STATEMENT OF

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BEFORE

THE COMMITTEE ON THE JUDICIARY

UNITED STATES SENATE

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BIG BANK BANKRUPTCY: 10 YEARS AFTER LEHMAN BROTHERS

AND

THE TAXPAYER PROTECTION AND RESPONSIBLE RESOLUTION ACT

Thank you for inviting me to testify regarding *Big Bank Bankruptcy: 10 Years After Lehman Brothers* and the *Taxpayer Protection and Responsible Resolution Act* ("TPRRA").

I am Donald S. Bernstein, Chairman of the Restructuring Group at Davis Polk & Wardwell LLP. I am on the Board of Editors of *Collier on Bankruptcy*, and have served as a Commissioner on the American Bankruptcy Institute's Commission on the Reform of Chapter 11, Chair of the National Bankruptcy Conference and President of the International Insolvency Institute. Representing one of the nation's largest financial institutions, I was among those present at the Federal Reserve Bank of New York that fateful weekend when Lehman Brothers failed, and since then I have spent a much of my time dealing with the fallout of the financial crisis, including working on resolution plans for a number of the largest U.S. financial institutions under Section 165(d) of the Dodd-Frank Act – commonly known as "living wills." I have also represented financial industry organizations, such as The Clearing House Association and SIFMA on issues related to the resolution of financial firms. I am, however, here in my individual capacity and not on behalf of any client. The views I express are my own, and not those of Davis Polk, any client or any organization with which I am affiliated.

My testimony today focuses on the Senate draft of TPRRA — legislation to add a new Chapter 14 to the federal Bankruptcy Code to facilitate the orderly resolution of distressed financial institutions. I want to thank the members of this Committee for convening these hearings to delve more deeply into the lessons learned from the failure of Lehman Brothers and the implications of those lessons for TPRRA.

As the members of the Committee will remember, the unplanned bankruptcy of Lehman Brothers in 2008 was preceded by a severe run on the firm's liquidity and a brief but unsuccessful effort to fashion a private sector rescue transaction, followed by the commencement of Lehman's bankruptcy proceedings. The commencement of bankruptcy proceedings led to wholesale close-outs of Lehman's financial contracts, the selling of collateral for those contracts, depressing asset prices in financial markets, and ultimately the sale of Lehman's businesses and remaining assets for a fraction of their pre-bankruptcy value. This chaotic sequence of events led to fear in the markets that other financial firms might suffer the same fate – a phenomenon sometimes called "contagious panic," resulting in runs on other firms that were only stopped by federal intervention.

In the harsh light of these events and their aftermath, it became quite clear that the abrupt unraveling of a systemically important financial institution ("SIFI") must be avoided and that an efficient means must be found of speedily causing the distressed institution's losses to be absorbed by private shareholders and creditors so valuable and systemically important operations of the firm can, without a taxpayer supported bailout, continue under new ownership and management or be wound down in an orderly manner as going concerns. This is what whole-firm recapitalization – the "single point of entry" approach to the resolution financial firms reflected in TPRRA – is designed to accomplish.

In 2008, U.S. regulators had a very limited set of legal and financial tools with which to stem contagious panic and resolve a distressed financial firm without a fire-sale

of assets and the unraveling of maturity transformation – the main and economically essential business of a financial institution. The inadequacy of those tools in 2008 and the lack of pre-failure resolution planning put taxpayers in the position of having to invest in financial firms to recapitalize and rescue them. Although the financial institutions recapitalized with government funds during the financial crisis generally repaid those investments with interest, most observers believed that better tools were needed to address the failure of financial firms without the need to put taxpayer funds at risk.

In my testimony before the House Judiciary Committee regarding the companion legislation to TPPRA that eventually became H.R.1667, the Financial Institutions Bankruptcy Act of 2017, I endorsed the idea that the Bankruptcy Code should be amended to add tools to facilitate the single-point-of-entry approach to resolving systemically important financial firms. This approach is similar to the approach developed by the Federal Deposit Insurance Corporation under Title II of the Dodd-Frank Act (Orderly Liquidation Authority or "OLA"). I strongly believe that, if the Bankruptcy Code were amended to add tools to facilitate the recapitalization of failing financial firms in this manner, the risk of disorderly liquidations, contagious panic and related market disruptions could be minimized, the value of distressed financial firms could be maximized for stakeholders, and the risk that taxpayers would have to bail out distressed financial firms would be greatly reduced.

