

**Too Much Discretion To Succeed:
Why A Modified Bankruptcy Code Is Preferable
To Title II Of The Dodd-Frank Act**

By James H.M. Sprayregen & Stephen E. Hessler¹

Submission in Response to Federal Reserve Request for Information Relating to
Dodd-Frank Act Section 216 Study Regarding the Resolution of Financial Companies
Under the Bankruptcy Code

Table of Contents

Executive Summary

I. Understanding Title II—And Its Flaws

A. The Dodd-Frank Act: Lehman’s Progeny

B. Too Much Discretion Will Not Eliminate Too Big To Fail

II. Modifying The Bankruptcy Code

A. Interplay Between Chapters 7, 11 & 14

B. Enhanced Government Role

C. Maintain Bankruptcy Court Judges

D. Eliminate Automatic Stay Safe Harbors For Qualified Financial Contracts

Conclusion

¹ We are partners in the restructuring group of Kirkland & Ellis LLP. The views expressed herein do not constitute legal advice, are solely our own, and are not offered on behalf of our firm, any client, or other organization.

Executive Summary

As restructuring practitioners, we strongly support the public policy imperative that having an effective framework for reorganizing distressed financial companies—especially those that are so large their failure may cause “systemic” economic harm—is critical to preventing future financial crises. The “orderly liquidation authority” set forth at Title II of the Dodd-Frank Act was intended by Congress to provide such a protective framework, and laudably so. But in our view, the wide-ranging and ill-defined discretion granted to regulators and other political actors by Title II actually undermines financial markets by promoting the very uncertainty and moral hazard the Dodd-Frank Act purports to combat. Most significantly, the prospect of a politically-sensitive regulatory agency assuming direct responsibility for administering the liquidation of a systemically-important distressed financial company, with the express ability to treat similarly-situated creditors dissimilarly, may trigger a classic “run on the bank,” as counterparties rush to enhance or exit their positions, based on their varying degrees of political influence.

The hallmark of any resolution regime for distressed financial companies must be clear rules administered by an impartial tribunal. From that perspective, we believe Title II is an inferior alternative to the well-established legal landscape of the Bankruptcy Code as applied by Bankruptcy Court judges. Based on our experience, we favor the adoption of certain relatively discrete modifications or clarifications to the existing provisions of Chapters 7 and 11 that would facilitate the orderly liquidation or reorganization of systemically-important financial companies.

These include:

- Provide standing to the primary regulators of financial companies to raise issues within their regulatory purview, and authorize consideration of the “public interest” (in accordance with the governing terms of the primary regulator’s statutory oversight) when reviewing a debtor financial company’s reorganization decisions;

- Maintain the use of Bankruptcy Court judges as the arbiters of financial company cases under Chapters 7 or 11, though perhaps limited to a predetermined set of experienced jurists who serve in the Federal Districts that most often handle cases of analogous size and complexity; and
- Eliminate most, if not all, of the safe harbors from the automatic stay for qualified financial contracts, subject to a very narrow exception and very stringent standard that would allow for the expiration of the stay 60 days after the petition date, for those qualified financial contracts for which an inability to terminate promptly would pose a demonstrated credible threat of ruinous harm to the counterparty, as balanced against the harm that termination would inflict upon the debtor (and the public interest).

With these reforms, Congress can further improve the reorganization (or, if necessary, liquidation) framework that is already the most tested and effective in the world—and further restore the responsible functioning of financial companies by repealing Title II or otherwise minimizing any possibility of its invocation.

I. Understanding Title II—And Its Flaws

At the outset, we think it provides important context to examine why Title II will not work as intended. The aphorism that militaries should not approach the next conflict by preparing to fight the last war presumably applies also to legislatures' responses to an economic downturn. Using that criterion, Title II appears to be particularly flawed, as it is premised on an incorrect diagnosis of the most recent recession, and provides a misguided remedy for preventing another financial crisis.

