategy that would involve the “bail-in” of long-term creditors of the holding company. But further reform is required. To that end, our recommendations begin with a proposal to narrow the path to OLA by building a more robust, effective bankruptcy process for financial companies. We then propose several reforms to OLA to eliminate opportunities for *ad hoc* disparate treatment of similarly

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<sup>1</sup> Executive Order No. 13772, Core Principles for Regulating the United States Financial System, 82 Fed. Reg. 9965 (Feb. 3, 2017).

<sup>2</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203 (Jul. 21, 2010).

<sup>3</sup> Presidential Memorandum for the Secretary of the Treasury, Orderly Liquidation Authority (Apr. 21, 2017).

situated creditors, reinforce existing taxpayer protections, and strengthen judicial review. These reforms will make OLA consistent with the rule of law and eliminate the ability of regulators to pick winners and losers among creditors. Our reforms would transform OLA into an effective mechanism for resolving financial institutions in a manner that treats creditors in a way that is substantially similar to how those creditors would be treated in bankruptcy and avoids the need for government bailouts. Appendix A provides a summary of the recommendations in this report.

Though the serious defects in OLA’s original design must be corrected, Treasury recommends retaining OLA as an emergency tool for use under only extraordinary circumstances. While bankruptcy must be the presumptive option, the bankruptcy of large, complex financial institutions may not be feasible in some circumstances, including when there is insufficient private financing. In those cases, a reformed OLA process—with predictable, clear allocation of losses to shareholders and creditors—is a far preferable alternative to destabilizing financial contagion or *ad hoc* government bailouts. In addition, Treasury recognizes that, without the assurance of OLA as an emergency tool, foreign regulators would be more likely to impose immediate new requirements on foreign affiliates of U.S. bank holding companies, raising their costs of business and harming their ability to compete internationally. The burden of those regulatory interventions would be felt in the United States not only by financial companies but also by their customers and counterparties.

### ***Bankruptcy First***

The President directed Treasury to consider whether an improved bankruptcy process “would be a superior method for resolution of financial companies” as compared to OLA. We conclude unequivocally that bankruptcy should be the resolution method of first resort. Our reason is simple: market discipline is the surest check on excessive risk-taking, and the bankruptcy process reinforces market discipline through a rules-based, predictable, judicially administered allocation of losses from a firm’s failure.

In the context of a distressed financial firm, a successful bankruptcy requires imposing losses on those who contracted to bear the risks of a firm’s failure—its shareholders, executives, and creditors—without causing a destabilizing ripple effect on the broader U.S. economy. This is no easy feat. Large, interconnected financial firms play a central role in financial intermediation and access to credit, but the current Bankruptcy Code was not designed to address the financial distress of a debtor engaged in activities such as significant derivatives transactions and short-term lending. Although these activities are central to well-functioning credit markets and a modern banking system, they can make solvent financial firms vulnerable to destabilizing run-like behavior that rapidly destroys value during times of market stress and can lead to financial contagion. Recognizing this reality, Treasury recommends significant reforms to make bankruptcy a more effective option for financial firms. We refer to this revised bankruptcy process as “Chapter 14” bankruptcy (a heretofore unused chapter of the Bankruptcy Code), and we build on a deeply researched proposal from the Hoover Institution and two carefully crafted

legislative proposals for bankruptcy reform—one of which passed the U.S. House of Representatives with broad bipartisan support.<sup>4</sup>

The Chapter 14 framework would preserve the key advantage of the existing bankruptcy process—clear, predictable, impartial adjudication of competing claims—while adding procedural features tailored to the unique challenges posed by large, interconnected financial firms. For those firms, an expedited process that leaves operating subsidiaries open for business is needed to reassure the market and limit the risk of financial contagion by avoiding runs on deposits and other liabilities by creditors and counterparties. Chapter 14 would address this challenge by building a two-entity recapitalization model into the Bankruptcy Code. Under this approach, a financial company could file for bankruptcy and petition the court for approval to transfer within 48 hours most of its assets and certain liabilities to a newly formed bridge company. The assets to be transferred to the bridge company would include the ownership interests of operating subsidiaries, allowing these entities to continue their operations and eliminating the incentive of their counterparties to run in a manner that would rapidly destroy value and create a contagion effect. To address the concern that counterparties to derivatives and other financial contracts reactively exercise their rights to terminate or liquidate immediately when bankruptcy is initiated, Chapter 14 would provide for a temporary stay on the exercise of such rights pending the potential transfer of qualified financial contracts to the bridge company. Most important, not a single dollar of taxpayer support would be used to capitalize the new bridge company.

Critically, shareholders, management, and specified creditors would bear all losses under Chapter 14, just as they do under the ordinary bankruptcy process. Chapter 14 would provide that predetermined obligations of the financial company would be “left behind” rather than transferred to the bridge company. Those left behind would include all shareholders of the debtor financial company as well as holders of “capital structure debt”—essentially, unsecured long-term debt held at the holding company level. Once such a “bail in” occurs, the equity in the newly established bridge company would be held by a special trustee for the sole benefit of the left-behind shareholders and creditors. The bridge company would remain in private hands, and its new management would be chosen by the new owners of the bridge company.

The statutory standard for invoking OLA is already exceedingly high.<sup>5</sup> But the adoption of a Chapter 14 bankruptcy process will further guarantee that OLA is truly the option of last

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<sup>4</sup> See Financial Institution Bankruptcy Act of 2017, H.R. 1667, 115th Cong. (2017); Financial CHOICE Act of 2017, H.R. 10, 115th Cong. §§ 121-23 (2017); Taxpayer Protection and Responsible Resolution Act, S. 1840, 114th Cong. §§ 2-4 (2015); Taxpayer Protection and Responsible Resolution Act, S. 1861, 113th Cong. §§3-5 (2013); Kenneth E. Scott, Thomas H. Jackson, John B. Taylor, eds., *Making Failure Feasible: How Bankruptcy Reform Can End “Too Big To Fail”* (2015) (providing the most recent version of the Hoover Institution proposal).

<sup>5</sup> See *infra* at page 7.

resort. Under current law, OLA can be triggered only if the failing firm cannot be resolved through bankruptcy without “serious adverse effects on financial stability.”<sup>6</sup> As noted above, however, the current Bankruptcy Code was not designed for large, complex financial firms. Chapter 14 bankruptcy would narrow the path to OLA by mitigating the potential destabilizing effects of the bankruptcy of a large financial firm. In this respect, the Chapter 14 process would build on the resolution planning process under Title I of the Dodd-Frank Act and other post-crisis developments that have made U.S. financial companies more readily resolvable in bankruptcy—including major increases in usable capital and liquidity buffers, elimination of significant short-term debt at the bank holding company level, and efforts to simplify and rationalize corporate entity structure. While Treasury has proposed reforms to the resolution planning framework and capital and liquidity requirements,<sup>7</sup> these developments have better prepared financial companies for resolution outside OLA, and Chapter 14 would complement that work.

### *Limiting and Reforming Orderly Liquidation Authority*

In addition to reducing the need for OLA, we recommend significant reforms to correct serious problems in its original design. First, Title II grants the FDIC excessively broad discretion on several key issues, including the treatment of creditors. Uncertainty concerning how competing classes of creditors will be treated is inconsistent with the rule of law and impairs the ability of market participants to price, monitor, and limit risk in the financial system. The FDIC has taken numerous steps to confine its own discretion, but those commitments should be strengthened in several respects:

- *Eliminate ad hoc Disparate Treatment.* Treasury proposes eliminating the FDIC’s authority to treat similarly situated creditors differently on an *ad hoc* basis. Both the initial transfer of liabilities to the bridge company under OLA and the subsequent administration of claims on the estate of the failed firm should follow established Bankruptcy Code principles. Only critical vendors needed for the continuation of vital services should be eligible for favored treatment, just as under bankruptcy law.
- *Provide for Adjudication of Claims by a Bankruptcy Court.* While the FDIC should manage the transfer and the disposition of the bridge company, Treasury proposes that a bankruptcy court be responsible for adjudicating claims. The FDIC would have standing to participate in the proceedings, but the impartiality and procedural

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<sup>6</sup> Dodd-Frank Act § 203(b)(2) (12 U.S.C. § 5383(b)(2)).

<sup>7</sup> See Department of the Treasury, *A Financial System That Creates Economic Opportunities: Banks and Credit Unions* (2017) at 37-71, <https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf>.



protections of a bankruptcy court would improve the fairness and regularity of the process.

- *Repeal Tax-Exempt Status of Bridge Company.* Treasury recommends repeal of the tax-exempt status of the bridge company. No private corporation, particularly one that is the result of a failed financial firm requiring a government resolution process, should enjoy such a large government-conferred competitive advantage.
- *Provide Greater Clarity on Resolution Strategy.* To enhance predictability, Treasury recommends that the FDIC clarify its commitment to use the SPOE resolution strategy that it has developed and refined over several years. The FDIC should also identify the circumstances, if any, in which SPOE would not be used. Greater clarity on these points will provide more certainty for counterparties of financial companies and permit them to better price and monitor the risks of their exposures.

Second, Title II provides significant protections against taxpayer exposure for losses, but those protections can and should be strengthened to eliminate any risk of unrecovered OLF loans. Among other reforms, Treasury proposes the following:

- *Use Guarantees and Premium Rates to Encourage Return to Private Credit Markets.* In the event the OLF is needed, Treasury and the FDIC should seek to limit its use as much as possible and expedite the bridge company's return to reliance on private sources of liquidity. To that end, Treasury recommends that loan guarantees of private funding should be preferred over direct lending. Loan guarantees may be more likely to reintroduce the bridge company to the private funding markets earlier, which, in turn, could permit the bridge to return to exclusively private sources of liquidity more quickly. To further incentivize a return to private funding, Treasury should use its authority to set the terms of any OLF advances to ensure that the FDIC only lends funds or provides loan guarantees if it charges an interest rate or guarantee fee set at a significant premium.
- *Secure any OLF Loans.* To the extent it is not able to limit use of the OLF to loan guarantees, the FDIC should lend on a secured basis, and Treasury should advance funds to the OLF only on those terms. The FDIC should seek high quality assets as collateral, publish a list of assets eligible to serve as collateral for an OLF loan, and only accept a different form of collateral with the approval of the Secretary of the Treasury.

- *Limit Duration of OLF Loans.* To protect against the risk that changed circumstances, including depreciation of assets, could inhibit repayment, the duration of OLF loans should be limited to a fixed term that is only as long as necessary to meet liquidity needs.
- *Expedite Industry Backstop Assessment.* The reforms proposed in this report will minimize the already low risk that a bridge company would be unable to repay OLF loans and thus trigger the industry-wide backstop assessment provided for by the statute. Nevertheless, in the unlikely event the OLF loans are not fully repaid by the bridge company, the backstop assessment should be imposed as soon as reasonably possible, which we expect would be well in advance of the five year deadline imposed by the Dodd-Frank Act.

Third, Title II provides only a limited, expedited judicial review of the government's decision to place a failing financial company into receivership. Treasury recommends strengthening judicial review of the decision to invoke OLA, while preserving regulators' ability to act swiftly in the event of a financial crisis. Title II currently provides for truncated 24-hour judicial review, limited to two of the seven determinations the Secretary of the Treasury is required to make in order to place a failing financial company into receivership. Treasury proposes that the reviewing court should instead be permitted to review the entire seven-point statutory determination under the "arbitrary and capricious" standard. This deferential review will not permit a court to substitute its judgment for that of the government, but it will provide additional assurance that the government's decision is the product of reasoned and well-supported analysis. In addition, Treasury recommends that Congress consider either (1) replacing the truncated pre-appointment review procedure with a more robust post-appointment petition to remove the FDIC as receiver, or (2) strengthening appellate review by permitting *de novo* review of the district court's decision, in light of the speed with which the district court must act.

With these reforms to OLA and a stronger bankruptcy regime for financial firms, the U.S. financial system will be more resilient in the event of a financial crisis while better protecting taxpayers. Treasury stands ready to work with Congress on the enactment of bankruptcy reform and intends to begin administrative implementation of the reforms proposed here that can be accomplished without legislation.

## BACKGROUND

### I. Statutory Framework of Orderly Liquidation Authority

Federal law has long provided a specialized insolvency regime for insured depository institutions and broker-dealers under the Federal Deposit Insurance Act (FDIA) and the Securities Investor Protection Act, respectively, and state laws prescribe an insolvency process for insurance companies. In 2010, Congress adopted a regime for resolving large, complex financial companies that are outside the scope of those specialized regimes. This new resolution tool, OLA, was intended as an alternative to the unsatisfactory choice between potentially destabilizing bankruptcies and the taxpayer-funded bailouts provided during the 2008-09 financial crisis.

#### A. Requirements for Invoking OLA

Title II of the Dodd-Frank Act erects a series of hurdles that must each be cleared before OLA may be used. These hurdles help to ensure that bankruptcy will be the preferred choice of resolution and that OLA will be the option of last resort.

First, the Federal Reserve, by a vote of two-thirds of the members then serving, must make a written recommendation as to the appointment of the FDIC as receiver of a failing financial company. The eight-point recommendation must consist of the following:

- an evaluation of whether the financial company is in default or in danger of default;
- a description of the effect that the default of the financial company would have on financial stability in the United States;
- a description of the effect that the default of the financial company would have on economic conditions or financial stability for low income, minority, or underserved communities;
- a recommendation regarding the nature and the extent of actions to be taken under Title II regarding the financial company;
- an evaluation of the likelihood of a private sector alternative to prevent the default of the financial company;
- an evaluation of why a case under the Bankruptcy Code is not appropriate for the financial company;
- an evaluation of the effects on creditors, counterparties, and shareholders of the financial company and other market participants; and
- an evaluation of whether the company satisfies the definition of a “financial company.”<sup>8</sup>

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<sup>8</sup> Dodd-Frank Act § 203(a) (12 U.S.C. § 5383(a)).

Second, another regulator must issue its own eight-point recommendation. In most cases, that regulator is the FDIC, which must approve the recommendation by a two-thirds vote of its board members.<sup>9</sup> In the case of broker-dealers or financial companies in which the largest U.S. subsidiary, measured by assets, is a broker-dealer, the Securities and Exchange Commission (SEC) must make the recommendation, by a two-thirds vote of the SEC commissioners then serving, and the FDIC must also be consulted.<sup>10</sup> And in the case of insurance companies or financial companies in which the largest U.S. subsidiary, measured by assets, is an insurance company, the Director of the Federal Insurance Office (FIO) must make the recommendation, and the FDIC must also be consulted.<sup>11</sup>

Third, if the Secretary of the Treasury receives the required recommendations, he must then make his own determination, in consultation with the President. This seven-point determination must consist of the following findings:

- the company is in default or in danger of default;
- the failure of the company and its resolution under otherwise applicable federal or state law (in almost all cases, this would mean a resolution under the Bankruptcy Code) would have serious adverse effects on U.S. financial stability;
- no viable private sector alternative is available to prevent the default of the company;
- any effect on the claims or interests of creditors, counterparties, and shareholders of the company and other market participants as a result of actions to be taken under OLA is appropriate, given the impact that any action taken under OLA would have on U.S. financial stability;
- any action taken under OLA would avoid or mitigate such adverse effects;
- 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
- the company satisfies the definition of “financial company.”<sup>12</sup>

Fourth, once the Secretary of the Treasury makes his determination, he must notify the board of directors of the financial company and seek its acquiescence or consent to the

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<sup>9</sup> *Id.*

<sup>10</sup> Dodd-Frank Act § 203(a)(1)(B) (12 U.S.C. § 5383(a)(1)(B)). In the event the FDIC is appointed receiver of a broker-dealer, the FDIC would in turn appoint the Securities Investor Protection Corporation to act as trustee of the broker-dealer. Dodd-Frank Act § 205(a)(1) (12 U.S.C. § 5385(a)(1)).