“Single-Point-Of-Entry” Approach to Resolution

In the United States, bank holding companies are utilized by the largest U.S. financial institutions. Banking and other critical operations of the firms are not conducted at the holding company level, but instead they are conducted in subsidiaries of the holding company. The single-point-of-entry approach to resolution involves commencing resolution proceedings only with respect to the financial firm’s top-level parent holding company, with all losses of the distressed financial firm being borne by shareholders and creditors of that entity, and not by creditors of the firm’s operating subsidiaries or by taxpayers.

The SIFI’s operating entities, like the firm’s banking or broker-dealer subsidiaries, would not be placed in insolvency or resolution proceedings. Instead, they would be recapitalized using assets earmarked by the holding company for that purpose and would continue to operate as subsidiaries of a newly created debt-free “bridge” holding company. The old holding company’s creditors and shareholders would be left behind either in bankruptcy proceedings or in an OLA receivership, creating a viable recapitalized firm the value of which would be preserved without requiring bankruptcy or a prolonged resolution process for the firm’s operating entities.

The objective of the single-point-of-entry approach to resolution is to preserve the continuity and value of the firm’s operating businesses and promote financial stability while the holding company’s shareholders and creditors absorb the firm’s losses. The holding company’s stakeholders nevertheless benefit because liquidation of the firm’s valuable operating businesses and assets at fire-sale prices is avoided and the going

concern value of the firm's operating subsidiaries is preserved. This value ultimately is available for distribution to stakeholders of the old holding company at the end of the resolution process.

For a "single point of entry" resolution to be successful, a financial institution's holding company must maintain sufficient capacity to absorb losses incurred by the firm. As a result, U.S. regulators now require SIFIs to maintain significant amounts of equity and long-term unsecured debt at the holding company level ("total loss absorbing capacity" or "TLAC") that is structurally subordinated to depositors and other creditors of the firms' operating subsidiaries. If a firm's equity becomes impaired as a result of operating losses, the layer of structurally subordinated loss absorbing debt at the holding company can be utilized to recapitalize the firm if the legal tools are available to speedily push the firm's operating losses up to the holding company while keeping systemically critical operating subsidiaries out of resolution proceedings.

U.S. financial firms, together with their primary regulators, have taken steps to enhance the ability to resolve financial firms using this recapitalization model. The firms have undergone substantial changes since 2008 that improve their resiliency, including a substantial increase in capital and balance sheet liquidity to meet regulatory requirements and risk management needs, the de-risking of the balance sheets, and capital restructuring to address regulatory requirements for sufficient amounts of loss absorbing debt and assets in their holding companies. In addition, the largest firms have implemented secured support agreements providing for the recapitalization of their subsidiaries should it become necessary, and they are implementing amendments to financial contracts to

reduce the risk of termination of such contracts in the event the holding company in the group commences bankruptcy proceedings.[1]

International Support for Recapitalization Strategy

A number of other countries have amended their laws so that so-called "special resolution regimes" administered by local regulators can be used to recapitalize foreign financial firms using the same whole-firm recapitalization approach we have developed here in the United States, adapted to the structure of financial firms outside the U.S. Among other developments in this regard is the implementation of the European Union of Bank Recovery and Resolution Directive (BRRD), which provides for the "*bailing in*" of capital structure debt, the preservation of financial contracts and the power to recognize foreign resolution regimes.[2]

Because of initiatives by regulators at the multinational level, including those of the Financial Stability Board and crisis management groups organized among key regulators of individual firms, there is substantial alignment among national regulatory authorities regarding the benefits of the recapitalization and bail-in approaches to dealing with distressed financial firms. A single-point-of-entry recapitalization protects home

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[1] Some of these developments are traced in materials that my colleagues and I prepared for a Conference sponsored by the Financial Institutions Center of the Wharton School titled *Resolution of Global Systemically Important Financial Institutions Under the Bankruptcy Code* (December 7, 2016). The materials are available at: https://live-wharton-fic.pantheonsite.io/wp-content/uploads/2017/08/Revised.PPT.Bnkrpt.ntes_.8.4.17.pdf.

