



Study on the Resolution of Financial Companies under the Bankruptcy Code

July 2011



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Preface: Implementing the Dodd-Frank Act

The Board of Governors of the Federal Reserve System (the Board) is responsible for implementing numerous provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). The Dodd-Frank Act requires, among other things, that the Board produce reports to the Congress on a number of potential reform topics.

See the Board's website for an overview of the Dodd-Frank Act regulatory reform effort (www.federalreserve.gov/newsevents/reform_about.htm) and a list of the implementation initiatives recently completed by the Board as well as several of the most significant initiatives that the Board expects to address in the future (www.federalreserve.gov/newsevents/reform_milestones.htm).

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Executive Summary

Under section 216 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act),¹ the Board of Governors of the Federal Reserve System (the Board), in consultation with the Administrative Office of the United States Courts (the Administrative Office), must conduct a study regarding the resolution of financial companies under Chapter 7 or Chapter 11 of the Bankruptcy Code.² Section 216 directs the Board specifically to study five topics, including (1) the effectiveness of the Bankruptcy Code for systemic financial companies, (2) the establishment of a special court or panel of judges for financial company bankruptcies, (3) the adoption of amendments to the Bankruptcy Code to enhance its ability to resolve financial companies, (4) the treatment of qualified financial contracts (QFCs) in U.S. insolvency laws, and (5) the establishment of a new chapter or subchapter of the Bankruptcy Code for financial companies. The five topics specified in section 216 generally correspond to specific proposals for amending the Bankruptcy Code that were presented to the Congress in connection with its consideration of the Dodd-Frank Act, specifically in connection with its consideration of the “orderly liquidation authority” (OLA) in Title II of the Dodd-Frank Act.

This study surveys existing literature regarding the five potential changes identified above, primarily as those proposals were articulated during the time period leading up to enactment of the Dodd-Frank

Act. The literature generally considers a variety of hypothetical amendments to the Bankruptcy Code as they might be applied to financial companies in the future, rather than addressing empirical studies of prior bankruptcy cases. On most topics, there is more literature arguing for changes to the status quo than there is literature arguing against such changes. This gives prominence to the arguments for change and, because this study focuses on a review of the relevant literature, that prominence is reflected in this study. The Board believes, however, that the importance and significance of the changes to financial company resolution discussed in this study underscore the need for a broad and robust debate about the merits and effects of the changes reviewed by the study. Consequently, the Board has not made any recommendations, either for or against the changes discussed in the study. Instead, in keeping with the statutory direction in section 216, this study is designed as a survey of the principal arguments for and against various Bankruptcy Code amendments relating to financial companies as those arguments have been articulated to date. This study may also serve as a point of departure for further public debate and, potentially, legislative consideration of future reform.

Introduction

Structure of the Statute and the Study

Section 216(a) of the Dodd-Frank Act requires that the Board, in consultation with the Administrative Office, conduct a study regarding the resolution of financial companies under Chapter 7 or Chapter 11 of the Bankruptcy Code. Section 216(a) requires the Board to include the following topics in its study

1. the effectiveness of Chapter 7 and Chapter 11 of the Bankruptcy Code in facilitating the orderly resolution or reorganization of systemic financial companies;
2. whether a special financial resolution court or panel of special masters or judges should be

¹ Pub. L. No. 111–203, 124 Stat. 1376 (2010).

² Section 216(b) of the Dodd-Frank Act requires that, not later than one year after the date of enactment, the Administrative Office submit to the Committees on Banking, Housing, and Urban Affairs and the Judiciary of the Senate and the Committees on Financial Services and the Judiciary of the House of Representatives, a report summarizing the results of the Board’s study conducted under section 216(a) of the Dodd-Frank Act. Section 216(b) further requires the Administrative Office thereafter to submit additional reports in each successive year until the fifth year after the date of enactment of the Dodd-Frank Act.

established to oversee cases involving financial companies to provide for the resolution of such companies under the Bankruptcy Code, in a manner that minimizes adverse impacts on financial markets without creating moral hazard;

3. whether amendments to the Bankruptcy Code should be adopted to enhance the ability of the Code to resolve financial companies in a manner that minimizes adverse impacts on financial markets without creating moral hazard;
4. whether amendments should be made to the Bankruptcy Code, the Federal Deposit Insurance Act, and other insolvency laws to address the manner in which QFCs of financial companies are treated; and
5. the implications, challenges, and benefits to creating a new chapter or subchapter of the Bankruptcy Code to deal with financial companies.