<sup>11</sup> Dodd-Frank Act § 203(a)(1)(C) (12 U.S.C. § 5383(a)(1)(C)). An insurance company is to be resolved as provided under state law governing insurance company insolvencies. Dodd-Frank Act § 203(e) (12 U.S.C. § 5383(e)).

<sup>12</sup> Dodd-Frank Act § 203(b) (12 U.S.C. § 5383(b)).

appointment of the FDIC as receiver.<sup>13</sup> If the financial company’s board does not consent or acquiesce, the Secretary of the Treasury must file a petition in federal district court.<sup>14</sup> The court then has 24 hours to conduct a two-point review of the Secretary of the Treasury’s finding that the financial company is in default or in danger of default and that the company satisfies the definition of “financial company.”<sup>15</sup> If the court does not conclude within 24 hours that either of those findings was arbitrary or capricious, the FDIC will be appointed as receiver.

In sum, before OLA may be used, numerous findings must be made, including that no private sector alternative is available and that resolution of the company under the Bankruptcy Code would have serious adverse effects on U.S. financial stability. Those findings, moreover, must be agreed upon by a supermajority of the members of two multimember regulators—the Federal Reserve and the FDIC (or, in certain cases, the SEC or FIO), as well as by the Secretary of the Treasury, in consultation with the President. And those decisions are further subject to immediate, though limited, judicial review.

### **B. Post-Appointment Checks on FDIC Authority**

Following the appointment of the FDIC as receiver, Title II provides checks on how the FDIC exercises its authority in implementing OLA, including its use of funds in the OLF. In particular, Treasury maintains control of any funding provided to the FDIC. The Secretary of the Treasury (or his designee) must approve each advance of funds to the FDIC. The Secretary sets the terms and conditions of such funding, including the interest rate, amount, and duration of the advances.<sup>16</sup> These constraints—and the further constraints Treasury recommends imposing—are discussed in more detail below. The FDIC must also develop an orderly liquidation plan, acceptable to the Secretary, regarding the provision and use of the funds.<sup>17</sup> And no amount greater than 10 percent of the assets of the covered financial company may be provided to the FDIC until the Secretary and FDIC have agreed on a plan and schedule for repayment.<sup>18</sup>

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<sup>13</sup> Dodd-Frank Act § 202(a)(1)(A)(i) (12 U.S.C. § 5382(a)(1)(A)(i)).

<sup>14</sup> *Id.*

<sup>15</sup> Dodd-Frank Act § 202(a)(1)(A)(iii) (12 U.S.C. § 5382(a)(1)(A)(iii)).

<sup>16</sup> Dodd-Frank Act § 210(n)(5)(B), (C) (12 U.S.C. § 5390(n)(5)(B), (C)).

<sup>17</sup> Dodd-Frank Act § 210(n)(9)(A) (12 U.S.C. § 5390(n)(9)(A)).

<sup>18</sup> Dodd-Frank Act § 210(n)(9)(B) (12 U.S.C. § 5390(n)(9)(B)). As discussed below, once the FDIC has completed a fair value estimate of the total consolidated assets of the covered financial company, advances under the OLF are limited to 90 percent of the amount of such value.

### **C. Accountability for the Financial Company, Management, and Shareholders**

If a firm is resolved through Title II rather than through bankruptcy, its board of directors and management bear responsibility for the firm's failure to adequately manage its risks. Accordingly, Title II mandates that management responsible for the financial company's failure be dismissed.<sup>19</sup> The bridge company (discussed below) would have a new board of directors and management team, including a new chief executive officer, chief financial officer, and chief risk officer, all chosen from the private sector.<sup>20</sup> Compensation could be clawed back from any current or former senior executive or director substantially responsible for the failure of the covered financial company.<sup>21</sup>

Further, Title II mandates that OLA be used in such a way that shareholders and creditors will bear the company's losses.<sup>22</sup> As discussed below, the FDIC has stated that, under the single point of entry model, it expects shareholders' equity, subordinated debt, and a substantial portion of the unsecured liabilities of the holding company (other than essential vendors' claims) to remain as claims against the receivership to be exchanged for securities issued by the bridge company.<sup>23</sup>

Finally, recognizing that a financial company resolution in OLA could represent a failure of the regulation and supervision of such an entity, the Inspector General of the Federal Reserve or the relevant primary financial regulatory agency would be required to report on the past effectiveness of the agency with respect to the covered financial company, identify acts or omissions of the regulator that helped to cause the failure of the company, and recommend administrative or legislative changes.<sup>24</sup>

## **II. Single Point of Entry Strategy**

In carrying out a resolution of a financial company under Title II, the FDIC has stated that it expects to use a "single point of entry" (SPOE) strategy in which only the U.S. top-tier

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<sup>19</sup> Dodd-Frank Act § 204(a)(2) (12 U.S.C. § 5384(a)(2)).

<sup>20</sup> Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614, 76616–17 (Dec. 18, 2013).

<sup>21</sup> See Dodd-Frank Act § 210(s) (12 U.S.C. § 5390(s)); 12 C.F.R. § 380.7. It has been suggested that the FDIC may have gone beyond the bounds of the statute in adopting the particular presumptions for determining whether a director or executive is to be deemed substantially responsible. See Dorothy Shapiro, *Federalizing Fiduciary Duty: The Altered Scope of Officer Fiduciary Duty following Orderly Liquidation under Dodd-Frank*, 17 Stan. J.L. Bus & Fin. 223, 240-57 (2012).

<sup>22</sup> Dodd-Frank Act § 204(a)(1) (12 U.S.C. § 5384(a)(1)).

<sup>23</sup> 78 Fed. Reg. at 76618.

<sup>24</sup> Dodd-Frank Act § 211(f) (12 U.S.C. § 5391(f)).

parent holding company would be placed into receivership.<sup>25</sup> Under the strategy, solvent subsidiaries, such as broker-dealers, insured depository institutions, and overseas subsidiaries, would continue operating as usual (and paying their obligations when due), thereby avoiding multiple competing insolvencies and minimizing further disruptions to the financial system.

Under the SPOE strategy, most of the assets of the holding company, including the equity in its subsidiaries, would be transferred to an FDIC-established bridge company, while the claims of shareholders and most unsecured creditors would be left in the receivership.<sup>26</sup> This transfer would likely leave the bridge company with a strengthened balance sheet that would give the market confidence in the bridge's solvency and its subsidiaries' continued operations. As soon as practical, the FDIC would return the bridge to private control. The claims left in the receivership would be subject to losses, shareholders would likely be wiped out, and unsecured creditors, including bondholders, would likely also absorb losses.<sup>27</sup>

Although the SPOE strategy would provide the bridge company with a stronger balance sheet, short-term liquidity from the private sector may not be immediately available. The Dodd-Frank Act authorizes the FDIC to issue obligations to Treasury, the proceeds of which are deposited into the OLF, and the FDIC can use the proceeds to make OLF loans to the bridge company.<sup>28</sup> In addition, the FDIC may issue loan guarantees to facilitate private sector lending to the bridge company.

The FDIC has stated that it “intends to maximize the use of private funding in a systemic resolution and expects the well-capitalized bridge company and its subsidiaries to obtain funding from customary sources of liquidity in the private markets.”<sup>29</sup> However, the FDIC acknowledged that “market conditions could be such that private sources of funding might not be immediately available.” As a result, the FDIC stated that, “if private sector funding cannot be immediately obtained,” the FDIC would borrow funds from Treasury and use the OLF funds to lend to the bridge company “on a fully secured basis.”<sup>30</sup> The FDIC goes on to state that it would borrow funds from Treasury “in limited amounts for a brief transitional period in the initial phase

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<sup>25</sup> Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614 (Dec. 18, 2013).

<sup>26</sup> *Id.* at 76616. Title II uses the term “bridge financial company.” See Dodd-Frank Act § 201(a)(3) (12 U.S.C. § 5381(a)(3)).

<sup>27</sup> 78 Fed. Reg. at 76618–76620.

<sup>28</sup> Dodd-Frank Act §§ 204(d), 210(h)(2)(G)(iv), 210(h)(4), and 210(n) (12 U.S.C. §§ 5384(d)(2), 5390(h)(2)(G)(iv), 5390(h)(4), and 5390(n)).

<sup>29</sup> 78 Fed. Reg. at 76616.

<sup>30</sup> *Id.*

of the resolution process and [Treasury] would be repaid promptly once access to private funding resumed.”<sup>31</sup>

There are statutory limitations on the use of the OLF, as it may only be used for liquidity funding. Dodd-Frank requires that “[i]n taking action under [OLA], the [FDIC] shall determine that such action is necessary for purposes of the financial stability of the United States.”<sup>32</sup> This means that each time the FDIC provides funds to the bridge company, the FDIC must determine that such funding support is necessary for U.S. financial stability. In addition, Title II makes clear that the OLF is to be used to provide liquidity, and not capital, by prohibiting the FDIC from taking an equity interest in the bridge company.<sup>33</sup>

Further, there are limits on the aggregate amount of obligations, including loans or guarantees, that the FDIC can issue or incur with respect to the resolution. The FDIC is required to calculate the fair value of the covered financial company’s total consolidated assets within 30 days of being appointed receiver. Until this calculation is completed, the maximum obligation limitation is equal to 10 percent of the covered financial company’s total consolidated assets based on its most recent financial statements. Once the FDIC completes the fair value calculation, the limit would generally be 90 percent of the total fair value amount.<sup>34</sup> This effectively represents a 10 percent discount, or “haircut,” of the fair value of the assets as a precaution against the risk that the fair value was overstated or that the value of the assets could decline.

Any loans that the FDIC makes using OLF borrowings will have repayment priority over all other unsecured claims that remain in the receivership estate.<sup>35</sup> In the event that the FDIC is unable to repay its loans from Treasury after exhausting amounts in the receivership and recouping amounts owed by the bridge, Title II ultimately requires the FDIC to impose assessments on the largest financial companies within a five year period to recoup such outlays.<sup>36</sup> The obligation to impose assessments was intended to protect taxpayers from bearing the losses from the liquidation of a failed financial company.<sup>37</sup>

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<sup>31</sup> *Id.*

<sup>32</sup> Dodd-Frank Act § 206(1) (12 U.S.C. § 5386(1)).

<sup>33</sup> Dodd-Frank Act § 206(6) (12 U.S.C. § 5386(6)).

<sup>34</sup> Dodd-Frank Act § 210(n)(6) (12 U.S.C. § 5390(6)).

<sup>35</sup> Dodd-Frank Act § 210(b)(1)(B) (12 U.S.C. § 5390(b)(1)(B)); 12 C.F.R. 380.23(a).

<sup>36</sup> Dodd-Frank Act § 210(o) (12 U.S.C. § 5390(o)).

<sup>37</sup> Dodd-Frank Act § 214(c) (12 U.S.C. § 5394(c)).



### III. Preparing for Resolution: Post-Crisis Developments

Although many regulatory reforms have been aimed at making financial firms less likely to fail,<sup>38</sup> preparing for resolution has been a key component of the post-crisis regulatory agenda. Regulators and industry have undertaken various changes designed to improve the resolvability of firms whether through bankruptcy or OLA. These include changes implemented as part of the resolution planning process; the Federal Reserve’s adoption of total loss=absorbing capacity, long-term debt, and clean holding company requirements; private sector and regulatory efforts to ensure enforcement of temporary stays of derivatives contracts; and the economic subordination of holding company debt.

#### A. Resolution Planning

The Dodd-Frank Act requires large bank holding companies (those with \$50 billion or more in total consolidated assets) and nonbank financial companies designated by the Financial Stability Oversight Council to prepare resolution plans (or “living wills”) for their rapid and orderly resolution under the Bankruptcy Code and submit them for review by the Federal Reserve and FDIC.<sup>39</sup> The largest bank holding companies in particular have gone through several rounds of plan submissions, revising them to address deficiencies and other shortcomings identified by the agencies and to comply with evolving agency guidance. This process of developing and revising resolution plans—though it could be improved as Treasury has recommended in a recent report<sup>40</sup>—has led to significant advances in the resolvability of these financial companies, thereby making resolution under the Bankruptcy Code a substantially more feasible option and making the need to resort to OLA less likely.

##### *Rationalization of legal entity structures*

Firms subject to the resolution planning requirements have developed criteria for assessing their legal entity structures on an on-going basis. Firms are expected to rationalize their structures in a way that would facilitate an orderly resolution and permit the sale of discrete operations in the course of a resolution.<sup>41</sup> Firms have significantly reduced the number of their

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<sup>38</sup> Such reforms have included substantial increases in the amount and quality of regulatory capital and liquidity required to be held by the largest bank holding companies and related disclosure requirements. See Department of the Treasury, *supra* note 7, at 37-43.

<sup>39</sup> Dodd-Frank Act § 165(d) (12 U.S.C. § 5365(d)).

<sup>40</sup> See Department of the Treasury, *supra* note 7, at 66–68.

<sup>41</sup> Federal Reserve and FDIC, *Guidance for 2018 §165(d) Annual Resolution Plan Submissions by Domestic Covered Companies that Submitted Resolution Plans in July 2015* 23-24, <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170324a21.pdf>.

subsidiaries and taken steps to better align legal entity structures with distinct business lines.<sup>42</sup> This realignment of legal entities is intended to reduce the fragmentation of business lines across legal entities that could complicate the sale or resolution of individual business units. Reducing the complexity of financial companies should reduce the complexity of a resolution and increase the likelihood that the value of viable business units can be preserved.

#### *Funding and capital needs for resolution*

One of the primary challenges in resolving a large financial company would be to ensure an adequate level of capital and liquidity to continue the operations of its subsidiaries. Through the resolution planning process, firms have prepared for this challenge by improving their abilities to assess and model potential capital and liquidity needs across key subsidiaries in the event of bankruptcy; by increasing their capital and liquidity levels accordingly and pre-positioning a certain amount of such capital and liquidity at particular entities; and by establishing mechanisms through which firms can transfer capital and liquidity to key material entities as needed.

Overall capital and liquidity levels have risen substantially as discussed more fully below. As to liquidity, the banking agencies' liquidity coverage ratio (LCR) rule requires large U.S. bank holding companies and their depository institution subsidiaries to hold a sufficient amount of high-quality liquid assets in order to withstand net cash outflows over a 30-day stressed scenario, in which it is assumed that they would not have access to funding and liquidity markets.<sup>43</sup>

Furthermore, firms are expected to demonstrate in their resolution plans that they possess enough capital and liquidity, whether centrally or pre-positioned at subsidiaries, to cover the sum of all the estimated amount of capital and liquidity that their material subsidiaries would need in the event of a bankruptcy filing at the holding company for a specified period of time. The Federal Reserve and FDIC have developed frameworks as to how a firm should estimate how much pre-positioning is needed at key subsidiaries prior to resolution and how much would be needed by such subsidiaries after the company files for bankruptcy, which is dependent to a significant extent on the nature of the business risk of the firm.<sup>44</sup>

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<sup>42</sup> Federal Reserve and FDIC, *Resolution Plan Assessment Framework and Firm Determinations* 7 (Apr. 13, 2016), <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160413a2.pdf>.

<sup>43</sup> 12 C.F.R. § 50.10 (OCC); 12 C.F.R. § 249.10 (Federal Reserve); 12 C.F.R. § 329.10 (FDIC). As of September 30, 2017, U.S. G-SIBs (as defined below) held about \$2.3 trillion in high-quality liquid assets, of which about 86 percent are the highest quality category ("Level 1" assets), which primarily consist of cash and Treasury securities. G-SIBs reported an average LCR of more than 120 percent, well above the minimum requirement of 100 percent. See the LCR disclosures available on each company's website.

<sup>44</sup> Federal Reserve and FDIC, *supra* note 41 at 5–11.