[2] *See Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms* (May 15, 2014). *See also* Andrea Thomas, *Germany Approves Plans to Force Creditors to Prop Up Struggling Banks*, THE WALL STREET JOURNAL (July 9, 2014)

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country interests by preserving financial stability and host-country interests by making resolution proceedings for host-country operations unnecessary. Since the counterparty credit exposures of the largest U.S. financial firms are highly concentrated in a few jurisdictions, such as the UK,[3] coordination and alignment among the relevant authorities can readily occur if appropriate advance planning among regulatory authorities can be done. Key to these efforts is the fact that recapitalization and bail-in strategies allow the firms to continue their business and meet their operating obligations in the ordinary course in both home and host countries. As a result, local regulators should not feel compelled to take precipitous actions that can hinder the resolution of the overall group.

Single-Point-of-Entry Resolution Under the Bankruptcy Code

To implement a single point of entry resolution under the Bankruptcy Code, the firm's bank holding company would be placed in bankruptcy, suspending repayment of the holding company's debt, but the firm's operating subsidiaries, with their losses recapitalized, would continue to operate outside of bankruptcy, paying their depositors and other creditors in the ordinary course of business. Ideally, the recapitalized operating subsidiaries would be transferred to a new debt free holding company (known as a

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[3] *See* FDIC Presentation to the FDIC Systemic Resolution Advisory Committee Meeting, Panel on International Resolution Strategy (Dec. 10, 2012) (over 90% of the total reported foreign activity for the top seven U.S. SIFIs is located in three foreign jurisdictions, with the UK having the largest footprint). Video available at http://www.vodium.com/MediapodLibrary/index.asp?library=pn100472_fdic_SRAC. Presentation slides from the meeting are available at http://www.fdic.gov/about/srac/2012/2012-12-10_international-resolution-strategy.pdf.

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"bridge company"), the value of which would be maximized for the benefit of stakeholders left behind in the bankruptcy proceedings of the old holding company.

Orderly Liquidation Authority provides the essential tools to implement this single-point-of-entry resolution strategy.[4] The Dodd-Frank Act makes clear, however, that the use of OLA, the U.S. special resolution regime, is to be limited to situations where bankruptcy is not a viable resolution strategy.[5] Thus, the Dodd-Frank Act seeks to encourage resolution under the Bankruptcy Code rather than under OLA and expressly requires that resolution plans assume the Bankruptcy Code would be used, despite the fact that critical resolution tools available under OLA currently are unavailable or not obviously available under the Bankruptcy Code.

The absence of these tools under the Bankruptcy Code has led U.S. Regulators, financial firms and private sector organizations like ISDA to develop work-arounds that make single-point-of-entry resolution feasible under current law. Among other things, they have developed contractual approaches to facilitating resolution, including by limiting, subject to appropriate conditions, termination rights under certain types of financial contracts, and by putting into place secured intercompany support agreements to assure that operating subsidiaries are timely recapitalized so they can remain outside of

[4] These tools include: (1) the power to create and transfer the failed holding company's assets to a bridge financial company; (2) a temporary stay on financial contract terminations and a temporary override of cross-defaults; (3) the ability to assume financial contracts and related guarantees; and (4) the availability of temporary secured liquidity.

[5] Section 203(b) of the Dodd-Frank Act provides in relevant part that the Orderly Liquidation Authority of Title II of the Dodd-Frank Act may not be legally invoked unless the Secretary of the Treasury determines that "the failure of the financial company and its resolution under otherwise applicable Federal or State law [e.g., the Bankruptcy Code] would have serious adverse effects on financial stability in the United States" and "any action under section 204 [of the Dodd-Frank Act] would avoid or mitigate such adverse effects . . . ."

resolution proceedings, even after holding company bankruptcy proceedings are commenced. In addition, the firms' resolution plans rely on the ability to obtain expedited relief from the bankruptcy court under current section 363 and other sections of the Bankruptcy Code in order to effectuate the single-point-of-entry strategy.