One of the central tenets of the Dodd-Frank Act is that, once a Title II proceeding has been instituted, liquidation of the financial company shall proceed exclusively under Title II, and no provision of the Bankruptcy Code shall apply.² (Conversely, for financial companies not subject to liquidation under Title II, solely the provisions of the Bankruptcy Code or other

² Section 202(c)(2).

applicable insolvency laws, but not Title II, shall govern.³) Another key directive of Title II is that “[n]o taxpayer funds shall be used to prevent the liquidation of any financial company under this title.”⁴

But, put simply, the so-called Great Recession was not caused primarily by real or perceived shortcomings of the Bankruptcy Code, and Title II’s focus on precluding taxpayer-funded bailouts of major banks does not justify supplanting Chapters 7 and 11 of the Code.

A. The Dodd-Frank Act: Lehman’s Progeny

While the bankruptcy filing of Lehman Brothers was not the sole reason for the Dodd-Frank Act, to the extent Lehman’s failure was believed to be a major cause of the financial crisis, and Dodd-Frank was Congress’s response to that crisis, Title II’s lineage can fairly be traced to Lehman. For instance, the Federal Deposit Insurance Corporation (the “FDIC”), the regulatory body empowered with the “orderly liquidation authority” of Title II, recently made one of its most significant policy statements since passage of the Dodd-Frank Act by releasing a report that explains how the FDIC would have hypothetically exercised these powers (had they existed at that time) to administer Lehman’s resolution (the “FDIC Lehman Report”).⁵ Through a series of unrealistic and inapposite assumptions, the FDIC posits the administration of Lehman’s estates under Title II would have imposed a lesser disruption on financial markets, and resulted in a greater recovery for Lehman’s creditors, than Lehman’s September 2008 filing and ongoing cases under Chapter 11 of the Bankruptcy Code.

³ Section 202(c)(1).

⁴ Section 214(a).

⁵ “The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act,” FDIC Quarterly, early release for the upcoming 2011, Volume 5, No. 2.

More specifically, to cite some of the more notable examples, the FDIC Lehman Report extols the FDIC's ability under Title II to transfer certain of a financial company's assets, liabilities, and operations to one or more "bridge financial companies" for preservation and sale as a going concern, while less valuable assets remain in receivership and are liquidated.

According to the FDIC:

There are no specific parallel provisions in the Bankruptcy Code, and therefore it is more difficult for a debtor company operating under Chapter 11 of the Bankruptcy Code to achieve the same result as expeditiously, particularly where circumstances compel the debtor company to seek bankruptcy protection before a wind-down plan can be negotiated and implemented. Where maximizing or preserving value depends upon a quick separation of good assets from bad assets, implementation delays could adversely impact a reorganization or liquidation proceeding.⁶

This is a curious criticism, given that section 363 of the Bankruptcy Code expressly authorizes Chapter 11 debtors, after notice and a hearing, to sell property of the estate⁷—and that Lehman actually did sell most of its North American operations to Barclays—and that Lehman did so within less than a week after its petition date, justifying the rapidity of the transaction on the ground that even slight delay would cause massive value destruction.⁸ Further, the extensive use of bridge financial companies contemplated by the FDIC Lehman Report is distinctly at odds with the fundamental directive of the Dodd-Frank Act, which states "[i]t is the purpose of [Title II] to provide the necessary authority to *liquidate* failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk

⁶ FDIC Lehman Report at 6-7 (footnote omitted).

⁷ 11 U.S.C. § 363.

⁸ Analogously, the highly accelerated Chapter 11 cases of General Motors and Chrysler, while not financial companies, are additional evidence that bridge financial companies are not needed to sell a debtor's "good" assets under section 363, and liquidate the rest.

and minimizes moral hazard.”⁹ It also begs the question whether Congress fully understood (much less intended) that even the FDIC would interpret the exercise of its “orderly liquidation authority” to require running a series of sale processes akin to that which Chapter 11 debtors already conduct under the Bankruptcy Code.¹⁰

Similarly, the FDIC Lehman Report notes favorably that the Dodd-Frank Act permits the FDIC to borrow funds from the Department of the Treasury to make loans to, or guarantee the obligations of, a financial company (or successor bridge financial company) in Title II proceedings. According to the FDIC:

Although the Bankruptcy Code provides for a debtor company to obtain DIP financing with court approval, there are no assurances that the court will approve the DIP financing or that a debtor company will be able to obtain sufficient—or any—funding or obtain funding on acceptable terms, or what the timing of such funding might be. For a systemically important financial institution, the market may be destabilized by any delay associated with negotiating DIP financing or uncertainty as to whether the bankruptcy court will approve DIP financing. Further, the terms of the DIP financing may limit the debtor’s options for reorganizing or liquidating and may diminish the franchise value of the company, particularly when the DIP financing is secured with previously unencumbered assets or when the terms of the DIP financing grant the lender oversight approval over the use of the DIP financing.¹¹

Here as well, given Title II’s aims (preclude bailouts, minimize moral hazard and market instability), it is entirely counterintuitive *not* to require that DIP financing be subject to

⁹ Section 204(a) (emphasis added).