### *Contractual arrangements for resolution*

The largest, most complex U.S. bank holding companies, known as global systemically important banks (G-SIBs),<sup>45</sup> have also taken important steps intended to ensure that the resources of the parent holding company can reliably be provided to operating entities in the event of bankruptcy. As described in their resolution plans, the U.S. G-SIBs have executed secured support agreements that contractually require the parent holding company (and, where applicable, the firm's intermediate holding company) to downstream to key entities the capital and liquidity they would need in the event of the bankruptcy of the parent holding company. These contractually binding mechanisms have been structured in a way that is intended to make such transfers less vulnerable to legal challenges in the event of a bankruptcy of the parent.

In addition, most U.S. G-SIBs have established intermediate holding companies to provide resources to the firm's operating subsidiaries in the event of the parent holding company's bankruptcy. Because the intermediate holding company would not have any third-party debt of its own, it could use its prefunded resources to support the operations of its operating subsidiaries. Intermediate holding companies provide greater funding flexibility because they allow financial resources to be directed to operating subsidiaries at the time and in the amount needed, avoiding the need for each individual operating subsidiary to hold all resources it might need in the event of the parent's resolution.<sup>46</sup> As discussed below, should Congress enact the Chapter 14 amendments to the Bankruptcy Code recommended by Treasury, financial companies would be further protected from legal challenges to the recapitalization of and provision of continued support to their operating subsidiaries during bankruptcy.

### *Continuation of key services in the event of resolution*

Financial companies subject to the resolution plan requirements have also taken key steps to prevent the disruption of intercompany services shared by multiple affiliates (such as treasury and information technology services) and critical third party services (such as central clearinghouses and other financial market utilities and data and software vendors) in the event of bankruptcy. Shared intercompany services are now subject to clear, legally binding service agreements that provide for ongoing services even if some affiliates have failed or are separated from the parent in resolution. Many of these critical services are now also housed in separate bankruptcy-remote entities or operating subsidiaries. Firms have modified vendor contracts to

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<sup>45</sup> See 12 C.F.R. § 217.402.

<sup>46</sup> Public versions of the resolution plans of the G-SIBs and other financial companies filed with the FDIC and Federal Reserve are available on the FDIC's website at <https://www.fdic.gov/regulations/reform/resplans/>

provide that services will continue to be provided even if the company declares bankruptcy.<sup>47</sup> With respect to their relationships with central clearinghouses, firms have been expected to develop playbooks and strategies to ensure continued access, as well as contingency plans for meeting operational, liquidity, and collateral requirements should the clearinghouse increase the stringency of such requirements in the event of a resolution.<sup>48</sup>

## **B. Total Loss-Absorbing Capacity and Clean Holding Company Requirements**

U.S. bank holding companies have greatly enhanced their loss-absorbing capacity in recent years.<sup>49</sup> These enhancements were capped off by the Federal Reserve's total loss-absorbing capacity (TLAC) and long-term debt requirements finalized in December 2016.<sup>50</sup> The TLAC requirements are essential to the execution of the SPOE resolution strategy contemplated for resolution under both OLA and the proposed Chapter 14 amendments to the Bankruptcy Code. The assumption behind the long-term debt requirement is that, in the run up to bankruptcy or resolution, the stressed firm will, by definition, find its capital position significantly or completely depleted. However, in a bankruptcy or resolution, such long-term debt would be available to be converted to equity, thus providing a source of private capital.<sup>51</sup> The availability of TLAC and the infusion of new equity as a result of the conversion of the long-term debt would generate market confidence to help avoid runs on deposits and other liabilities and by trading counterparties that could otherwise lead to financial contagion.

The current amount of TLAC issued by the G-SIBs is substantial. Today, U.S. G-SIBs have an estimated aggregate TLAC amount of approximately \$2 trillion, which represents about 30 percent of their aggregate risk-weighted assets.<sup>52</sup> This is a significant increase from the pre-crisis period in which U.S. G-SIB firms had loss-absorbing capacity of only 5 percent of risk-

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<sup>47</sup> Federal Reserve Board and FDIC, *Resolution Plan Assessment Framework and Firm Determinations (2016)* 7 (Apr. 13, 2016), <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160413a2.pdf>.

<sup>48</sup> Federal Reserve and FDIC, *supra* note 41, at 14–16.

<sup>49</sup> See Department of the Treasury, *supra* note 7, at 37–43.

<sup>50</sup> Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements, 82 Fed. Reg. 8266 (Jan. 24, 2017). The TLAC and long-term debt requirements appear at 12 C.F.R. § 252.60 et seq. and 12 C.F.R. § 252.160 et seq. Treasury has recommended certain adjustments to the TLAC rule. See Department of the Treasury, *supra* note 7 at 55–56.

<sup>51</sup> 82 Fed. Reg. 8266 at 8267.

<sup>52</sup> Treasury staff estimates based on company reports and Federal Reserve filings. Of this \$2 trillion aggregate TLAC amount (as of September 30, 2017), \$830 billion is comprised of common equity tier 1 regulatory capital, \$120 billion in additional tier 1 capital, and the balance in eligible long term and subordinated debt.

weighted assets.<sup>53</sup> TLAC levels amounting to an average of approximately 30 percent of risk-weighted assets represents the far upper range of historic losses experienced by banks during the most recent financial crisis as well as past financial crises.<sup>54</sup> More importantly, G-SIBs had little or no long-term convertible debt prior to the crisis that could have provided an equity infusion as those institutions neared insolvency.

The SPOE resolution strategy is also facilitated by Federal Reserve rules requiring U.S. G-SIBs to maintain a “clean” top level bank holding company, based on the expectation that the simpler the holdings of the top level parent company are, the simpler a transfer of assets to a bridge company would be. To this end, the top-tier bank holding company of a G-SIB may not issue short-term debt other than to a subsidiary or enter into qualified financial contracts, such as repurchase agreements or derivatives, other than certain credit enhancements or certain instruments issued to a subsidiary. The rule also limits the aggregate value of certain other liabilities that the U.S. G-SIB may issue.<sup>55</sup>

### **C. Stays on Runnable Contracts in Resolution**

The terms of qualified financial contracts (QFCs), which include swaps, other derivative contracts, repurchase agreements (repos) and reverse repos, and securities lending and borrowing agreements, generally provide that in the event that a party to a QFC or its affiliate enters a bankruptcy or resolution proceeding, its counterparty may terminate the QFC. Although the clean holding company requirements referenced above reduce the extent to which U.S. G-SIBs enter into QFCs, the “cross-default” provisions of QFCs entered into by subsidiaries of the U.S. G-SIB holding company would themselves permit termination of the QFC upon the entry into

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<sup>53</sup> Treasury staff estimates based on company reports and Federal Reserve filings. As of March 31, 2009, U.S. G-SIBs’ tier 1 common regulatory capital amounted to about 5 percent of risk-weighted assets. Other capital instruments, such as long-term senior unsecured debt were not considered usable at the time to absorb losses.

<sup>54</sup> See Basel Committee on Banking Supervision, *Calibrating Regulatory Minimum Capital Requirements and Capital Buffers: A Top-down Approach* (Oct. 2010), <http://www.bis.org/publ/bcbs180.pdf>. This study analyzes losses sustained by a group of seventy-three large banks from fourteen countries from the third quarter of 2007 through the fourth quarter of 2009 and peak losses sustained during prior systemic crises from various countries and regions. Apart from a few outliers, the losses (measured as pre-tax net income) experienced by these global banks during the financial crisis ranged between zero and 8 percent of risk-weighted assets. See also Beverly Hirtle, *Using Crisis Losses to Calibrate a Regulatory Capital Buffer*, Liberty Street Economics (Oct. 24, 2011), <http://libertystreeteconomics.newyorkfed.org/2011/10/using-crisis-losses-to-calibrate-a-regulatory-capital-buffer.html>.

<sup>55</sup> 12 C.F.R. § 252.64. The Federal Reserve has also applied such requirements to the U.S. intermediate holding companies of foreign G-SIBs. See 12 C.F.R § 252.166.

resolution of the holding company. Counterparties that have positive mark-to-market gains would have a strong incentive to terminate their contracts and claim the gain. The resulting counterparty flight could further de-stabilize a firm in resolution because it could rapidly deplete a firm's liquidity resources and force the sale of assets or collateral to satisfy the counterparty's rights upon termination. Such sales during periods of market stress could amount to "fire sales" that could, in turn, depress prices on assets held by other firms throughout the financial system and thus destroy significant value.<sup>56</sup>

Under the Bankruptcy Code, creditors are generally subject to an automatic stay, which prevents them from enforcing their rights to, for instance, foreclose on collateral upon the filing of a bankruptcy petition.<sup>57</sup> However, the Bankruptcy Code provides a "safe harbor" for QFCs that allows QFC counterparties to exercise their rights against the debtor immediately upon default.<sup>58</sup> Title II provides a one business day stay on QFC contracts following the date of the appointment of the FDIC as receiver.<sup>59</sup> This is intended to allow the FDIC enough time to decide whether to, for example, transfer such contracts to the bridge company.<sup>60</sup> Even with this provision, however, there is a risk that a foreign court exercising jurisdiction over a covered financial company's counterparty may not recognize the stay provisions of U.S. law.

Regulators and firms have worked together to help address deficiencies in how the Bankruptcy Code and OLA regimes govern QFCs. The International Swaps and Derivatives Association (ISDA), in coordination with the Financial Stability Board, developed a protocol that contractually binds adhering parties to the temporary stay provisions of special resolution regimes. Twenty-one global banks signed a revised version of the protocol in November 2015.<sup>61</sup>

Last year, the Federal Reserve, FDIC, and OCC finalized parallel regulations requiring U.S. G-SIBs and their subsidiaries (and foreign G-SIBs' U.S. operations) to include provisions in their QFCs that would prevent counterparties from exercising default rights based on the entry

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<sup>56</sup> See, e.g., Andrei Shleifer & Robert Vishny, *Fire Sales in Finance and Macroeconomics*, 25 *Journal of Economic Perspectives* 29 (2011).

<sup>57</sup> 11 U.S.C. § 362.

<sup>58</sup> 11 U.S.C. §§ 362(b)(6), (7), (17), (27).

<sup>59</sup> Dodd-Frank Act § 210(c)(10)(B)(i)(I) (12 U.S.C. § 5390(c)(10)(B)(i)(I)).

<sup>60</sup> Dodd Frank Act § 210(c)(9) (12 U.S.C. § 5390(c)(9)).

<sup>61</sup> Press Release, International Swaps and Derivatives Association, *Major Banks Sign Relunched ISDA Resolution Stay Protocol* (Nov. 12, 2015), <http://www2.isda.org/attachment/ODAwnNQ==/Resolution%20Stay%20Protocol%20relaunch%20FINAL.pdf>.

into a bankruptcy or resolution proceeding.<sup>62</sup> Under the rule subsequently adopted by the Federal Reserve and FDIC, G-SIBs are required to provide in their non-cleared QFCs that any default rights or restrictions on the transfer of the QFCs are limited to the same extent as they would be pursuant to Title II (or the FDIA in the case of insured depository institutions). In addition, G-SIBs are generally prohibited from including terms in their QFCs that would allow a counterparty to exercise default rights based on the entry of a G-SIB affiliate into a resolution proceeding under Title II, the FDIA, or any other resolution proceeding.

#### **D. Economic Subordination of Holding Company Debt**

A key advantage of the SPOE strategy is that it is aimed at fostering continued viability at the operating subsidiary level by focusing resolution at the level of the holding company parent. This approach has the advantage of minimizing a disruption to the clients and counterparties of the operating subsidiaries that could spread contagion. The SPOE strategy and the adoption of the TLAC requirements have been designed to effectively subordinate a U.S. G-SIB's holding company creditors to its operating company creditors. Firms' improved disclosure of their resolution plans, in accordance with regulatory guidance, has greatly enhanced market awareness of these plans and the implications for shareholders and creditors should they be implemented in the event of a resolution. In particular, credit market participants have recognized that holding company TLAC debt is subordinated to operating company debt. All three rating agencies, for example, have effectively removed their expectations of government support for U.S. G-SIBs' holding company creditors over the past several years.<sup>63</sup>

What remains less clear, however, is whether market participants expect that losses will not be imposed on certain classes of operating subsidiary creditors. If such an expectation were

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<sup>62</sup> Restrictions on Qualified Financial Contracts, 82 Fed. Reg. 42882 (Sept. 12, 2017) (Federal Reserve rule); Restrictions on Qualified Financial Contracts of Certain FDIC-Supervised Institutions, 82 Fed. Reg. 50228 (Oct. 30, 2017) (FDIC rule); Mandatory Contractual Stay Requirements for Qualified Financial Contracts, 82 FR 56630 (Nov. 29, 2017) (OCC rule).

<sup>63</sup> Gara Alfonso & João Santos, *What Do Rating Agencies Think about "Too-Big-to-Fail" Since Dodd-Frank?* Liberty Street Economics Blog, Federal Reserve Bank of New York (June 29, 2015), <http://libertystreeteconomics.newyorkfed.org/2015/06/what-do-rating-agencies-think-about-too-big-to-fail-since-dodd-frank.html>. See also Moody's Investors Service, *Rating Action: Moody's Concludes Review of Eight Large US Banks* (Nov. 14, 2013), [https://www.moody.com/research/Moodys-concludes-review-of-eight-large-US-banks--PR\\_286790](https://www.moody.com/research/Moodys-concludes-review-of-eight-large-US-banks--PR_286790); Fitch Ratings, *TLAC Supports the Upgrades of Eight U.S. G-SIB Operating Companies*, (May 19, 2015), <https://www.fitchratings.com/site/pr/984992>; S&P Global, *U.S. Global Systemically Important Bank Holding Companies Downgraded Based On Uncertain Likelihood Of Government Support* (Dec. 3, 2015), [https://www.capitaliq.com/CIQDotNet/CreditResearch/RenderArticle.aspx?articleId=1490452&SctArtId=357868&from=CM&nsI\\_code=LIME&sourceObjectId=9438258&sourceRevId=1&fee\\_ind=N&exp\\_date=20251202-14:59:54](https://www.capitaliq.com/CIQDotNet/CreditResearch/RenderArticle.aspx?articleId=1490452&SctArtId=357868&from=CM&nsI_code=LIME&sourceObjectId=9438258&sourceRevId=1&fee_ind=N&exp_date=20251202-14:59:54).

to exist, then SPOE could create a competitive distortion between the operating subsidiaries of firms presumed to be candidates for Title II and those that are not. It is possible that any advantage conferred on the operating subsidiaries of a firm presumed to be a Title II eligible candidate is borne by its holding company creditors because the long-term unsecured debt of the holding company is used to recapitalize the operating subsidiaries to ensure their viability. It is also possible that the advantage conferred on operating subsidiaries of such firms is not borne fully by the holding company creditors but rather derives from an expectation that government support would be provided to the firm.

A number of factors make it difficult to measure the extent of any such market distortion. These factors include (i) the SPOE strategy's relatively recent development, (ii) the recent adoption of TLAC requirements, and (iii) the difficulty in distinguishing any expectation of government support from changes in individual firms' credit fundamentals, market supply and demand factors, and macro-economic conditions. Continued study of this issue is warranted as observable market data from a range of market and credit cycles becomes available.

#### **IV. International Considerations**

In the event of the failure of a financial company with significant international operations, cooperation with foreign authorities would be imperative in order to avoid a disorderly resolution that destroys value and causes systemic instability.<sup>64</sup>

##### **A. Coordination with Foreign Authorities**

Since the financial crisis, U.S. authorities have worked with their foreign counterparts to improve coordination and to plan for the resolution or bankruptcy of a cross-border financial company. The goal of these efforts has been to ensure that a resolution of a large, internationally active financial company is conducted on a uniform basis, rather than through multiple, competing insolvency proceedings run by U.S. and various foreign authorities with respect to the particular subsidiaries and branches under each authority's supervision. Financial regulators and resolution authorities are more likely to coordinate with each other when they have familiarity with each other's resolution frameworks and how they are to be used in the event of a crisis.<sup>65</sup>

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<sup>64</sup> For a discussion of the challenges presented by the resolution of a cross-border institution, including obstacles to cross-border information sharing among regulators, see Richard Herring, *The Challenge of Resolving Cross-Border Financial Institutions*, 31 Yale J. on Reg. 853, 857–863 (2014); Jacopo Carmassi & Richard Herring, *The Cross-Border Challenge in Resolving Global Systemically Important Banks in Making Failure Feasible*, *supra* note 4, at 249–270.