TPPRA adds tools to the Bankruptcy Code that would obviate the need for these work-arounds.[6] Among other things, the draft bill (1) clarifies that bank holding companies can recapitalize their operating subsidiaries prior to or in connection with resolution, (2) clarifies that the Bankruptcy Code can be used to accomplish the transfer of recapitalized subsidiaries to a new holding company using a bridge company structure, and (3) provides for a short stay of financial contract close-outs and the assumption and preservation of financial contracts, overriding ipso facto (bankruptcy) defaults and cross-defaults that might impede the resolution process. The current draft of TPRRA amalgamates and improves upon features of the previous Senate and House bills, and, importantly, adopts the recommendation of the U.S. Department of the Treasury to remedy a shortcoming of a prior version of the bill by removing a provision that sought to repeal Title II of the Dodd-Frank Act.[7]

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[6] *See* Thomas H. Jackson, *Bankruptcy Code Chapter 14: A Proposal,* in BANKRUPTCY NOT BAILOUT: A SPECIAL CHAPTER 14 (Hoover Institution, Kenneth E. Scott & John B. Taylor, eds., 2012); Thomas H. Jackson, *Building on Bankruptcy: A Revised Chapter 14 Proposal for the Recapitalization, Reorganization, or Liquidation of Large Financial Institutions*, Hoover Institution, The Resolution Project (Draft, July 9, 2014); Ken Scott, *The Context for Bankruptcy Resolutions* (Draft, July 9, 2014). *See also* BPC Report, pp. 11-14 (recommendations for amending the Bankruptcy Code to facilitate the execution of a single-point-of-entry strategy under the Bankruptcy Code).

[7] *See* U.S. Department of Treasury, *Orderly Liquidation Authority and Bankruptcy Reform* (Feb. 21, 2018), available at: https://home.treasury.gov/sites/default/files/2018-02/OLA_REPORT.pdf.

Comments on Specific Provisions of TPRRA

1. Commencement of Involuntary Proceedings

TPRRA provides for the commencement of Chapter 14 proceedings with respect to a bank holding company, either voluntarily by the distressed firm itself, or involuntarily by the Federal Reserve Board, and includes a set of procedures for a speedy hearing and appeals if an involuntary petition is contested. However, some have expressed concern over the speed with which appellate review of an involuntary Chapter 14 filing must be completed.

In my view, the statute should do everything it can to encourage voluntary rather than involuntary proceedings. Apart from the procedural concern referred to above, the ability of regulators to commence involuntary proceedings, which is largely a mechanism to motivate a timely voluntary filing, is unobjectionable, but, in my view, also unnecessary. Even without an express right to commence a Chapter 14 case, the regulators have the necessary tools to motivate a timely voluntary bankruptcy filing by a distressed financial firm, given the advance resolution planning that has already taken place in connection with the firms' living wills and the ability of U.S. regulators to invoke OLA if a firm unduly delays commencement of Chapter 14 proceedings.

2. Protection of Directors from Liability for Commencing Proceedings

Concern about director liability for the simple act of commencing bankruptcy proceedings can unnecessarily delay or discourage boards of directors of distressed companies from acting, and this risk is especially acute with respect to financial firms, which explains why financial firms have typically failed only at the point of a collapse of

their liquidity and after many of the firm's assets have already been sold at fire-sale prices. In order to encourage timely voluntary action by directors of failing financial firms, Title II of the Dodd-Frank Act insulates directors from liability for consenting to the appointment of the FDIC as receiver.[8] I concur with the recommendation of the National Bankruptcy Conference in its letter to the House Judiciary Committee of January 29, 2014 that it is advantageous to include a corresponding provision for the commencement of voluntary resolution proceedings under the Bankruptcy Code, and TPRRA appropriately includes such a provision.

I believe the language in the current version of the Senate bill has been appropriately limited in scope so that financial institution boards of directors will remain accountable for their pre-bankruptcy actions, but they will not have to concern themselves over the risk of liability when they are invoking, presumably with the support of their primary regulators, provisions designed to resolve the failing firm, maximize its value to stakeholders and minimize systemic risk.

Conclusion

As I stated in my previous testimony, no single resolution procedure will be perfect for all situations. However, improving the resolution tools under the Bankruptcy Code in the manner provided in TPRRA will maximize the flexibility to resolve distressed financial firms in a manner that minimizes systemic risk and does not put

[8] Dodd-Frank Act § 207.

taxpayers at risk while preserving due process and the rule of law. For this reason, I strongly support the enactment of TPRRA while retaining OLA as a back-up resolution procedure for large financial firms.

I want to thank the Committee for allowing me this opportunity to present my views. I would of course be delighted to answer any questions members of the Committee may have about my testimony.