¹⁰ Another related, unrealistic aspect of the FDIC Lehman Report is its blasé assertion that, although the Dodd-Frank Act requires promptly terminating the board of directors and senior management of a financial company in a Title II resolution proceeding, the preservation and sale of the most valuable assets via transfers to one or a series of bridge financial companies is achievable because those entities’ operations will be managed by the failing financial companies employees, “under the strategic direction of the FDIC,” and aided by the use of retained “contractors” and “former executives, managers, and other individuals with experience and expertise in running [similar] companies” *Id.* at 7.

¹¹ FDIC Lehman Report at 8.

reasonable limitations such as market testing, creditor scrutiny, secured lender consent and conditions, the grant of additional security interests, and court approval. Moreover, funds loaned by the FDIC are given repayment priority as administrative expenses, but:

In the unlikely event that recoveries from the disposition of assets are insufficient to repay amounts owed to the United States, there will be a subsequent assessment on the [financial] industry to repay those amounts. By law, no taxpayer losses from the liquidation process are allowed.¹²

This is illogical on its face. Effectively guaranteeing access to DIP financing will not curb excessive risk taking by financial companies. The ability to recoup unpaid losses by taxing Wall Street will not encourage prudent lending by the government. And because repayment “assessments” on third-party financial companies may be passed on to customers, including retail banking customers, the Dodd-Frank Act does not disallow taxpayer losses.¹³

In sum, the FDIC’s own hypothetical analysis reveals the Dodd-Frank Act does not address the real lessons of Lehman. Title II purports to end bailouts, but lest anyone forget, Lehman filed for Chapter 11 because the government *refused* to provide Lehman a bailout. Title II purports to ensure market stability, but it was the lack of a bailout for Lehman, in the midst of ad hoc and inconsistent decisions to provide government rescues to Bear Stearns, Fannie Mae and Freddie Mac, and AIG, that jolted markets in the fall of 2008—not concerns that the Bankruptcy Code was incapable of administering Lehman’s resolution. The Dodd-Frank Act is properly understood as a populist reaction by Congress to the Federal government’s commitment

¹² Id. at 9.

¹³ In a similar vein, the FDIC Lehman Report highlights that professional fees in Lehman’s Chapter 11 cases have already exceeded \$1 billion, and implies that similar costs will not be incurred in a Title II liquidation. Id. at 3 n.18. But the Dodd-Frank Act itself allows holders of disallowed claims to file suit in Federal District Court, and the lack of defined rules or precedent to govern Title II proceedings almost certainly will generate substantial litigation. Thus there is significant reason to doubt that a Title II liquidation would be materially less expensive to administer than a conventional case under the Bankruptcy Code.

of trillions of dollars of public funds for financial companies, notwithstanding estimates that nearly all of these loans or guarantees already have been or will be repaid, and possibly with a profit. But Title II is not justified by Lehman’s Chapter 11 cases, which are a testament to the Bankruptcy Code’s ability to handle effectively the resolution of even the largest distressed financial companies.

B. Too Much Discretion Will Not Eliminate Too Big To Fail

The signal weakness of Title II is that it imbues the FDIC with essentially unfettered discretion to exercise its “orderly liquidation authority,” and in so doing, essentially ensures the Dodd-Frank Act’s goals will not be achieved. Insofar as the Act does require that “[a]ll financial companies put into receivership under [Title II] shall be liquidated” and “[n]o taxpayer funds shall be used to prevent the liquidation of any financial company under this title,”¹⁴ it does follow that public dollars will not be used (or at least not directly) to “bail out” a failing financial company. But lenders care primarily (if not exclusively) about being repaid; they typically are not concerned with whether the borrower survives or which entity, private or public, funds the repayment. And thus Title II of the Dodd-Frank Act provides only superficial protection against another financial crisis.