<sup>65</sup> See Jeffrey N. Gordon & Mark J. Roe. *Financial Scholars Oppose Eliminating “Orderly Liquidation Authority” As Crisis-Avoidance Restructuring Backstop* (May 23, 2017), <https://corpgov.law.harvard.edu/wp-content/uploads/2017/05/Scholars-Letter-on-OLA-final-for-Congress.pdf>.



Cross-border cooperation on resolution planning takes place on an ongoing basis through firm-specific crisis management groups (CMGs). CMGs bring together home and key host authorities to discuss resolution plans for G-SIBs on an annual basis. CMGs have been convened for all U.S. and foreign G-SIBs and provide a forum to address the cross-border challenges of resolving a large, globally active financial company. U.S. authorities also work with key foreign jurisdictions to develop memoranda of understanding, cooperation agreements, and other methods to formalize understandings of resolution proceedings, including with the European Union,<sup>66</sup> Canada,<sup>67</sup> and China.<sup>68</sup>

In addition, U.S. authorities have worked bilaterally with international counterparts (*e.g.*, Japan, Switzerland, and Germany<sup>69</sup>) to improve understanding and cooperation during a cross-border resolution. For example, in October 2016, the Treasury, FDIC, Federal Reserve, and other U.S. financial regulators built on the firm-specific CMG work to undertake a high-level exercise to walk through a hypothetical cross-border resolution of a G-SIB with the corresponding authorities from the United Kingdom and the European Union.<sup>70</sup> A similar exercise took place in October 2014 with U.S. and UK authorities.<sup>71</sup> Several of the regulatory developments discussed above have also advanced efforts at international cooperation, including measures to provide sufficient loss absorption and recapitalization resources (such as the Federal Reserve's adoption of its TLAC rule, discussed above) and the development of the ISDA stay protocol and adoption of regulations regarding the enforcement of contractual stays of QFCs.

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<sup>66</sup> Press Release, *European Banking Authority, US Agencies conclude Framework Cooperation Arrangement on Bank Resolution* (Sept. 29, 2017), <https://www.eba.europa.eu/-/eba-and-us-agencies-conclude-framework-cooperation-arrangement-on-bank-resolution>.

<sup>67</sup> Press Release, FDIC, *FDIC Announces Memorandum of Understanding With Canada Deposit Insurance Corporation. Agreement Provides Formal Basis for Information Sharing and Cooperation Related to Resolution Planning and Implementation* (Jun. 12, 2013), <https://www.fdic.gov/news/news/press/2013/pr13051.html>.

<sup>68</sup> Press Release, FDIC, *FDIC Signs Memorandum of Understanding With the People's Bank of China* (Oct. 24, 2013), <https://www.fdic.gov/news/news/press/2013/pr13093.html>.

<sup>69</sup> Speech, FDIC, *Martin J. Gruenberg to the Eurofi High Level Seminar 2016* (April 21, 2016), <https://www.fdic.gov/news/news/speeches/spapr2116.pdf>.

<sup>70</sup> Press Release, FDIC, *U.S., European Officials to Hold Planned Coordination Exercise on Cross-Border Resolution Planning* (Oct. 5, 2016), <https://www.fdic.gov/news/news/press/2016/pr16087.html>.

<sup>71</sup> Press Release, FDIC, *U.S. and U.K. Officials Meet to Discuss Key Components for the Resolution of a Global Systemically Important Bank* (Oct. 13, 2014), <https://www.fdic.gov/news/news/press/2014/pr14084.html>.

Even with these advances in resolution planning, some foreign authorities continue to question whether a traditional bankruptcy proceeding can adequately address the systemic issues arising from a cross-border financial institution failure. Foreign authorities also have concerns about the ability to coordinate effectively with a bankruptcy judge as opposed to their U.S. regulatory peers. Many have suggested that an exclusive reliance on bankruptcy to resolve a U.S. financial company would likely incentivize foreign authorities' use of existing powers to "ring-fence" U.S. banking operations in their jurisdictions in order to protect local stakeholders' interests in a crisis.

## **B. Ring-fencing**

"Ring-fencing" in this context refers to the limitations on the transfer of funds from institutions in a host country to their respective parent holding companies in the home country or affiliates located in other countries and other requirements to make the institutions' operations in the host country more independent from that of their affiliates.<sup>72</sup> The incentive for host country regulators to do this is straightforward: they want to ensure the maximum amount of funds remain in the host country to ensure local depositors, creditors, and other stakeholders are paid first. Requirements that are imposed on a generalized basis in advance of any crisis are referred to as *ex ante* (or permanent) ring-fencing; regulators may also determine to impose *ex post* (or temporary) restrictions on transfers of funds on a particular entity should it or its affiliates enter financial difficulty. The elimination of OLA could provide incentives for foreign authorities to engage in both *ex ante* and *ex post* ring-fencing of U.S. banking operations abroad to an extent that may impair the efficient allocation of capital and that may ultimately reduce resolvability.

The bankruptcy of a large financial company lacking sufficient private funding could lead to runs by counterparties on the remaining liquid assets of the company. Under these circumstances, host country authorities would be concerned that assets in their countries would be transferred to the ultimate parent company or other affiliates in the home country (or in a third country) in order to satisfy terminations by counterparties of those affiliates, leaving insufficient assets to pay depositors and other creditors in the host country. In order to forestall this outcome, the host country could seek to limit any transfers to affiliates, but, depending on the circumstances, they may not have time to impose such restrictions once a resolution is underway. This dynamic in turn incentivizes foreign authorities to impose ring-fencing upon the parent financial company's declaration of bankruptcy or even, prior to that, when a firm is showing signs of financial distress. Such preemptive action, however, would itself make a failure and disorderly resolution more likely by ensuring that the failure of the company would lead to

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<sup>72</sup> For further discussion of ring-fencing measures, see Katia D'Hulster & Inci Ötoker-Robe, *Ring-Fencing Cross-Border Banks: An Effective Supervisory Response?* 16 *Journal of Banking Regulation* 169 (2015); Carmassi & Herring, *supra* note 64, at 266–270.

multiple, competing insolvencies. In this scenario, *ex post* ring-fencing would likely increase the total losses imposed on all creditors and counterparties by a financial company failure.

Faced with this prospect, some foreign authorities may determine that the best course of action is to impose ring-fencing requirements on the operations of all foreign banks in their countries well in advance of any crisis. Under this model, foreign authorities could require U.S. institutions to form subsidiaries in such foreign authorities' jurisdictions, require all banking operations in those host countries to be transferred to those subsidiaries, and require that significant amounts of capital and liquidity be "pre-positioned" in these subsidiaries. Alternatively, foreign authorities could dispense with the requirement to establish subsidiaries but nevertheless require banks to hold increased amounts of capital and liquidity at branches in the host country. Such ring-fencing on an *ex ante* basis would have the effect of requiring U.S. financial companies to hold more capital and liquidity and would constrain the flexibility of companies to allocate their resources across the firm as needed in the event of financial difficulty. For instance, in the normal course of operations, a global firm could leverage its geographic diversification to direct resources to a subsidiary suffering losses because of, *e.g.*, local market conditions. However, in the event that *ex ante* ring-fencing measures had been imposed, such a firm would be restricted in its ability to direct resources where needed. If improperly calibrated, such restrictions could make firms more vulnerable to failure.

A substantial degree of *ex ante* ring-fencing inhibits the efficient allocation of resources within a firm during non-stress periods as well. One of the principal advantages of maintaining cross-border operations is to permit an affiliate in a country with an excess supply of liquidity (*e.g.*, a high savings rate) to lend to a country with an expanding economy, thus encouraging economic growth and providing higher returns for investors. When transfers within the global firm are substantially curtailed, however, such efficiencies may be lost.

## ANALYSIS & RECOMENDATIONS

Treasury’s recommendations are informed by three overarching policy goals.

First, consistent with Core Principle 1(c), a sound resolution regime should avoid moral hazard arising from the belief that certain classes of equity or debt will likely be “bailed out” or otherwise granted special relief. That belief may arise where rules and procedures for resolution of failed financial companies are not clearly specified in advance. The resulting expectation of bailouts or special treatment diminishes creditors’ economic incentive to constrain risk-taking by avoiding exposure to excessive risk. If the treatment of creditors is clearly specified *ex ante*—with a transparent hierarchy of claims and a process for impartial adjudication of claims—the free market will better price the credit risk.

Second, consistent with Core Principle 1(b), shareholders and creditors of a failed firm, not taxpayers, should bear any and all losses. Protection of taxpayers requires an orderly, rule-based procedure for resolution of a large financial company, with appropriate access to secured liquidity in order to avoid a policy of *ad hoc* bailouts seen in previous financial crises.

Third, consistent with Core Principles 1(d) and 1(e), a sound resolution regime for financial corporations should minimize adverse effects of the resolution on the financial system. This requires a framework that provides for a source of secured liquidity to continue critical operations during the course of the resolution, limit financial contagion, and guard against potentially destabilizing ring-fencing of foreign affiliates of U.S. financial companies.

### I. An Enhanced Bankruptcy Regime for Financial Companies

As bank holding companies have been working to improve their resolvability under the Bankruptcy Code, Congress has been working to reform the Bankruptcy Code itself to address the specific problems posed by the resolution of financial corporations.<sup>73</sup> The House of Representatives has already passed one such proposal.<sup>74</sup> These bills draw on the work of the Hoover Institution and the FDIC’s development of the SPOE model of resolution.<sup>75</sup>

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<sup>73</sup> See Financial CHOICE Act of 2017, H.R. 10, 115th Cong. §§ 121-23 (2017) (“Financial CHOICE Act”); Financial Institution Bankruptcy Act of 2017, H.R. 1667, 115th Cong. (2017) (“2017 FIBA”); Financial Institution Bankruptcy Act of 2016, H.R. 2947, 114th Cong. (2016); Financial Institution Bankruptcy Act of 2014, H.R. 5421, 113th Cong. (2014); Taxpayer Protection and Responsible Resolution Act, S. 1840, 114th Cong. §§ 2-4 (2015) (“2015 TPRRA”); and Taxpayer Protection and Responsible Resolution Act, S. 1861, 113th Cong. §§3-5 (2013) (“2013 TPRRA”).

<sup>74</sup> The House passed 2017 FIBA on April 5, 2017. 163 Cong. Rec. H2715-20 (daily ed. Apr. 5, 2017).

<sup>75</sup> The Hoover Institution proposal was first set forth in Kenneth E. Scott and John B. Taylor, eds., *Bankruptcy Not Bailout: A Special Chapter 14* (2012). The Hoover Institution has since refined its proposed new Bankruptcy Code chapter, in part to incorporate some of the concepts introduced by the

Treasury strongly endorses the adoption of bankruptcy reform. By facilitating resolution through the SPOE strategy, the proposed amendments to the Bankruptcy Code would better enable an orderly resolution for even the largest bank holding companies. This would, in turn, bolster bankruptcy as the presumptive approach for all failed financial corporations, making it less likely that OLA will be needed. Under Title II, OLA may be triggered only upon a determination by the Secretary of the Treasury that the failing firm cannot be resolved through bankruptcy without “serious adverse effects on [U.S.] financial stability.”<sup>76</sup> If the Bankruptcy Code can be enhanced to make successful bankruptcy possible in a broader set of circumstances without serious adverse effects on U.S. financial stability, the potential scope of OLA would be substantially reduced.

Below we discuss the key bankruptcy reforms that we endorse, address the challenges that would be posed by the bankruptcy of a large financial corporation, and make certain recommendations that should be considered further as reform efforts proceed. As noted above, for the sake of simplicity, we refer to these bankruptcy reform proposals as “Chapter 14,” following the Hoover proposals and Senate bills to date. Additional procedural details of a new Chapter 14 are set forth in Appendix B to this report. Appendix C sets forth Treasury’s recommendations with respect to additional policies Congress should consider when further evaluating Chapter 14 proposals.

#### **A. The New Chapter 14 Bankruptcy Process**

The existing provisions of the Bankruptcy Code were not designed with the resolution of a large, complex financial corporation in mind. In particular, the Bankruptcy Code was not designed to address the financial distress of a debtor engaged in significant derivatives activities and short-term borrowing. These activities are at the core of the intermediation services that financial institutions provide but also make them vulnerable to swift market reactions and destabilizing runs. The process contemplated by the current Bankruptcy Code is too prolonged to allow for the resolution of some financial corporations without risking run-like behavior that could erode the remaining value of the corporation before it can be reorganized.<sup>77</sup> A Chapter 14

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FDIC in its SPOE strategy, discussed above, for executing an OLA strategy under Title II of the Dodd-Frank Act. See Thomas H. Jackson, *Building on Bankruptcy: A Revised Chapter 14 Proposal* in Making Failure Feasible, *supra* note 4, 15-58.

<sup>76</sup> Dodd-Frank Act § 203(b)(2) (12 U.S.C. § 5383(b)(2)).

<sup>77</sup> *H.R. 1667, the “Financial Institution Bankruptcy Act of 2017”*: Hearing on H.R. 1667 Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary, 115th Cong. 3 (2017) (written testimony of John B. Taylor, Professor, Stanford University and Senior Fellow, Hoover Institution) (the existing “bankruptcy process is likely to be too slow for the fast moving markets that these types of firms deal in, and it is difficult with this process to prevent runs in a failing firm and thus prevent a crisis”).

approach, in contrast, would permit a recapitalization to be accomplished during the course of a 48-hour stay on actions by QFC counterparties.

To address these deficiencies in the current Bankruptcy Code, Chapter 14 would follow a two-entity recapitalization model.<sup>78</sup> Under this model, a covered financial corporation filing for bankruptcy would petition the court for approval of a transfer within 48 hours of most of its assets and some of its liabilities to a newly formed bridge company. A court would permit the transfer if the court determines, based upon a preponderance of the evidence, that the transfer satisfies certain conditions, including that the transfer is necessary to prevent serious adverse effects on financial stability in the United States and that the bridge company is likely to satisfy the obligations of any debt, executory contract, or QFC transferred to it.<sup>79</sup> The 48-hour stay allows the bankruptcy case to proceed over a “resolution weekend,” commencing on Friday, allowing for the operating subsidiaries to open for business on Monday with minimal market disruptions, thus following a similar timeframe as contemplated for a resolution under OLA.

Critically, the assets to be transferred to the bridge company would include the ownership interests of operating subsidiaries, allowing these entities to continue their operations and eliminating the incentive of their counterparties to run. To address the concern that counterparties to derivatives and other QFCs could exercise their rights to terminate, liquidate, or accelerate the QFCs upon the entry of the company into bankruptcy, the Chapter 14 proposals provide for a temporary stay on the exercise of such rights pending the potential transfer of the QFCs to the bridge company.<sup>80</sup>

Consistent with Treasury’s recommendations to reform OLA to encourage market discipline and risk monitoring by creditors, the Chapter 14 process would also provide for a clear, predictable allocation of losses. The success of bankruptcy for a failing financial corporation depends critically on clear rules—defined *ex ante*—providing for the allocation of losses. The Chapter 14 approach would clearly provide that certain obligations of the covered financial corporation would be “left behind” with the debtor rather than transferred to the bridge company. Those left behind would include the claims of all shareholders of the debtor covered financial corporation as well as the claims of holders of “capital structure debt,” the definition of which is discussed in detail in Appendix C. The initial equity securities in the bridge company would be held by a special trustee for the sole benefit of these left behind shareholders and creditors. The special trustee would have reporting requirements to the debtor and could only

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<sup>78</sup> The recapitalized bridge company is a legally distinct and separate entity from the pre-SPOE failing financial company. *See* Jackson in Making Failure Feasible, *supra* note 4, at 20; H.R. Rep. No. 115-80, at 4–5 (2017).