During the consideration of the legislation that ultimately became the Dodd-Frank Act, debates over the provisions that became the OLA were framed in large part in terms of whether or not the Bankruptcy Code or a special resolution process was more effective for handling insolvent systemic financial companies.³ Some proponents of the OLA argued that the OLA was necessary in light of perceived weaknesses in the ability of the Bankruptcy Code to facilitate an orderly resolution of a systemic financial company. Some opponents of the OLA, however, contended that the Bankruptcy Code, either in its current form or with appropriate amendments, is robust enough for handling insolvent financial companies, even systemic ones, so that the enactment of the OLA was unnecessary.

This study addresses the specific topics that Congress directed the Board to study in the order in which they are set forth in the statute, after an introductory review of some of the key terms used but not defined in the statute. The study then covers the effectiveness of the Bankruptcy Code for “systemic” financial companies and proceeds from there to consideration of proposals for a special panel of judges or special masters for financial company bankruptcies. The study next considers amendments to the Bankruptcy Code for financial companies generally that could minimize adverse impacts on financial markets without creating moral hazard. The study then addresses the remaining two specific categories of Bankruptcy

³ See “Reorganization, Liquidation, Resolution” subsection on pages 3–4.

Code amendments: those relating to QFCs, and those relating to the creation of a new chapter or subchapter of the Bankruptcy Code to deal with financial companies.

Significant Statutory Terms of General Applicability

Section 201(a)(11) of the Dodd-Frank Act defines “financial company” for the purposes of Title II, and therefore for the purposes of this section 216 study. Other significant terms used in section 216, however, are not defined, including “resolution” and “reorganization.” “Systemic” and “effectiveness,” two other significant terms used but not defined in section 216, are discussed in the section below that addresses proposals relating to the “effectiveness” of the Bankruptcy Code for systemic financial companies.

Definition of “Financial Company”

The definition of “financial company” in section 201(a)(11) of the Dodd-Frank Act relies on a test of whether a particular company is a bank holding company, a nonbank financial company supervised by the Board, or any company “predominately engaged” in “activities that are financial in nature” (as well as any subsidiary of such a company that is not an insured depository institution or an insurance company). Section 4(k) of the Bank Holding Company Act⁴ defines specific activities as “activities that are financial in nature.”⁵ Section 4(k) also authorizes the Board to determine whether an activity is financial in nature, and specifies the factors to be considered in making such a determination.⁶ The Board’s Regulation Y,⁷ which implements section 4(k) of the Bank Holding Company Act, defines a broad range of activities that are financial in nature. These include lending money or securities, insuring, guaranteeing, or indemnifying against loss, providing financial, investment, or economic advisory services, securitizing, underwriting, dealing in or making a market in securities, and activities determined to be closely related to banking.⁸ References to “financial companies” in this study generally do not refer to insured depository institutions or to insurance companies (unless the context indicates otherwise), since

⁴ 12 U.S.C. section 1843(k).

⁵ 12 U.S.C. section 1843(k)(4).

⁶ 12 U.S.C. section 1843(k)(1)–(3).

⁷ Bank Holding Companies and Change in Bank Control, 12 C.F.R. section 225.

⁸ See 12 C.F.R. section 225.86.

those entities are not permitted to be debtors under the Bankruptcy Code.

Reorganization, Liquidation, Resolution

There are three principal avenues for actively addressing the resolution of an insolvent financial company. The company can be reorganized under the Bankruptcy Code (in which case it generally continues to operate), liquidated under the Bankruptcy Code, or otherwise resolved under one of various special resolution regimes. Although all three alternatives can generally be described as “resolution,” the terms “reorganization” and “liquidation” are most often associated with Chapter 11 or Chapter 7, respectively, of the Bankruptcy Code. “Resolution” in the context of financial companies is most often associated with special regimes that have historically been reserved for handling the insolvency of regulated financial entities such as insured depository institutions and insurance companies.

The primary authority for a corporate reorganization is Chapter 11 of the Bankruptcy Code.⁹ In a Chapter 11 reorganization, the debtor is able to negotiate with its creditors (sometimes even before filing a petition) to confirm a plan of reorganization that will allow for the restructuring of the debtor’s liabilities so that the company will be able to satisfy them. These negotiations take place in the context of a judicial proceeding administered by a federal bankruptcy judge. Once a plan of reorganization has been confirmed, the company, typically under the authority of its existing management team, will take the actions outlined by the plan. The debtor is often then able to emerge from bankruptcy and resume operations.

The primary authority for a corporate liquidation is Chapter 7 of the Bankruptcy Code.¹⁰ In a Chapter 7 liquidation, the debtor’s assets are liquidated by a Chapter 7 trustee, appointed by the United States trustee or by a vote of authorized creditors,¹¹ and the proceeds of the liquidation are distributed among the debtor’s creditors depending on the priority of their claims. As with a Chapter 11 reorganization, the Chapter 7 liquidation process takes place in the context of a judicial proceeding administered by a federal bankruptcy judge. The debtor generally chooses whether the case is to be a Chapter 11 reorganization or a Chapter 7 liquidation.