Described generally, the “moral hazard” targeted by the Dodd-Frank Act results when creditors are incentivized to make risky loans because prevailing legal and regulatory regimes effectively operate to privatize gains but socialize losses. Put simply, investors will engage in increasingly speculative behavior if they are reasonably assured they will enjoy outside profits if an investment succeeds, but the government will shield them from outside harms if it

¹⁴ Section 214(a).

fails. Title II expressly authorizes the dissimilar treatment of similarly situated creditors.¹⁵ And because any excess costs of liquidation will be funded by assessments on third-party financial companies,¹⁶ the Dodd-Frank Act essentially authorizes the unlimited ability to pay creditors whatever amounts are deemed necessary to stabilize the economy, according to the political and regulatory priorities of whomever is in power at that time. The combined effect of these provisions, unfortunately, may be the failure to discourage further reckless behavior by market actors attempting to internalize the post-Title II reality that, while certain financial *companies* may no longer be too big to fail, certain *creditors* of those companies may be too politically important to be made to suffer large losses.

Unchecked discretion generates uncertainty, and uncertainty is especially problematic in the context of financial markets attempting to divine the likely actions of political bodies. Indeed, even a threshold determination of whether a distressed financial company will be resolved through a Title II liquidation or a conventional bankruptcy case, is subject to the discretion of the Treasury Secretary (in consultation with the President, the FDIC, and the Federal Reserve).¹⁷ In other words, the Dodd-Frank Act does not even signal certainty to the marketplace as to if and when a Title II proceeding will apply.

Consider the following hypothetical, albeit highly plausible, scenario. As the distress of a financial company that is perceived to be a candidate for a Title II liquidation deepens, politically powerful investors that are convinced they can leverage their influence with government officials may hold (or even increase) their positions. Less connected (or even

¹⁵ Section 210(b)(4).

¹⁶ Section 210(o)(1).

¹⁷ Section 203.

politically unpopular) counterparties may perceive they are at risk of dissimilar treatment, and rush to sell or unwind their positions. It is thus unfortunately ironic that the specter of Title II intervention by the FDIC, an institution whose historic mission has been to safeguard public confidence in the safety of retail deposits, may serve as the trigger for a classic “run on the bank” by spurring enormous pressure on distressed financial companies.

II. Modifying The Bankruptcy Code

We acknowledge that, while Title II of the Dodd-Frank Act is not a helpful (much less necessary) replacement for the Bankruptcy Code, enacting certain modifications to the Code likely would assist in the orderly reorganization or liquidation of distressed financial companies. To that end, a group of experts sponsored by Stanford University’s Hoover Institution has offered a proposal to add a new Chapter 14 to the Code.¹⁸ We understand this package of amendments was recently presented to both the FDIC and the Federal Reserve (also in response to the request for comments under Section 216 of the Dodd-Frank Act).¹⁹

Proposed Chapter 14 appears to be the leading alternative to Title II, and we endorse its overarching thesis: that a financial company resolution framework involving transparent and predictable rules, and administered by an impartial tribunal, is vastly preferable to undefined and untested guidelines, subject to the wide-ranging (and politically-sensitive) discretion of regulators. That said, we do not support all of Chapter 14’s prescriptions, and below are our views on some of the most important provisions.

¹⁸ “Bankruptcy Code Chapter 14: A Proposal,” Hoover Institution, Stanford University, Resolution Project Publications, (April 2011), <http://media.hoover.org/sites/default/files/documents/Resolution-Group-Bankruptcy-Code-Chapter%2014-Proposal-20110421.pdf>.

¹⁹ John B. Taylor, “How to Avoid the New Bailout Authority,” Economics One Blog (May 5, 2011), <http://johnbtaylorblog.blogspot.com/2011/05/how-to-avoid-new-bailout-authority.html>.