<sup>79</sup> *See, e.g.*, 2017 FIBA, § 3 (proposed 11 U.S.C. § 1185(c)).

<sup>80</sup> H.R. Rep. No. 115-80, at 7–8 (2017).

distribute the equity securities held in trust in accordance with an order of the court overseeing the Chapter 14 bankruptcy case.

## **B. Challenges for Chapter 14 Bankruptcy**

Although a Chapter 14 bankruptcy process would be a significant improvement over the existing Bankruptcy Code, challenges would remain. Commenters have correctly noted the importance of having sufficient liquidity to operate the bridge company, obtaining input from the financial corporation's regulators, and being able to coordinate with foreign authorities. A Chapter 14 approach, with some possible enhancements discussed below, would address these challenges.

### **1. Liquidity**

Many commenters have expressed doubts as to whether, in the event of the failure of a large financial corporation, sufficient private liquidity would be available to fund the bridge company.<sup>81</sup> Liquidity is undoubtedly one of the most significant challenges to the resolution of a financial corporation. But several factors should mitigate this difficulty.

First, various reforms to the structure and operations of large bank holding companies since the financial crisis have likely reduced the amount of financing that would be necessary.<sup>82</sup> The SPOE model of resolution both helps to conserve liquidity and, by providing for a bridge company with a clean capital structure and a strong balance sheet, facilitates the resumption of private sector funding. Additionally, financial corporations are required in their resolution plans to calculate and provide for their liquidity needs in the event of a resolution to ensure that each material subsidiary would have enough liquidity both to continue operating and to meet peak liquidity needs during the company's resolution.<sup>83</sup>

Second, Chapter 14 bankruptcy reforms would help to address liquidity challenges by providing for a stay on QFCs for a maximum of 48 hours pending the potential transfer of assets

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<sup>81</sup> See Paul L. Lee, Bankruptcy Alternatives to Title II of the Dodd-Frank Act—Part II, 132 *Banking L.J.* 503, 550 (2015) and commentary cited therein.

<sup>82</sup> See David A. Skeel Jr., *Financing Systemically Important Financial Institutions in Bankruptcy* in *Making Failure Feasible*, *supra* note 4, at 63-64.

<sup>83</sup> See Federal Reserve and FDIC, *Guidance for 2018 §165(d) Annual Resolution Plan Submissions by Domestic Covered Companies that Submitted Resolution Plans in July 2015*, 7-11 (2017), <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170324a21.pdf>. We note that Treasury has proposed reforms to better tailor the resolution planning framework and capital and liquidity requirements. See Department of the Treasury, *A Financial System That Creates Economic Opportunities: Banks and Credit Unions* (2017) at 37-71, <https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf>.

and certain liabilities to the bridge company. As discussed above, such a stay would prevent QFC counterparties from exercising their contractual rights with respect to netting and close out due to bankruptcy by, for example, requiring payment from the financial corporation or liquidating the assets held by such counterparties as collateral. The stay thus prevents counterparties from draining the company of liquidity and value before it has had a chance to reorganize.

Third, Treasury recommends that Title II remain in place—with the reforms we propose below—as an option of last resort in extraordinary circumstances.

## 2. Role for Regulators

Another challenge of designing a bankruptcy regime for financial companies is to ensure that the primary regulators have an appropriate role. Treasury supports the provision in the Chapter 14 proposals that would permit the FDIC, Federal Reserve, OCC, Commodity Futures Trading Commission, the SEC, and the Secretary of the Treasury to raise and be heard on any issue in the bankruptcy case.<sup>84</sup> Such a provision would ensure that the court obtains the benefit of the agencies' expertise regarding the financial corporation and, perhaps most significantly, the implications of the proceeding on U.S. financial stability.

Many commenters have noted the difficulties of resolving a large financial corporation with complex, global operations.<sup>85</sup> In the Title II context, Treasury, the FDIC, the Federal Reserve, and other applicable primary financial regulatory agencies would be able to coordinate with their foreign counterparts to facilitate an efficient resolution, but some commentators have expressed concern that such coordination would be difficult to achieve in a resolution under the Bankruptcy Code.<sup>86</sup> Providing a clear ability for U.S. regulators to have standing in the bankruptcy case should demonstrate to foreign authorities that U.S. regulators will be able to inform the court of the international considerations relevant to the resolution. Treasury also believes that providing that courts may grant standing to foreign regulators to raise and be heard on issues in the bankruptcy case where relevant would promote better coordination in a resolution of a covered financial corporation with extensive cross-border operations.

The Hoover Institution proposal and a Senate bill would also permit certain regulators to commence bankruptcy cases against covered financial corporations if certain clearly defined conditions are met.<sup>87</sup> The challenge of such a proposal lies in weighing the potential benefit of

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<sup>84</sup> See, e.g., 2017 FIBA, § 3 (proposed 11 U.S.C. § 1184).

<sup>85</sup> See, e.g., Herring, *supra* note 64.

<sup>86</sup> See Lee, *supra* note 81, at 549 and commentary cited therein.

<sup>87</sup> Jackson in Making Failure Feasible, *supra* note 4, at 50; 2013 TPRRA, § 4 (proposed 11 U.S.C. § 1403(a)).



permitting a regulatory commencement of bankruptcy—addressing the hypothetical scenario of a recalcitrant financial corporation board of directors resisting filing for bankruptcy until it is too late for bankruptcy to be a viable solution—against the potential complications of vesting authority in both the board of directors and the regulator.

Congress could consider a middle ground between authorizing the primary regulator to initiate a Chapter 14 case and giving the regulator party-in-interest standing. The current legislative proposals require the court to make a number of findings before ordering the transfer to the bridge company, including that the transfer is necessary to prevent serious adverse effects on financial stability in the United States. Federal judges may find it difficult to make this factual finding, particularly within a short timeframe. One solution would be to provide that a determination by the Federal Reserve that the financial stability condition has been met should be afforded judicial deference. As a practical matter, even without this provision, the court would likely rely on the Federal Reserve’s expertise and assessment of the financial stability implications of the transfer to the bridge company. Explicitly permitting the court to defer to the Federal Reserve would reflect this reality. It would also provide additional assurance that the transfer petition is acted upon swiftly.

Regardless of whether such changes are pursued, the Federal Reserve, FDIC, and other U.S. financial regulatory agencies would have the ability under Chapter 14 to coordinate during the pendency of the bankruptcy process with their foreign counterparts, and it would be crucial for them to do so, beginning well in advance of any filing. This sort of international coordination would be well outside the scope of a bankruptcy court’s purview, but these agencies would be well positioned to take on this role, given their capacity as regulators of the financial corporation in resolution (and as regulators of the bridge company), the likelihood that the court would weigh heavily their advice as to the propriety of granting the transfer petition, and their roles in commencing and effecting a Title II resolution should bankruptcy be determined not to be viable. Treasury recommends that the U.S. regulators redouble their efforts to establish protocols for cooperation with their foreign counterparts with the aim of giving all parties confidence in the feasibility of the bankruptcy approach should it ever need to be used. To facilitate these efforts, and given the Secretary’s responsibility for making a systemic risk determination under Title II and approving any use of the OLF, Treasury should deepen its participation in the crisis management groups discussed above.

### **3. Judicial Expertise**

Another challenge for Chapter 14 is to ensure that judges presiding over the bankruptcy cases have sufficient expertise. Chapter 14 proposals have provided for a designated set of judges to be available to be assigned to a Chapter 14 case, should one be filed. Specifically, the

House and Senate bills would require the Chief Justice of the United States to designate “not fewer than 10 bankruptcy judges to be available to hear a [Chapter 14] case.”<sup>88</sup>

Alternatively, Hoover Institution scholars have proposed that any Chapter 14 legislation provide for a designated set of district court judges. Under this proposal, a designated district judge would be required to preside over the case up to the point of the transfer of assets and liabilities to the bridge company, at which point the district judge could then refer the case to a bankruptcy judge or appoint a bankruptcy judge to assist the district judge as a special master.<sup>89</sup>

Treasury endorses the designation of a set of judges in advance. Providing this responsibility to the Chief Justice would help ensure that the designated judges have the relevant competence and expertise to preside over a Chapter 14 case. Further, these judges, once designated, could engage in planning and coordination exercises, including cross-border efforts (*e.g.*, the crisis management groups discussed above). Such efforts could, in consultation with Treasury and the financial regulatory agencies, be undertaken with the assistance of the Federal Judicial Center (the research and education agency of the judicial branch).

More specifically, Treasury supports the House and Senate bills’ provision for pre-selection of bankruptcy judges to hear Chapter 14 cases given their expertise in presiding over resolution proceedings. However, Treasury also recommends that further consideration be given to the alternative of designating district judges. Because district judges generally have broader juridical experience than bankruptcy judges, they may be better able to address the U.S. financial stability implications of a Chapter 14 filing.<sup>90</sup> And because appeals from final decisions of district judges would go directly to the relevant court of appeals without an intermediate appeal, finality of judgments would be achieved more quickly.

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<sup>88</sup> 2015 TPRRA, § 4 (proposed 28 U.S.C. § 298); 2017 FIBA, § 4 (proposed 28 U.S.C. § 298); Financial CHOICE Act, § 123 (proposed 28 U.S.C. § 298).

<sup>89</sup> Jackson in Making Failure Feasible, *supra* note 4, at 57.

<sup>90</sup> In the Puerto Rico Oversight, Management, and Economic Stability Act (“PROMESA”), Congress determined that it was appropriate for the Chief Justice to appoint a district judge, not a bankruptcy judge, to preside over the debt restructuring of a territory of the United States. PROMESA § 308, 48 U.S.C. § 2168 (2016). On May 5, 2017, Chief Justice John Roberts appointed U.S. District Judge for the Southern District of New York Laura Taylor Swain to preside over the debt restructuring case of the Commonwealth of Puerto Rico. Matthew Goldstein, Judge in Puerto Rico’s Debt Lawsuit Handled Major Financial Cases, *N.Y. Times*, May 5, 2017. Judge Swain had previously been a U.S. bankruptcy judge before being appointed to the district court. *Id.*

## II. Reform of Orderly Liquidation Authority

The Dodd-Frank Act provides that bankruptcy shall be the presumptive and preferred method of resolving bank holding companies and other financial companies.<sup>91</sup> The premise of the Dodd-Frank Act is that financial companies, regardless of size, should be able to be resolved in the same way as any other company, but that a special resolution regime—OLA—should be available as an option of last resort should its use be necessary to prevent serious adverse effects on U.S. financial stability.

As discussed above, numerous improvements, including TLAC with its long-term debt requirements, the adoption of the SPOE strategy, and the development of resolution plans, have made it more likely that bankruptcy would be able to be used successfully to resolve even the largest financial companies. Not only are financial companies required to demonstrate in their resolution plans that they can credibly be resolved through bankruptcy, they are also highly incentivized to avoid a Title II proceeding, given the potential for clawbacks on executive compensation and removal of the board of directors and senior management discussed above. Further, the Bankruptcy Code reforms proposed in this report would significantly enhance the ability of large financial companies to be resolved in bankruptcy. By making bankruptcy more feasible, these developments have effectively reduced the likelihood that Title II would ever need to be used, and the proposed amendments to the Bankruptcy Code would reduce that likelihood even further.

Treasury recommends, however, that Title II remain as an emergency tool for use in extraordinary circumstances. Bankruptcy should be the resolution tool of first resort, but even the improved Chapter 14 bankruptcy process may not be feasible in some cases for large, complex, cross-border financial institutions. If sufficient private financing is unavailable, OLA may prove necessary to avoid financial contagion while at the same time allocating losses to shareholders and creditors based on a clear, predictable hierarchy of claims.

In addition, a reformed Title II will make bankruptcy more viable by avoiding preemptive interventions by foreign authorities. Foreign authorities should take comfort that, should bankruptcy fail, Title II would still be available as a last resort. With the knowledge that Title II serves as an emergency backstop, foreign authorities should be more willing to let a resolution proceed through bankruptcy instead of initiating separate resolution proceedings of

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<sup>91</sup> See Dodd-Frank Act § 165(d)(4) (12 U.S.C. § 5365(d)(4)) (requiring resolution plans required to be filed by financial companies to facilitate an orderly resolution under Chapter 11 of the Bankruptcy Code); Dodd-Frank Act § 203(b)(2) (12 U.S.C. § 5383(b)(2)) (requiring that the Secretary of the Treasury make a determination, prior to seeking to appoint the FDIC as receiver of a financial company under Title II, that 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, with applicable Federal law constituting for the majority of financial companies the Bankruptcy Code).

affiliates of the company in their respective host countries. For the same reason, retaining and reforming Title II should give foreign authorities sufficient comfort that they should not feel the need to impose severe ring-fencing requirements on U.S. affiliates in their host country that would trap a failed financial company's capital and liquidity overseas.<sup>92</sup>

Although it is crucial that OLA be retained, it must be reformed. Changes to the structure and implementation of Title II are warranted to address rule-of-law weaknesses of OLA and prevent arbitrary government action; provide greater transparency and certainty to creditors to help ensure that risk is properly priced by private actors; and further shield taxpayers from any and all costs of a Title II resolution.

## **A. Providing for Clear Rules Administered with Impartiality**

### **1. Restrict FDIC's Ability to Treat Similarly Situated Creditors Differently**

The goal of any resolution regime should be to ensure that creditors of, for example, a bank holding company know *ex ante* where they stand in the hierarchy of claims. Title II, however, grants the FDIC broad discretion to treat similarly situated creditors differently without a clearly defined standard to protect disfavored creditors against arbitrary FDIC action.<sup>93</sup> For example, Title II authorizes the FDIC to treat similarly situated creditors differently if the FDIC makes a general determination that such favored treatment “is necessary to maximize the value of the assets of the covered financial company.”<sup>94</sup> The FDIC's authority to treat certain creditors in the same class more favorably pertains both to the transfer of assets and liabilities from the covered financial company to the bridge company and the post-transfer process of resolving claims against the estate of the failed company.<sup>95</sup>

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<sup>92</sup> See Letter from Nat'l Bankruptcy Conf. to Sens. Crapo and Grassley, Reps. Hensarling and Goodlatte, et al. 9 (Mar. 17, 2017), <http://nbconf.org/wp-content/uploads/2015/07/NBC-Letter-re-Resolution-of-Systemically-Important-Financial-Institutions-March-17-2017.pdf>.

<sup>93</sup> See, e.g., *Who Is Too Big to Fail? Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts?: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. of Financial Services*, 113th Cong. 8–9 (May 15, 2013) (testimony of John B. Taylor, Professor, Stanford University and Senior Fellow, Hoover Institution) (“There will be every incentive for the FDIC to provide additional funds to some creditors, additional funds over and above what they would get under a normal bankruptcy or in the marketplace.”); *id.* at 20 (testimony of Joshua Rosner, Managing Director, Graham Fisher & Co.).

<sup>94</sup> Dodd-Frank Act § 210(b)(4)(A) (12 U.S.C. § 5390(b)(4)(A)).

<sup>95</sup> The FDIC may favor particular claimants of the covered financial company if the FDIC determines that such action is necessary (i) to maximize the value of the assets of the covered financial company; (ii) to initiate and continue operations essential to implementation of the receivership or any bridge financial company; (iii) to maximize the present value return from the sale or other disposition of the assets of the

The FDIC has recognized the need to provide creditors with greater certainty in pricing credit risk and has sought to address criticisms by limiting its own discretion. Specifically, the FDIC adopted a regulation providing that it shall not exercise this authority to favor any holders of long-term senior debt, subordinated debt, or equity.<sup>96</sup> However, the FDIC reserved the power to favor general or short-term creditors upon the affirmative vote of a majority of the members of the board of directors of the FDIC then serving.<sup>97</sup> Were the FDIC to use this authority to privilege short-term unsecured creditors over long-term unsecured creditors, it would arguably be providing the short-term creditors with a bail-out at the expense of the long-term creditors. Counterparties who have bargained for certain rights and priorities should not have their bargain unpredictably upended, with some parties favored over others, in the event of a resolution.<sup>98</sup> Such preferential treatment would not only be inconsistent with the rule of law but also would weaken the ability of creditors to properly price and monitor risk.

The FDIC has indicated that, in practice, the only types of unsecured creditors that might receive preferential treatment are essential vendors, *i.e.*, those that provide services essential to the continued operation of the receivership or the bridge company such as utility service providers or payment processors.<sup>99</sup> Nevertheless, the FDIC retains authority to accord preferential treatment to creditors beyond this narrow set of service providers.

The FDIC deserves credit for its efforts to limit preferential treatment permitted by the Dodd-Frank Act, but a stronger rule is necessary. Bankruptcy law provides a model for ensuring impartial, rule-based priority of claims, with a narrow exception for “critical vendors” necessary

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covered financial company; or (iv) to minimize the amount of any loss realized upon the sale or other disposition of the assets of the covered financial company. Dodd-Frank Act § 210(b)(4) (12 U.S.C. § 5390(b)(4)). The FDIC may favor particular creditors in transferring assets and liabilities to the bridge under any of these circumstances other than those provided under (ii) above. Dodd-Frank Act § 210(h)(5)(E) (12 U.S.C. § 5390(h)(5)(E)).

<sup>96</sup> 12 C.F.R. § 380.27(b)(1)–(3).

<sup>97</sup> 12 C.F.R. § 380.27(b)(4).

<sup>98</sup> See Kenneth E. Scott, *A Guide to Resolution of Failed Financial Institutions: Dodd-Frank Title II and Chapter 14*, in *Bankruptcy Not a Bailout* 11–12 (Kenneth E. Scott, John B. Taylor eds., 2012); Randall D. Guynn, *Framing the TBTF Problem: The Path to a Solution*, in *Across the Great Divide: New Perspectives on the Financial Crisis*, 288–289 (Martin Neil Baily and John B. Taylor eds., 2014).

<sup>99</sup> See Orderly Liquidation Authority, 76 Fed. Reg. 4207, 4211 (Jan. 25, 2011) (“Examples of operations that may be essential to the implementation of the receivership or a bridge financial company include the payment of utility and other service contracts and contracts with companies that provide payments processing services. These and other contracts will allow the bridge company to preserve and maximize the value of the bridge financial company’s assets and operations to the benefit of creditors, while preventing a disorderly and more costly collapse.”)

to assuring continued provision of vital services. Under bankruptcy law, a debtor, with court approval, may be permitted to pay the prepetition claims of critical vendors if it can show that such payments will enable a successful reorganization; that without such payments, the vendors would cease doing business with the debtor; and that the disfavored creditors would be as well off in the reorganization as they would have been in a liquidation proceeding.<sup>100</sup>

Treasury recommends aligning the OLA standard with the better defined bankruptcy standard, which could be accomplished by the FDIC amending its regulations in one of two ways.<sup>101</sup> First, the various standards<sup>102</sup> for favoring certain similarly situated creditors in Title II could be narrowed to the one that best approximates the bankruptcy standard. Specifically, the FDIC could be subjected to a requirement that it determine that payment of the creditor is necessary “to initiate and continue operations essential to implementation of the receivership or any bridge company,”<sup>103</sup> or the standards set forth in Title II could be replaced in their entirety by a single standard that articulates the judicially-established bankruptcy standard. Under either formulation, this authority would be unlikely to be needed in a Title II resolution as financial companies required to file resolution plans have made changes to their management of their critical vendors to better ensure continuity of services during a resolution.<sup>104</sup>

## **2. Provide for the Bankruptcy Court to Adjudicate Claims Against the Receivership**

The adjudication of claims could be made more transparent by removing this adjudicatory responsibility from the FDIC altogether so that the Bankruptcy Code is generally

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<sup>100</sup> See, e.g., *In re Kmart Corp.*, 359 F.3d 866, 872-73 (7th Cir. 2004). See also *In re Tropical Sportswear Int'l Corp.*, 320 B.R. 15, 17 (Bankr. M.D. Fla. 2005) (applying *Kmart's* three-part test to authorize payment of certain critical vendor claims); *In re News Publ. Co.*, 488 B.R. 241, 244 (Bankr. N.D. Ga. 2013) (applying *Kmart's* three-part test to authorize payment of certain critical vendor claims); but see *In re CoServ, L.L.C.*, 273 B.R. 487, 498-99 (Bankr. N.D. Tex. 2002) (articulating a different three-part test to authorize payment of certain critical vendor claims).

<sup>101</sup> Either rulemaking would be wholly consistent with the Dodd-Frank Act because the FDIC is required to harmonize its regulations with the Bankruptcy Code to the extent possible. Dodd-Frank Act § 209 (12 U.S.C. § 5389).

<sup>102</sup> See *supra* note 95.

<sup>103</sup> Dodd-Frank Act § 210(b)(4)(A)(ii) (12 U.S.C. § 5390(b)(4)(A)(ii)).

<sup>104</sup> See, e.g., The Goldman Sachs Group, Inc., *2017 Resolution Plan Public Section 36* <https://www.fdic.gov/regulations/reform/resplans/plans/goldman-165-1707.pdf> (“We have identified all resolution-critical external vendors and have negotiated modifications of our legal agreements with them to provide for the continuity of service of all other entities, even if a contracting entity enters some form of bankruptcy proceedings”).

adhered to with respect to both substance and procedure. Treasury recommends that a bankruptcy court, not the FDIC, adjudicate the claims against the receivership. Title II could be amended to provide that, in a resolution involving a bridge company (as all resolutions under the SPOE model are assumed to involve), after the transfer of assets and liabilities to the bridge, the bankruptcy court would administer the claims of those whose liabilities were left in the receivership.<sup>105</sup>

The FDIC’s expertise is best focused on effecting the transfer of assets and liabilities to the bridge company, managing the bridge company until it—or its successors—are returned to private ownership, and administering the OLF, if it is needed. The adjudication of claims, in contrast, is a process that bankruptcy courts administer every day. While the FDIC has great experience in adjudicating the claims of insured depository institutions, the claims priority applicable in those cases, under the FDIA, is not the same as that provided under Title II; furthermore, the balance sheets of insured depository institutions, particularly given the presence of deposits as the primary class of liabilities of an insured depository institution, are quite different from those of the holding companies likely to be the covered financial companies in any Title II proceeding.<sup>106</sup>

The priority of claims provided for under Title II generally tracks the Bankruptcy Code, and the two principal features of the Title II priority that deviate from the Bankruptcy Code priority were included for sound policy reasons. Taxpayers should continue to be protected by the elevated priority that Title II accords to amounts owed to the United States,<sup>107</sup> and the lower priority under Title II provided for claims for wages and salaries of executives of the covered financial company should be retained to properly align management incentives.<sup>108</sup>

### **3. Clarification of the Standard for Commencing a Title II proceeding**

A finding that a financial company is “in default or in danger of default” is a required precondition to appointing the FDIC as receiver of the company under Title II.<sup>109</sup> This standard should be clarified by specifying more clearly when a firm would be considered to be “in danger

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<sup>105</sup> See H. Rodgin Cohen & Michael M. Wiseman, *Resolving Resolution: A Path to End “Too Big to Fail” and Taxpayer Exposure*, Brookings (Mar. 15, 2017), <https://www.brookings.edu/research/resolving-resolution-a-path-to-end-too-big-to-fail-and-taxpayer-exposure/>.

<sup>106</sup> Any conforming amendments to Title II would need to be drafted in a way that clearly delineates the bankruptcy court’s limited responsibility in making determinations on claims against the covered financial company in receivership.

<sup>107</sup> See Dodd-Frank Act § 210(b)(1)(B) (12 U.S.C. § 5390(b)(1)(B)).

<sup>108</sup> See Dodd-Frank Act § 210(b)(1)(G) (12 U.S.C. § 5390(b)(1)(G)).

<sup>109</sup> Dodd-Frank Act § 203(b)(1) (12 U.S.C. § 5383(b)(1)).

of default.” Title II defines “default or in danger of default” by reference to four tests: in essence, that a bankruptcy case has been or likely will promptly be commenced; that the financial company has incurred or is likely to incur losses that would substantially deplete its capital; that the assets of the financial company are, or are likely to be, less than its liabilities; or that the company is, or is likely to be unable to, pay its obligations in the normal course of business.<sup>110</sup> In each of the last three cases, the term “likely to be” (or “likely to incur”) is used without further definition. To reduce the potential for regulatory overreach, Treasury recommends defining this term by reference to a particular period—such that the danger of the capital depletion, balance sheet insolvency or illiquidity is imminent. Treasury recommends that any such likelihood determination or recommendation be made by reference to at most the next 90 days. This would remove an unnecessary degree of discretion left to the agencies as to how to determine the *temporal* element of the “likelihood” standard; the agencies would still have to determine, given the facts and circumstances of a particular financial company, how to define the *probability* of such an occurrence happening within that 90 day period.

#### **4. Repealing Tax-Exempt Status of Bridge**

Title II currently provides that a bridge company—the company to which certain assets and liabilities of the covered financial company being resolved are transferred—shall be exempt from all federal, state, and local taxes.<sup>111</sup> This provision is without any policy or legal basis whatsoever and would give the bridge an “enormous advantage” over the bridge’s private sector competitors.<sup>112</sup> Treasury recommends that Congress repeal this provision so that the bridge company pays the same rate of taxes as its competitors.

#### **5. Confirmation of the FDIC SPOE Notice**

The FDIC should explicitly confirm its commitment to its SPOE strategy described above. Specifically, the FDIC should finalize its December 2013 notice, referenced above, and respond to the comments received on its SPOE strategy for conducting resolutions in Title II. Doing so will clarify the expectations of counterparties of financial companies and market participants and permit them to better price the risks of their exposures. Further, such action could help address concerns that the FDIC still retains too much discretion under Title II and that

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<sup>110</sup> Dodd-Frank Act § 203(c) (12 U.S.C. § 5383(c)).

<sup>111</sup> Dodd-Frank Act § 210(h)(10) (12 U.S.C. § 5390(h)(10)).

<sup>112</sup> *Who Is Too Big to Fail? Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts?: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. of Financial Services*, 113th Cong. 7 (May 15, 2013) (statement of David A. Skeel Jr., Professor, University of Pennsylvania Law School); *id.* at 9 (statement of John B. Taylor, Professor, Stanford University and Senior Fellow, Hoover Institution). *See also* Statement of Patrick McHenry, Chairman of the Subcomm. on Oversight and Investigations, *id.* at 2.



this discretion leads to too much unpredictability as to how a resolution would be conducted.<sup>113</sup> If there are any circumstances under which the FDIC does not believe SPOE would be the preferred resolution method, it should make those clear to put the market on notice.

## **B. Ensuring Market Discipline and Strengthening Protection for Taxpayers**

### **1. Limiting the Duration of Advances to the OLF**

The duration of any advances under the OLF should be limited to a short, fixed term that is only as long as necessary to meet demonstrated liquidity needs. The FDIC expects that it would lend to a bridge company for only a brief period,<sup>114</sup> and Treasury's authority to set the terms of OLF advances would allow Treasury to require that any advances be repaid as soon as possible.<sup>115</sup> As noted above, the initial Title II funding authorized for a bridge company must be sufficient to prevent runs on its short term funding and bring stability to the financial entity to prevent financial contagion should private financing in the requisite amounts not be available. Yet after the company has been stabilized and private parties have had time to perform basic diligence on the company, it is probable that, even in the midst of a significant financial crisis, the private sector will be able to provide financing during the pendency of the liquidation.<sup>116</sup>

If, at the borrowing maturity date, the bridge company continues to need liquidity in excess of what is available in the private markets to maintain confidence in the operation of the bridge company, Treasury would consider an FDIC advance request for additional funding. Treasury flexibility in granting an additional FDIC advance request at the expiration of the initial term would help to reassure the market when the initial advance is made.

### **2. Using Guarantees and Premium Interest Rates to Encourage Return to Private Credit Markets**

In the event the OLF funding is needed, Treasury and the FDIC should seek to limit its use to the fullest extent possible and expedite the bridge company's return to reliance on private sources of liquidity. To that end, Treasury recommends that loan guarantees should be preferred over direct lending and that direct loans should be offered at a premium interest rate.

Guarantees should be used whenever feasible as an alternative to direct lending to encourage the bridge company to return to the private credit markets as soon as possible. In some circumstances, private sector funding may be available in sufficient amounts to fund the bridge company, but either initial uncertainty regarding the bridge company's financial condition

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<sup>113</sup> See Guynn, *supra* note 98, at 288.

<sup>114</sup> 78 Fed. Reg. at 76617.

<sup>115</sup> Cf. Cohen & Wiseman, *supra* note 105 (proposing a six-month repayment requirement).

<sup>116</sup> See Skeel, *supra* note 4, at 81.

or volatility in the financial markets generally may prevent private lenders from making commitments to the bridge company without such a guarantee. The use of loan guarantees may be more likely to permit the introduction of the bridge company to the private funding markets earlier, which, in turn, could permit the bridge to return to exclusively private sources of liquidity more quickly.<sup>117</sup>

To further incentivize use of private funding markets, the FDIC should only lend funds at a premium interest rate and should only provide guarantees after charging a premium guarantee fee. The Dodd-Frank Act provides that the Secretary of the Treasury shall determine the rate of return of any lending to the FDIC and requires the Secretary to take into consideration the current average yield on outstanding Treasury securities of comparable maturity plus an interest rate surcharge to be determined by the Secretary.<sup>118</sup> The statute further requires that such surcharge “shall be greater than the difference between (i) the current average rate on an index of corporate obligations of comparable maturity and (ii) the current average rate on outstanding marketable obligations of the United States of comparable maturity.”<sup>119</sup> This spread represents the floor of the interest rate surcharge to be imposed by Treasury; the interest rate surcharge charged to the FDIC (and thus to the bridge company) should include any further premium needed to sufficiently encourage the bridge to return to private market funding as soon as possible. Treasury will likewise require the FDIC to charge a premium guarantee fee should the OLF be used to provide guarantees of private sector funding.

### **3. Secured Lending Only**

The FDIC should lend only on a secured basis to ensure that taxpayers are protected. The FDIC has indicated that it would expect its lending under the SPOE to be done on a secured basis.<sup>120</sup> To the extent it is not able to limit use of the OLF to guarantees of private sector funding, the FDIC should commit to providing any direct loans on a secured basis, and Treasury should not advance funds to the FDIC unless it does.

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<sup>117</sup> Treasury believes that FDIC guarantees should presumptively be treated the same as FDIC direct loan obligations for purposes of compliance with the maximum obligation limitation. For example, Treasury expects that it will not approve an FDIC orderly liquidation plan unless such plan provides that any amounts guaranteed by the FDIC will count on a dollar-for-dollar basis toward the maximum obligation limitation.

<sup>118</sup> Dodd-Frank Act § 210(n)(5)(C) (12 U.S.C. § 5390(n)(5)(C)).

<sup>119</sup> *Id.*

<sup>120</sup> *See* 78 Fed. Reg. at 7616 (“If private-sector funding cannot be immediately obtained, the Dodd-Frank Act provides for [the OLF] to serve as a back-up source of liquidity support that would only be available on a fully secured basis.”).

The FDIC should seek high quality assets as collateral and should publish a list of collateral it deems eligible to secure OLF loans. The collateral acceptable to Federal Reserve Banks for discount window lending provides a helpful starting point for identifying acceptable collateral.<sup>121</sup> If the FDIC proposes to accept as security for an OLF loan any collateral of a type not previously identified by the FDIC as being eligible, such proposed collateral should be approved by the Secretary of the Treasury on a case-by-case basis.