A. Interplay Between Chapters 7, 11 & 14

Chapter 14 is envisioned as a financial company-specific supplement to the existing chapters of the Bankruptcy Code (including, most relevantly for present purposes, the corporate liquidation provisions of Chapter 7 and the corporate reorganization provisions of Chapter 11). Accordingly, a Bankruptcy Code proceeding for a systemically-important financial company would commence as a filing under Chapter 14 and Chapters 7 or 11, with Chapter 14 altering the provisions of Chapters 7 or 11 only as needed for the specialized issues that arise in the orderly liquidation or reorganization of financial companies. But Chapter 14 would not reject the decades of precedent and practice that have refined the Code and that otherwise provide an established resolution framework for major corporations, including systemically-important financial companies. We think this is an appropriately modest and viable construct—in contrast to Title II, which replaces wholesale any application at all of the Bankruptcy Code.

B. Enhanced Government Role

The Bankruptcy Code does not presently provide an expansive grant of standing to the Federal government to participate in Chapter 7 or 11 cases. Section 1109(b) states “[a] party in interest, including the debtor, the trustee, a creditors’ committee, an equity security holders’ committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter.”²⁰ The Code does include a limited right to be heard to the Securities and Exchange Commission,²¹ but otherwise, unless the Federal government has a claim against or equity interest in a debtor, regulatory bodies generally

²⁰ 11 U.S.C. § 1109(b).

²¹ Section 1109(a) states “[t]he Securities and Exchange Commission may raise and may appear and be heard on any issue in a case under this chapter, but the Securities and Exchange Commission may not appeal from any judgment, order, or decree entered in the case.” 11 U.S.C. § 1109(a).

do not have standing to appear, in their capacity as regulators, and advance their public interest mandates, in financial company cases under Chapters 7 or 11.

Proposed Chapter 14 would provide standing to the primary regulators of financial companies to raise issues within their regulatory purview, and we agree this is a worthwhile amendment. A related and equally important modification, we believe, would be to expressly authorize the Bankruptcy Court to consider the “public interest” in financial company cases—to be construed in accordance with the governing terms of the regulator’s statutory oversight of financial companies. Described very summarily, the Bankruptcy Code authorizes a debtor to undertake a non-ordinary course transaction upon a showing it is a justified exercise of the debtor’s business judgment, which is understood to mean a transaction that is in the best interests of the debtor’s stakeholders. This standard does not allow much (if any) latitude to analyze the impact of a debtor’s reorganization choices on non-creditor third parties—or on systemic economic stability—and thus it should be revised accordingly.

We note our modification is not without precedent, as the Bankruptcy Code already includes the “public interest” as an applicable factor in the Bankruptcy Court’s review of most of the debtor’s key restructuring decisions in railroad cases.²² We think this is an especially apt parallel, in light of the integral importance of the railroads to the American economy at the time these provisions were enacted. Today, the orderly resolution of systemically-important financial companies, as with the railroads in prior generations, is likewise vital to protecting the public interest.

²² Section 1165 requires that “[i]n applying sections 1166, 1167, 1169, 1170, 1171, 1172, 1173, and 1174 of this title, the court and trustee shall consider the public interest in addition to the interests of the debtor, creditors, and equity security holders.” 11 U.S.C. § 1165. Those sections involve, for instance, the ability to change wages or working conditions established by collective bargaining agreement, lease rejection or abandonment of a railroad line, and confirmation of a reorganization plan or liquidation.

On this same front, proposed Chapter 14 would amend the Code to allow a financial company's primary regulator to file an involuntary petition, thus commencing a Chapter 7 or 11 case without the debtor's consent. Given that regulators already have myriad methods of effectively requiring that a financial company commence a voluntary case under the Bankruptcy Code, we agree making this ability explicit (and, again, subject to review as safeguarding the public interest) should help motivate financial companies to confront their problems early and diligently pursue responsible restructuring options. Indeed, it is commonly understood that Lehman's expectation of a bailout (mis)led it to delay preparing to file for Chapter 11 protection until merely hours before doing so, which significantly heightened the internal and external chaos at the outset of the case.²³ Title II purports to preclude bailouts, but the prospect of an Administration with politically-motivated reasons not to commence a liquidation proceeding, along with the virtual assurance of a Treasury Department DIP loan, provides markedly less incentive for a distressed financial company to begin laying the groundwork for a soft landing into bankruptcy than does the ability of a primary regulator, with direct oversight responsibilities, to file an involuntary Chapter 7 or 11 case.

That said, proposed Chapter 14 also would allow primary regulators the right to file their own motions for the use, sale, or lease of a debtor's property under section 363, and would provide that a primary regulator is not subject to a debtor's exclusive right to file a reorganization plan under section 1121.²⁴ We do not support these changes, because they effectively cede to primary regulators co-equal control over two of a debtor's most important restructuring tools. Like all parties in interest, a primary regulatory should have standing to file a

²³ Notably, the Federal government provided to General Motors an initial bailout for the limited purpose of having additional time to prepare its Chapter 11 filing.

²⁴ 11 U.S.C. §§ 363, 1121.

motion to compel the debtors to pursue value-maximizing transactions, or to file a motion to terminate exclusivity for “cause” (including for the reason that allowing a primary regulator to propose a plan furthers the public interest). But here as well, a primary regulator, like all parties in interest, should be required to first obtain court permission before usurping a Chapter 7 or 11 debtor’s prerogatives on these critical decisions.

Finally, as a party in interest with standing to appear and be heard on matters within its purview, a primary regulator also could bring a motion under section 1104 requesting appointment of a trustee to manage the debtor financial company’s affairs.²⁵ Section 1104 should be amended, though, to provide that, in the event the Bankruptcy Court grants a trustee motion filed by a primary regulator of a financial company, the appointment shall be made by the Bankruptcy Court (and not the United States Trustee), with notice to and consideration of submissions from applicable Federal government bodies (e.g., the Treasury Department, Federal Reserve, and the FDIC).

C. Maintain Bankruptcy Court Judges

The U.S. Code provides that bankruptcy cases are filed in the applicable Federal District Court, which may then “refer” the cases to the Bankruptcy Court in that judicial District.²⁶ As a matter of course, every Federal District Court has a standing order that all bankruptcy cases filed therein are automatically referred to that jurisdiction’s Bankruptcy Courts (except for certain limited issues or in certain limited circumstances). Proposed Chapter 14 would direct all cases involving systemically-important financial companies to a pre-designated panel of District Court judges from the Second Circuit and District of Columbia Circuit, and

²⁵ 11 U.S.C. § 1104.

²⁶ 28 U.S.C. § 157.

those District Court judges would be precluded from referring the case to the applicable Bankruptcy Court judges, though the District Court judges could appoint special masters to hear all issues that otherwise could be heard by Bankruptcy Court judges.

We strongly disagree with this idea. Most importantly, we do not accept Chapter 14's rationale for preventing Bankruptcy Court judges from presiding over financial company resolutions, which is: the systemic economic implications of a Chapter 14 case require the independence of a judge who has lifetime appointment under Article III of the U.S. Constitution (which includes District, but not Bankruptcy, Court judges). We have never heard a Bankruptcy Court judge's independence doubted, publicly or privately, because he or she has less than lifetime tenure. The more salient consideration should be whether a District or Bankruptcy Court judge has greater experience and facility applying the Bankruptcy Code, and we are not aware of any persuasive argument it is the former.

We do accept it may be advisable to limit Chapter 14 cases to a predetermined set of judges who are most knowledgeable about how to administer a financial company resolution under the Bankruptcy Code. These could be the Bankruptcy Court judges of the Southern District of New York and the District of Delaware, who most often among their brethren handle cases of analogous size and complexity, although other Districts also have extensive experience with so-called "mega" Chapter 11 cases.

Lastly, Chapter 14's proposed use of special masters is presently prohibited by the Federal Rules of Bankruptcy Procedure, and with good reason, at least in this context.²⁷ A fatal flaw of Title II is that it utilizes regulators to hear issues that most appropriately should be decided by judges. The special masters to be authorized by Chapter 14 are at least subject to the

²⁷ Fed. R. Bankr. P. 9031.

direction and oversight of a District Court judge, but Chapter 14 would still be similar to Title II in that both regimes preclude entirely having the most qualified possible arbiter—a Bankruptcy Court judge—administer the resolution of a systemically-important financial company under the Bankruptcy Code.