Lending only on a secured basis, based on verified fair market asset values and at premium rates, would align use of the OLF with long-established principles of central banking.<sup>122</sup> Lending on such terms will protect taxpayers and reduce the potential for moral hazard.

#### **4. Expedite OLF Industry-Wide Backstop Assessment**

The reforms proposed in this report will further minimize the risk that the bridge company will be unable to repay OLF loans and thus trigger the industry-wide backstop assessment. Nevertheless, in the unlikely event the OLF loans are not fully repaid by the bridge, an assessment should be charged as soon as reasonably possible, which we expect would be well in advance of the five-year deadline imposed by the Dodd-Frank Act.<sup>123</sup>

#### **C. Strengthening Judicial Review**

Treasury recommends strengthening the judicial review provisions of Title II to provide a more robust check on the decision to invoke OLA. As presently structured, Title II provides for limited, expedited judicial review of the government's decision to place a failing financial company into receivership. Under Title II, if the board of directors of the financial company does not acquiesce or consent to the appointment of the FDIC as receiver, the Secretary of the Treasury must petition the U.S. District Court for the District of Columbia for an order

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<sup>121</sup> Federal Reserve Collateral Guidelines, (May 30, 2017), [https://www.newyorkfed.org/banking/collateral\\_pledging.html](https://www.newyorkfed.org/banking/collateral_pledging.html). Further consideration will need to be given as to the appropriate types of collateral used to secure OLF funding. *See generally*, Gov't Accountability Office, 11-696, Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance (2011), <http://www.gao.gov/new.items/d11696.pdf>; Bank for International Settlements, *Central Bank Collateral Frameworks and Practices* (Mar. 2013), <https://www.bis.org/publ/mktc06.pdf>.

<sup>122</sup> *See* Walter Bagehot, *Lombard Street: A Description of the Money Market* (1873); John F. Bovenzi, Randall D. Guynn, and Thomas H. Jackson, Bipartisan Policy Center, *Too Big to Fail: The Path to a Solution* 27, 42–53 (2013); Randall D. Guynn, *Framing the TBTF Problem*, *supra* note 98, at 290; Letter from Nat'l Bankruptcy Conf., *supra* note 92, at 3.

<sup>123</sup> Dodd-Frank Act § 210(o)(1) (12 U.S.C. § 5390(o)(1)). *Cf.* Cohen & Wiseman, *supra* note 105 (suggesting acceleration of assessments).

authorizing the appointment.<sup>124</sup> The district court has only 24 hours to review the petition before it is deemed granted by operation of law. During those 24 hours, the Secretary’s petition is kept under seal and the judicial proceedings remain strictly confidential.<sup>125</sup> Further, although the Secretary must make seven statutory findings before petitioning for appointment of a receiver, the district court may review only two of those findings: that the company is in default or in danger of default and that the company satisfies the definition of a “financial company.”<sup>126</sup> There is no judicial review of the Secretary’s five other findings, including the finding that the company’s failure would have serious adverse effects on U.S. financial stability and the finding that no viable private sector alternatives are available.<sup>127</sup> Finally, while the company or the Secretary may appeal any decision of the district court within 30 days, Title II prohibits the appellate courts from issuing any stay or injunction pending appeal.<sup>128</sup>

Some scholars have raised concerns about the adequacy of these judicial review provisions.<sup>129</sup> With respect to the scope of review, they object that the majority of the Secretary’s required findings are entirely unreviewable. And with respect to the process, they contend that a 24-hour review period affords neither sufficient time for a financial company to mount a serious defense nor adequate time for a court to engage in meaningful deliberation. The result, critics suggest, is to convert judicial review into a rubber stamp. Critics have also expressed concern that judicial review would occur behind closed doors, without public notice to affected persons or institutions.

Treasury recommends reforming Title II to enable a more robust opportunity for judicial review. With respect to the scope of review, Treasury recommends allowing a court to review all seven of the Secretary’s required findings under the “arbitrary and capricious” standard set

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<sup>124</sup> Dodd-Frank Act § 202(a)(1)(A)(i) (12 U.S.C. § 5382(a)(1)(A)(i)).

<sup>125</sup> Dodd-Frank Act § 202(a)(1)(A)(ii)-(iii) (12 U.S.C. § 5382(a)(1)(A)(ii)-(iii)).

<sup>126</sup> *Id.*

<sup>127</sup> *See* Dodd-Frank Act § 203(b) (12 U.S.C. § 5383(b)).

<sup>128</sup> Dodd-Frank Act § 202(a)(1)(B) (12 U.S.C. § 5382(a)(1)(B)).

<sup>129</sup> *See* Thomas W. Merrill & Margaret L. Merrill, *Dodd-Frank Orderly Liquidation Authority: Too Big for the Constitution?*, 163 U. Pa. L. Rev. 165, 204-24 (2014); *Examining Constitutional Difficulties and Legal Uncertainties in the Dodd-Frank Act: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. of Financial Services*, 113th Cong. 6-7, (2013) (statement of Thomas W. Merrill, Professor, Columbia Law School); Kenneth E. Scott, *The Context for Bankruptcy Resolutions, in Making Failure Feasible*, *supra* note 4, at 9; David A. Skeel Jr., *The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences* 131 (2011); Paul L. Lee, *supra* note 81, at 542-43; and Peter J. Wallison, *The Error at the Heart of the Dodd-Frank Act* (Sept. 6, 2011), <http://www.aei.org/publication/the-error-at-the-heart-of-the-dodd-frank-act/>.

forth in the Administrative Procedure Act.<sup>130</sup> Review under this deferential standard will not permit a court to substitute its judgment for that of the government, but it will provide additional assurance that the government's decision is the product of reasoned and well-supported analysis.

With respect to the review timing and process, Treasury recommends additional reforms. As currently constituted, Title II aims to give judicial review to financial companies *before* a receiver is appointed, while at the same time truncating that review so regulators may act quickly to meet the demands of a financial crisis. But the cost of this trade-off is a judicial review process that may not allow adequate time for full judicial deliberation. Treasury recommends two possible approaches to address this problem.

First, Title II could be reformed to align with the *ex post* review procedure afforded to failed insured depository institutions under the FDIA.<sup>131</sup> Under this approach, the existing *ex ante* review procedure would be replaced by full judicial review on a more typical schedule *after* the appointment is made. The financial company, not later than 30 days after the appointment of the FDIC as receiver, could bring an action in federal district court to remove the FDIC as receiver. There would be no statutory time limit for the court to issue a decision. There would also be no strict confidentiality requirements, as they are unnecessary for a review that occurs after a receiver is appointed. Under this approach, Title II's restriction on granting stays or injunctions pending appeal could also be removed. Judicial review would instead operate under the normal rules of federal procedure, which give courts flexibility to act as quickly as they deem appropriate and to grant preliminary relief pending appeal.

Second, and alternatively, the judicial review process could be reformed without eliminating the 24-hour period of judicial review before the FDIC is appointed as receiver. Although a court may have difficulty conducting a full review in 24 hours, it may be preferable to retain some pre-appointment review than to have none at all. Even if limited, such review may nevertheless be a valuable safeguard in the (extremely unlikely) event of a clear abuse of power. If Title II's 24-hour period of pre-appointment review were retained, Treasury would recommend combining it with a more robust appellate process. Title II could be amended to make clear that, in the event of an appeal, the district court's decision is to be reviewed by the circuit court *de novo* on all issues and without regard to the arguments made in the district court. As explained above, appellate review would also encompass all seven findings of the Secretary.

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<sup>130</sup> 5 U.S.C. § 706.

<sup>131</sup> See 12 U.S.C. § 1821(c)(7); Merrill & Merrill, *supra* note 129, at 77–179, 214–15.

## APPENDICES

### Appendix A: Summary of Recommendations

#### *Bankruptcy*

Treasury endorses the addition of an enhanced “Chapter 14” bankruptcy regime for financial companies. In addition, Treasury makes the following specific recommendations with respect to bankruptcy reform. These recommendations are discussed in greater detail in the sections referenced in the chart below.

<i>Section of Report</i>	<i>Recommendation</i>	<i>Policy Responsibility</i>
<i>Role for Regulators, page 28</i>	Treasury endorses statutory provision of standing to domestic regulators to raise issues and be heard in the Chapter 14 bankruptcy case.	Congress
	Treasury recommends providing that a court may grant standing to foreign regulators where relevant.	Congress
	Congress should consider providing that a court should give deference to a Federal Reserve determination as to the financial stability implications of a transfer to the bridge company.	Congress
	Treasury recommends that U.S. regulators redouble their efforts to establish protocols for cooperation with their foreign counterparts with the aim of giving all parties confidence in the feasibility of the bankruptcy approach.	Regulators
<i>Judicial Expertise, page 29</i>	Treasury endorses the designation by the Chief Justice of a set of bankruptcy judges in advance to preside over any Chapter 14 bankruptcy case.	Congress
	Congress should consider the alternative approach of designating district court judges.	Congress

<b><i>Section of Report</i></b>	<b><i>Recommendation</i></b>	<b><i>Policy Responsibility</i></b>
<i>Definition of “Capital Structure Debt,” page 49</i>	Treasury recommends that the definition of “capital structure debt” include all unsecured debt for borrowed money other than QFCs, as provided for in the most recent House and Senate bills. However, unlike these bills but consistent with the Hoover Institution’s proposal, Treasury further recommends the inclusion in the definition of “capital structure debt” of a secured lender’s unsecured deficiency claim for an under-secured debt.	Congress
<i>Appropriate Scope for Eligibility for Chapter 14, page 50</i>	Treasury recommends against including an asset threshold in defining which financial companies are eligible for Chapter 14.	Congress
	Treasury recommends that the definition of “covered financial corporation” under Chapter 14 be consistent with the definition of “financial company” contained in both Title II and the FDIC implementing regulations.	Congress / regulators

## ***Orderly Liquidation Authority***

Treasury recommends retaining but reforming Orderly Liquidation Authority of Title II of the Dodd-Frank Act. In addition, Treasury makes the following specific recommendations with respect to OLA. These recommendations are discussed in greater detail in the sections referenced in the chart below.

<b><i>Section of Report</i></b>	<b><i>Recommendation</i></b>	<b><i>Entities/Institutions that would implement the recommendation</i></b>
<i>Restrict FDIC's Ability to Treat Similarly Situated Creditors Differently, page 32</i>	Treasury recommends that the FDIC's latitude to treat similarly situated creditors differently should be narrowed to conform to the bankruptcy standard under which only critical vendors may be given favored treatment if necessary.	FDIC
<i>Provide for the Bankruptcy Court to Adjudicate Claims Against the Receivership, page 34</i>	Treasury recommends that in a resolution involving a bridge company, after the transfer of assets and liabilities to the bridge, the bankruptcy court be given the responsibility for administering the claims of those whose liabilities were left in the receivership.	Congress
<i>Clarification of the Standard for Commencing a Title II proceeding, page 35</i>	Treasury recommends that the statutory tests for determining when a financial company is in "default or in danger of default" (a condition to being placed into OLA) be clarified to require that each test is likely to be met within a specified period, to be no more than 90 days from the determination.	Treasury, Federal Reserve, FDIC, SEC, and FIO, as appropriate, with respect to any firm being considered for OLA
<i>Repealing Tax-Exempt Status of Bridge, page 36</i>	Treasury recommends repeal of the tax-exempt status of the bridge company.	Congress
<i>Confirmation of the FDIC SPOE Notice, page 36</i>	Treasury recommends that the FDIC finalize its notice regarding the SPOE strategy; if there are any circumstances under which the FDIC does not believe SPOE would be the preferred resolution method, it should make those clear.	FDIC
<i>Limiting the Duration of Advances to the OLF, page 37</i>	Treasury believes that advances from the OLF should have as short a duration as possible.	Treasury, FDIC



<b>Section of Report</b>	<b>Recommendation</b>	<b>Entities/Institutions that would implement the recommendation</b>
<i>Using Guarantees and Premium Interest Rates to Encourage Return to Private Credit Markets, page 37</i>	Treasury believes that loan guarantees should be preferred over direct lending; loans and guarantees should only be extended if a premium interest rate or guarantee fee is charged.	Treasury, FDIC
<i>Secured Lending Only, page 38</i>	Treasury believes that the FDIC should seek high quality assets as collateral, publish a list of assets eligible to serve as collateral for an OLF loan, and only accept a different form of collateral with the approval of the Secretary of the Treasury.	Treasury, FDIC
<i>Expedite OLF Industry-Wide Backstop Assessment, page 39</i>	Treasury recommends that any assessments be charged as soon as reasonably possible.	FDIC
<i>Strengthening Judicial Review, page 39</i>	Treasury recommends allowing a court to review all seven—rather than two, as currently permitted—of the Secretary of the Treasury’s findings required for putting a company into an OLA receivership under the “arbitrary and capricious” standard.	Congress
	Treasury recommends consideration of the following alternatives:	
	Replacing the current <i>ex ante</i> truncated judicial review with a full judicial review after the appointment of the FDIC as receiver.	Congress
	Retaining <i>ex ante</i> review but clarifying that, in the event of an appeal, the district court’s decision is to be reviewed by the circuit court <i>de novo</i> and without regard to the arguments made in the district court.	Congress

## Appendix B: Description of Congressional Chapter 14 Proposals

The various congressional proposals take substantially similar approaches to the overall structure and procedures of carrying out a Chapter 14 bankruptcy. The proposals limit access to Chapter 14 to “covered financial corporations.”<sup>132</sup> Covered financial corporations include bank holding companies and corporations engaged in financial activities.<sup>133</sup> The debtor must state under penalty of perjury that, to the best of its knowledge, it meets the definition of “covered financial corporation.”<sup>134</sup> A covered financial corporation may commence a case under Chapter 14 by filing a voluntary petition with the court;<sup>135</sup> however, an earlier Senate proposal would also permit the filing of a petition by the Federal Reserve.<sup>136</sup>

Chapter 14 contains, in addition to the automatic stay under Chapter 11 of the Bankruptcy Code, a stay of collection actions by specific types of creditors upon the filing of the bankruptcy petition.<sup>137</sup> Termination rights contained in any debt, contract, lease, or agreement based on a default by the debtor or the insolvency of, or the commencement of a bankruptcy case by, the debtor are stayed for up to 48 hours after the case is commenced. Further, whereas QFC counterparties are generally exempt from the automatic stay provisions in cases filed under Chapter 11 of Bankruptcy Code,<sup>138</sup> the liquidation, termination, and acceleration rights of QFC counterparties would be stayed under Chapter 14 for up to 48 hours after the case is commenced.<sup>139</sup>

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<sup>132</sup> Financial CHOICE Act, § 121 (proposed 11 U.S.C. §§ 101(9A), 109(b)(4)); 2017 FIBA, § 2 (proposed 11 U.S.C. §§ 101(9A), 109(b)(4)); 2015 TPRRA, § 2 (proposed 11 U.S.C. §§ 101(9A), 109(i)).

<sup>133</sup> Appendix C contains a more extensive discussion of the definition of “covered financial corporation,” including the meaning of engaging in financial activities.

<sup>134</sup> Financial CHOICE Act, § 122 (proposed 11 U.S.C. § 1183); 2017 FIBA, § 3 (proposed 11 U.S.C. § 1183); 2015 TPRRA, § 3 (proposed 11 U.S.C. § 1403).

<sup>135</sup> *Id.* The House proposals would not permit the commencement of a case by the filing of an involuntary petition. *See, e.g.*, Financial CHOICE Act, § 122 (proposed 11 U.S.C. § 1181) (providing that the Bankruptcy Code section allowing involuntary petitions to be filed does not apply).

<sup>136</sup> 2013 TPRRA, § 4 (proposed 11 U.S.C. 1403(a)(2)).

<sup>137</sup> Financial CHOICE Act, § 122 (proposed 11 U.S.C. §§ 1187-88); 2017 FIBA, § 3 (proposed 11 U.S.C. §§ 1187-88); 2015 TPRRA, § 3 (proposed 11 U.S.C. §§ 1407-08).