D. Eliminate Automatic Stay Safe Harbors For Qualified Financial Contracts

The Bankruptcy Code currently provides that counterparties to qualified financial contracts (such as repurchase or swap agreements) are not subject to the automatic stay imposed by section 362 that otherwise bars conventional contract counterparties from relying on an *ipso facto* clause in an agreement to terminate the contract and exercise rights to enforce any security interests in the debtor’s collateral.²⁸ Put simply, when a debtor files for bankruptcy, most contract counterparties are stayed from terminating their agreement with the debtor and/or engaging in self-help remedies against estate assets,²⁹ but these pro-debtor protections do not apply to qualified financial contract counterparties.³⁰ As a result, a bankruptcy filing by a financial company with significant qualified financial contracts may be marked by chaos at the outset as counterparties, unimpeded by the automatic stay, proceed to terminate and enforce their rights in the debtor’s assets.

Notably, the Dodd-Frank Act does not effectively address this major problem, as Title II provides that, upon appointment of the FDIC as receiver for the purpose of liquidating a distressed financial company, qualified financial contract counterparties shall be stayed from exercising any termination rights until 5:00 p.m. (eastern time) on the business day following the

²⁸ 11 U.S.C. § 362. An *ipso facto* clause typically provides, among other things, that the commencement of a voluntary or involuntary case under the Bankruptcy Code is an automatic breach of contract.

²⁹ 11 U.S.C. § 365(e)(1).

³⁰ 11 U.S.C. §§ 555, 556, 559, 560, 561.

date of the FDIC's appointment, or after the counterparty receives notice the qualified financial contract has been transferred to a bridge financial company.³¹ According to the FDIC Lehman

Report:

The receiver's ability to transfer qualified financial contracts to a third party [such as a solvent financial institution or a bridge financial company] in order for the contracts to continue according to their terms—notwithstanding the debtor company's insolvency—provides market certainty and stability and preserves the value represented by the contracts.³²

As an initial matter, we do not concur with the highly unrealistic proposition that, within only one business day of its appointment, the FDIC will be sufficiently prepared to make informed transfer determinations (or effectuate those determinations) for a major financial company's entire book of qualified financial contracts. But more importantly, this is yet another massive and problematic grant of discretion to the FDIC to pick Title II winners and losers. First, the FDIC must determine which counterparties will have their qualified financial contracts transferred to a solvent financial institution or bridge financial company (thus presumably maintaining the full economic benefits of those agreements), and which contracts will remain with the failed financial company (thus presumably providing those counterparties with only the liquidation value of their claims). And second, the FDIC must determine which solvent financial institutions (among the failing financial company's competitors) may be the transferees of possibly undervalued qualified financial contracts. Here as well, even the pre-appointment prospect of the FDIC potentially exercising this discretion, much less the FDIC actually invoking these broad powers, will destabilize markets and erode the value of qualified financial contracts.

³¹ Section 210(c)(10)(B).

³² Id. at 8.

Proposed Chapter 14 also would modify the so-called “safe harbors” to the automatic stay for qualified financial contracts. Most significantly, as to derivatives and swaps, Chapter 14 would amend the Code to provide that counterparties are subject to the automatic stay for three days after the petition date, at which point counterparties may utilize the safe harbors and proceed to terminate the agreements and exercise rights against collateral.

On this point, our view is that Chapter 14’s proposed modification is too limited, and we support eliminating most, and perhaps all, of the automatic stay safe harbors for qualified financial contracts. For the reasons explained below, our default position is these safe harbors should not exist at all, though we acknowledge it is at least hypothetically possible there may be some type of financial product that is specially deserving of a safe harbor—with the following caveats.

First, because an exemption from the automatic stay is an extraordinary right, it should be limited to an extremely narrow class of qualified financial contracts for which an inability to terminate promptly, at the counterparty’s election, would pose a demonstrated credible threat of ruinous harm to the counterparty, as balanced against the harm that termination would inflict upon the debtor (and the public interest). Second, to disincentivize qualified financial contract drafters from responding to this reform by structuring all manner of non-deserving contracts in the guise of exempt agreements, the safe harbor should only become available 60 days after the petition date.³³ And like all parties in interest, any counterparty that hypothetically could demonstrate an inability to terminate its qualified financial contract immediately after the petition date would pose a credible threat of ruinous harm to the

³³ This modification as well is not without precedent. See, e.g., 11 U.S.C. § 1110 (providing the automatic stay under section 362 expires 60 days after the petition date for creditors with a security interest in certain aircraft vessels and equipment, unless the debtor within that period obtains court authority to assume and cure any defaults under the agreement).