<sup>138</sup> *See, e.g.*, 11 U.S.C. §§ 362(b)(6), (b)(7), (b)(27), 555.

<sup>139</sup> As discussed in more detail above, various regulatory changes and reforms to the structure and operations of large bank holding companies since the financial crisis have likely reduced the amount of financing that would be necessary and permit a brief, 48 hour stay to further the objectives of the SPOE model of resolution. The brief stay is necessary to temporarily relieve immediate liquidity demands on the debtor covered financial corporation while the debtor executes the transfer to the bridge company.

The crux of the Chapter 14 resolution regime is the transfer of the covered financial corporation’s assets, contracts, and liabilities other than capital structure debt<sup>140</sup> to a newly created bridge company.<sup>141</sup> The transfer may not occur until at least 24 hours after the case has been commenced.<sup>142</sup> Before ordering the transfer to proceed, the court must conduct a hearing and make certain determinations based on a preponderance of the evidence.<sup>143</sup> The court must determine, among other things, that the transfer “is necessary to prevent serious adverse effects on financial stability in the United States,” that the bridge company is likely to be able to satisfy its obligations under any debt or contract transferred to it, and that the transfer “does not provide for the assumption of any capital structure debt by the bridge company.”<sup>144</sup>

The order approving the transfer to the bridge company must also provide for the appointment of a special trustee to which all of the equity securities of the bridge company will be transferred.<sup>145</sup> The special trustee will distribute the assets held in trust to those holding claims against the bankruptcy estate, either in accordance with a confirmed plan or as otherwise ordered by the court.<sup>146</sup>

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The clean capital structure and strong balance sheet of the bridge company makes it more likely to be able to satisfy, upon the expiration of the stay, obligations to QFC counterparties under QFCs transferred to the bridge company and facilitates the resumption, if necessary, of private-sector funding to the bridge company.

<sup>140</sup> Appendix C contains a more extensive discussion of the definition of “capital structure debt.”

<sup>141</sup> Financial CHOICE Act, § 122 (proposed 11 U.S.C. § 1185); 2017 FIBA, § 3 (proposed 11 U.S.C. § 1185); 2015 TPRRA, § 3 (proposed 11 U.S.C. § 1405).

<sup>142</sup> *See, e.g.*, Financial CHOICE Act, § 122 (proposed 11 U.S.C. § 1185(a)).

<sup>143</sup> *See, e.g.*, Financial CHOICE Act, § 122 (proposed 11 U.S.C. §§ 1185(a), (c)).

<sup>144</sup> *See, e.g.*, Financial CHOICE Act, § 122 (proposed 11 U.S.C. § 1185(c)). As to the financial stability condition, 2013 TRPPA, § 4 (proposed 11 U.S.C. § 1406(c)(1)) provides instead that the transfer must be “necessary to prevent imminent substantial harm to financial stability in the United States.” As to the bridge company’s ability to satisfy obligations transferred to it, 2013 TRPPA, § 4 (proposed 11 U.S.C. § 1406(c)(4)) provides that the Federal Reserve must certify to the court that the bridge company provides adequate assurance of future performance of such obligations.

<sup>145</sup> Financial CHOICE Act, § 122 (proposed 11 U.S.C. §§ 1185(c)(7), 1186); 2017 FIBA, § 3 (proposed 11 U.S.C. §§ 1185(c)(7), 1186); 2015 TPRRA, § 3 (proposed 11 U.S.C. §§ 1405(c)(7), 1406).

<sup>146</sup> *See, e.g.*, Financial CHOICE Act, § 122 (proposed 11 U.S.C. § 1186(c)). 2013 TPRRA, § 4 (proposed 11 U.S.C. § 1405(c)) provides that “[t]he special trustee shall distribute the assets held in trust in accordance with the plan on the effective date of the plan.”

Chapter 14 provides for a panel of 10 bankruptcy judges, designated by the Chief Justice of the United States, to be available to hear a Chapter 14 case.<sup>147</sup> The chief judge of the applicable court of appeals for the district in which the case has been filed will assign a bankruptcy judge from the panel to hear the case. Chapter 14 provides for the temporary assignment of the bankruptcy judge to the district in which the case has been filed, if necessary.<sup>148</sup>

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<sup>147</sup> Financial CHOICE Act, § 123 (proposed 28 U.S.C. § 298(a)(1)); 2017 FIBA, § 4 (proposed 28 U.S.C. § 298(a)(1)); 2015 TPRRA, § 4 (proposed 28 U.S.C. § 298(a)).

<sup>148</sup> Financial CHOICE Act, § 123 (proposed 28 U.S.C. § 298(a)(3)); 2017 FIBA, § 4 (proposed 28 U.S.C. § 298(a)(3)); 2015 TPRRA, § 4 (proposed 28 U.S.C. § 298(b)(2)).

## Appendix C: Additional Policy Considerations for Chapter 14

### Definition of “Capital Structure Debt”

The term “capital structure debt” refers to the debt of the covered financial corporation that, along with the equity of the covered financial corporation, would be required to be left behind with the debtor upon the transfer of the debtor’s assets, contracts, and other liabilities to a bridge company in a two-entity recapitalization.<sup>149</sup> Treasury recommends that the definition of “capital structure debt” include all unsecured debt for borrowed money other than QFCs, as provided for in the most recent House and Senate bills.<sup>150</sup> The fully secured portion of secured debt should be excluded from the definition—as provided for in the most recent House and Senate bills.<sup>151</sup> However, unlike the congressional proposals but consistent with the Hoover Institution’s approach, Treasury endorses the inclusion in the definition of “capital structure debt” of a secured lender’s unsecured deficiency claim for an under-secured debt—that is, the portion of a debt secured by collateral in excess of the value of the collateral.<sup>152</sup>

When creditors assume their claims will be fully paid, they have less incentive to monitor the firm’s performance and impose or enforce constraints on its risktaking.<sup>153</sup> The broad

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<sup>149</sup> See Jackson in Making Failure Feasible, *supra* note 4, at 31-32. See also, e.g., 2017 FIBA, § 3 (proposed 11 U.S.C. § 1182).

<sup>150</sup> See, Financial CHOICE Act, § 122 (proposed 11 U.S.C. § 1182); 2017 FIBA, § 3 (proposed 11 U.S.C. § 1182); and 2015 TPRRA, § 3 (proposed 11 U.S.C. § 1402). Each of these bills define “capital structure debt” identically as “all unsecured debt of the debtor for borrowed money for which the debtor is the primary obligor, other than a qualified financial contract and other than debt secured by a lien on property of the estate that is to be transferred to a bridge company pursuant to an order of the court under” the section providing for the transfer to the bridge company. An earlier Senate bill would define “capital structure debt” as “debt other than a qualified financial contract, of the debtor for borrowed money with an original maturity of at least 1 year.” 2013 TPRRA, § 4 (proposed 11 U.S.C. § 1402).

<sup>151</sup> An earlier Senate bill would not have excluded secured debt from the definition of “capital structure debt.” 2013 TPRRA, § 4 (proposed 11 U.S.C. § 1402).

<sup>152</sup> See Jackson in Making Failure Feasible, *supra* note 4, at 49. The House and Senate bills would exclude all secured claims—including the fully secured portion and the under-secured portion of a secured claim (*i.e.*, the deficiency claim)—from the definition of “capital structure debt” and would provide for the transfer of any such deficiency claim to the bridge company. See, e.g., 2017 FIBA, § 3 (proposed 11 U.S.C. §§ 1182, 1185(c)(4)) (excluding “debt secured by a lien on property of the estate that is to be transferred to a bridge company” from the definition of “capital structure debt” and requiring the bridge company to assume all debt, including deficiency claims, arising in respect of any property subject to a lien that is transferred to the bridge company).

<sup>153</sup> H.R. 1667, the “Financial Institution Bankruptcy Act of 2017”: Hearing on H.R. 1667 Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary,

definition of “capital structure debt” we recommend is designed to eliminate this moral hazard as well as any related subsidy effect. Accordingly, this provision should discourage excessive risk-taking by financial companies that could be resolved under Chapter 14.

A broad definition of “capital structure debt” would also enhance the bridge company’s ability to attract private liquidity financing. The broader the definition of “capital structure debt,” the more unsecured debt would be left behind and the lower the debt service obligations of the bridge company. The result would be a better capitalized bridge company capable of attracting more private financing.

It is worth noting that recent developments discussed in this report make the question of what precisely to include as capital structure debt somewhat less consequential. Specifically, the Federal Reserve’s recently adopted “clean holding company” requirements provide that, among other things, bank holding companies that are U.S. G-SIBs generally may not issue, with few exceptions, short-term debt.<sup>154</sup> The rule also limits the aggregate value of certain other liabilities that the U.S. G-SIB may issue.<sup>155</sup> What remains important is that, however the definition of “capital structure debt” is formulated, creditors will be aware *ex ante* of how they will be treated in a resolution.

### **Appropriate Scope for Eligibility for Chapter 14**

The House and Senate Bills have defined the scope of the “covered financial corporations” that may file for bankruptcy under a new Chapter 14 of the Bankruptcy Code to include bank holding companies and other holding companies engaged in financial activities.

Specifically, recent House bills<sup>156</sup> have defined “covered financial corporation” to include:

- any bank holding company *and*
- any corporation that exists for the primary purpose of owning, controlling and financing its subsidiaries, that has total consolidated assets of \$50,000,000,000 or greater, and for which, in its most recently completed fiscal year,
  - annual gross revenues derived by the corporation and all of its subsidiaries from activities that are financial in nature and, if applicable, from the ownership or

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115th Cong. 6 (2017) (written testimony of John B. Taylor, Professor, Stanford University and Senior Fellow, Hoover Institution).

<sup>154</sup> 12 C.F.R. § 252.64(a).

<sup>155</sup> 12 C.F.R. § 252.64(b). The Federal Reserve has also applied such requirements to the U.S. intermediate holding companies of foreign G-SIBs. 12 C.F.R. § 252.166.

<sup>156</sup> *See, e.g.*, 2017 FIBA, § 2 (proposed 11 U.S.C. § 101(9A)).

- control of one or more insured depository institutions, represents 85 percent or more of the consolidated annual gross revenues of the corporation *or*
- the consolidated assets of the corporation and all of its subsidiaries related to activities that are financial in nature and, if applicable, related to the ownership or control of one or more insured depository institutions, represents 85 percent or more of the consolidated assets of the corporation.

The House bills define “financial in nature” by reference to section 4(k) of the Bank Holding Company Act of 1956 and would exclude broker-dealers, commodity brokers, insurance companies and depository institutions from the definition of “covered financial corporation.”<sup>157</sup>

The most recent Senate bill includes within the definition of “covered financial corporation” bank holding companies and any corporation that exists for the primary purpose of owning, controlling, and financing subsidiaries that are predominantly engaged in activities that the Federal Reserve has determined are financial in nature or incidental to such financial activities for purposes of section 4(k) of the Bank Holding Company Act of 1956. The Senate bill would have the same exclusions as the House bills.<sup>158</sup>

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<sup>157</sup> Financial CHOICE Act, § 121 (proposed 11 U.S.C. § 101(9A)); 2017 FIBA, § 2 (proposed 11 U.S.C. § 101(9A)). Section 4(k) of the Bank Holding Company Act of 1956 permits a financial holding company to engage in any activity, and to acquire and retain the shares of any company engaged in any activity, that the Federal Reserve determines to be financial in nature or incidental to such financial activity. 12 U.S.C. § 1843(k)(1)(A).

<sup>158</sup> 2015 TPRRA, § 2 (proposed 11 U.S.C. § 101(9A)). An earlier Senate proposal would not limit “covered financial corporations” to holding companies. 2013 TPRRA § 3 (proposed 11 U.S.C. § 101(9A)). The Hoover Institution proposal, in contrast, would define “covered financial corporation” as “any corporation that is substantially engaged in providing financial services or financial products (other than financial market [utilities]) and any subsidiary of that corporation that . . . is substantially engaged in providing financial services or financial products.” The Hoover Institution proposal excludes subsidiaries that are broker-dealers, commodity brokers, or depository institutions; however, it includes insurance company subsidiaries. Jackson in Making Failure Feasible, *supra* note 4, at 48.

### ***Asset threshold***

Though each of the House and Senate bills would permit a bank holding company of any size to qualify as a covered financial corporation, the House bills would restrict eligibility for non-bank holding companies to those with assets of \$50 billion or greater.<sup>159</sup>

The only reason for commencing a Chapter 14 case would be to proceed with a transfer of property of the estate to the bridge company. The House and Senate bills would require as a condition to such a transfer that the court determine, based upon a preponderance of the evidence, that the transfer is “necessary to prevent serious adverse effects on financial stability in the United States.”<sup>160</sup> This condition would seem to preclude most if not all covered financial corporations with assets of less than \$50 billion (and likely many more covered financial corporations with assets well in excess of \$50 billion).

On balance, Treasury recommends against including an asset threshold in the definition of “covered financial corporation.” Not including an asset threshold would provide for greater consistency with regard to bank holding companies and non-bank holding companies given that the various legislative proposals have no asset threshold for bank holding companies. Further, an asset threshold could mistakenly be seen as delineating which institutions are considered to have systemic importance and which are not. A new Chapter 14 should be available to all financial corporations that otherwise meet the definition of “covered financial corporation” and that would meet the financial stability condition for transfers to the bridge company. In any case, as a practical matter, Chapter 14 would be most relevant for the largest, most complex financial corporations.

### ***Reference to financial activities***

Regardless of how exactly a “covered financial corporation” is defined, what is crucial is that the definition be as clear as possible to avoid confusion as to which corporations would be considered “covered financial corporations” and thus eligible for resolution under a new Chapter 14. This is perhaps of even greater significance in the context of the Bankruptcy Code than it is with respect to Title II. Under Title II, there are considerable checks and balances, including the Federal Reserve, the Treasury, and generally the FDIC each having to agree that the company

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<sup>159</sup> The Hoover Institution, despite having proposed a \$100 billion asset threshold under a previous version of its proposal, now recommends that no dollar limit be included “on the view that Chapter 14 provides a superior reorganization mechanism for all financial institutions.” Jackson in *Making Failure Feasible*, *supra* note 4, at 34.

<sup>160</sup> Financial CHOICE Act, § 122 (proposed 11 U.S.C. § 1185(c)(1)); 2017 FIBA, § 3 (proposed 11 U.S.C. § 1185(c)(1)); 2015 TPRRA, § 3 (proposed 11 U.S.C. § 1405(c)(1)). An earlier Senate bill provides instead that the transfer must be “necessary to prevent imminent substantial harm to financial stability in the United States.” 2013 TRPPA, § 4 (proposed 11 U.S.C. § 1406(c)(1)).



meets the definition of “financial company.” Under a new Chapter 14, a company would have to satisfy itself and state to the court under penalty of perjury that to the best of its knowledge it meets the definition of “covered financial corporation.”

Under Title II, the definition of “financial company” includes companies that are predominantly engaged in activities that the Federal Reserve has determined are financial in nature or incidental thereto; provided that, to be considered “predominantly engaged,” at least 85 percent of the financial company’s revenues must be derived from such activities.<sup>161</sup> The FDIC, in consultation with Treasury, has adopted a regulation providing further clarity as to the meaning of “predominantly engaged,” in particular by defining the accounting standards that would apply to the determination and providing a comprehensive list of financial activities, based on the Federal Reserve’s determinations to date.<sup>162</sup>

It is important that such a level of specificity and clarity be incorporated into the definition of “covered financial corporation” under the Bankruptcy Code. More specifically, Treasury recommends that any definition of “covered financial corporation” under a new Chapter 14 be consistent with the definition of “financial company” contained in both Title II and the FDIC implementing regulations.

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<sup>161</sup> 12 U.S.C. §§ 5381(a)(11)(B)(iii), 5381(b).

<sup>162</sup> 12 C.F.R. § 380.8(c).