counterparty, as balanced against the injury that termination would inflict upon the debtor, has the right under section 362(d) to petition the court to lift the stay immediately.³⁴

As an initial matter, in 1978, at the time of enactment of the Bankruptcy Code and the proposed imposition of the automatic stay on the rights of all secured lenders to exercise foreclosure rights, the banking industry claimed the provision would severely curtail the availability of leveraged loans. Of course, that did not occur, as lawyers began drafting credit agreements and indentures to provide that a bankruptcy filing is a termination event that automatically accelerates the maturity of the loan to the petition date, and the Code required debtors to provide adequate protection against diminution in value of collateral, thus limiting the impact of the automatic stay (though still precluding lenders' ability to reclaim collateral during the pendency of the bankruptcy, without first obtaining court authority to do so).

The exemption from the automatic stay for qualified financial contracts was the subsequent result of the successful lobbying efforts of the financial community, not a distinction based upon sound bankruptcy policy, and the results exemplify the law of unintended consequences. Put simply, the management of distressed financial companies with major qualified financial contract positions are not incentivized to seek bankruptcy protection early enough in the restructuring process, before so much value has been eroded that multiple reorganization options may be foreclosed. This state of affairs is caused by the understanding that proceeding to file for chapter 11 protection will not prevent a "run on the bank," as qualified financial contract counterparties retain their full termination rights after the petition date. This may not only doom the going-concern prospects of the debtor; it also may require a Federal government bailout. This was case with AIG, whose qualified financial contract positions were

³⁴ 11 U.S.C. § 362(d).

so sizable and interconnected to other major international financial institutions, that a possible bankruptcy filing, followed by a complete inability of AIG to stay the unwinding of counterparties' contracts, severely limited the protections typically afforded by commencing a Chapter 11 case.

Congress approved in section 1107 the concept of a “debtor in possession” retaining the ability to manage its businesses postpetition, not to shield executives from the consequences of their stewardship, but to ensure that decisionmakers of distressed corporations are not disincentivized from pursuing necessary restructuring decisions that may involve or lead to a Chapter 11 filing—and their prompt dismissal upon the automatic appointment of a trustee.³⁵ The Dodd-Frank Act’s directive that a distressed financial company’s board of directors and senior management must be removed immediately³⁶ is especially counterproductive given that Title II did not materially reform the automatic stay safe harbors for qualified financial contracts.

Inevitably, qualified financial contract counterparties, like secured lenders three decades ago, will protest that, eliminating the safe harbors will decimate their markets. But we expect these highly sophisticated parties, just as they learned to draft all manner of commercial transactions as qualified financial contracts (so as not to be subject to the automatic stay), will adapt their documentation and other practices accordingly, and the resulting benefit (restoring a Chapter 11 filing as a viable option for financial companies with major qualified financial contracts exposure) will outweigh the detriment (subjecting qualified financial contract counterparties to the same treatment under the Bankruptcy Code as other secured creditors).

³⁵ 11 U.S.C. § 1107.

³⁶ Section 204(a)(2).

Lastly, Chapter 14's proposal for an immediate and interim extension of the automatic stay for three days for qualified financial contracts is not particularly helpful. For example, when Congress most recently amended the Bankruptcy Code, it imposed a maximum time limit of 210 days (without lessor consent) for debtors to determine whether to assume commercial leases,³⁷ and experts widely believe this limitation made it prohibitively difficult for retail debtors to revise their business plans and make informed lease assumption and rejection decisions quickly enough, with the result being a spate of retail debtor liquidations. To require a financial company debtor to review its entire portfolio of qualified financial contracts, and determine for each one, within only three days after the petition date, whether assumption or rejection is in the best interests of the debtor's estates, is not commercially pragmatic.

Conclusion

The wide-ranging, undefined, and politically-sensitive discretion granted by Title II actually promotes the moral hazard and disruption of financial markets the Dodd-Frank Act was intended to minimize. With certain reforms that are designed to address the unique circumstances (and systemic implications) of distressed financial companies, the well-established framework of the Bankruptcy Code as applied by Bankruptcy Court judges should remain the most effective liquidation or reorganization option available.

³⁷ 11 U.S.C. § 365(d)(4).