⁹ See 11 U.S.C. sections 1101–74.

¹⁰ See 11 U.S.C. sections 701–84.

¹¹ See 11 U.S.C. sections 701–2.

There are various provisions of the Bankruptcy Code that make certain kinds of financial companies ineligible for filing a bankruptcy petition. Examples include exclusions from eligibility for insured depository institutions,¹² U.S. branches and agencies of foreign banks,¹³ and insurance companies.¹⁴ Other provisions of the Bankruptcy Code provide that certain kinds of financial companies may file only a Chapter 7 (liquidation) petition, and are not eligible to file for a reorganization under Chapter 11. Examples include broker-dealers and commodities brokers.¹⁵ Furthermore, with respect to broker-dealers, the Securities Investor Protection Corporation (SIPC) plays a particular role in a broker-dealer insolvency. Specifically, when SIPC files an application for a protective decree under the provisions of the Securities Investor Protection Act (SIPA),¹⁶ any proceedings under the Bankruptcy Code with respect to a broker-dealer are stayed until the conclusion of the SIPA proceeding.¹⁷

The mechanism for resolution of a failed insured depository institution is the administrative receivership process conducted by the Federal Deposit Insurance Corporation (FDIC).¹⁸ Insured depository institutions generally are closed by their chartering authority (the state regulator, the Office of the Comptroller of the Currency, or the Office of Thrift Supervision) and the FDIC is appointed as the receiver of the closed institution.¹⁹ The goal of this regime is explicitly stated in the Federal Deposit Insurance Act (FDIA) as being to resolve the financial distress of a failed bank in the manner that is least costly to the FDIC’s deposit insurance fund.²⁰

¹² 11 U.S.C. section 109(b)(2).

¹³ 11 U.S.C. section 109(b)(3)(B). Federally-licensed branches and agencies of foreign banks are resolved under special provisions of the International Banking Act of 1978 (12 U.S.C. section 3102), while state-licensed branches and agencies are resolved under applicable state law (*see, e.g.*, N.Y. Bank. L. section 606).

¹⁴ 11 U.S.C. section 109(b)(2). Insolvent insurance companies are generally resolved under a state insolvency proceeding administered by a state insurance commissioner.

¹⁵ 11 U.S.C. section 109(d).

¹⁶ 15 U.S.C. sections 78aaa *et seq.*

¹⁷ 11 U.S.C. section 742.

¹⁸ See Federal Deposit Insurance Act, 12 U.S.C. sections 1811 *et seq.* (2009).

¹⁹ See *Who Is the FDIC?*, www.fdic.gov/about/learn/symbol/index.html. The FDIC can also be appointed as conservator. 12 U.S.C. section 1821(e).

²⁰ 12 U.S.C. section 1823(c)(4)(A)(ii). Under certain circumstances, a resolution other than a least-cost resolution may be authorized pursuant to the “systemic risk exception.” Generally, this exception applies if both the Board and the FDIC Board, by a vote of at least two-thirds of their members, and the Secretary of the Treasury, in consultation with the President, deter-

The FDIC has several options as receiver for resolving institution failures, but the option most used is to sell some or all of the deposits and loans of the failed institution to another institution (purchase and assumption). In purchase and assumption transactions, customers of the failed institution automatically become customers of the assuming institution. Creditors have the ability to file claims with the FDIC for non-deposit liabilities, but generally do not have standing to take any other actions in connection with the receivership. The process does not take place in a court setting, but certain aspects of it are subject to judicial review under specific circumstances.²¹

Title II of the Dodd-Frank Act introduced a new resolution regime—the OLA—to the U.S. legal landscape. The OLA will apply only in the event that the Secretary of the Treasury (after consultation with the President) determines, based on the recommendation of the Board and the Board of the FDIC, that among other things the failure of a financial company would have serious adverse effects on financial stability in the United States and that taking action under the OLA with respect to that company would avoid or mitigate such adverse effects.²² Where such a determination cannot be made with respect to a financial company that is in default or in danger of default, the Bankruptcy Code or a regulatory resolution regime (such as state laws and regulations for resolving insolvent insurance companies) would apply to handle the insolvency of the financial company.

Key Differences between the Bankruptcy Code and Regulatory Resolution

There are a number of fundamental differences between reorganization or liquidation under the Bankruptcy Code and regulatory resolution regimes. Three are noted here. First, there are differences in the objectives of the regimes. The Bankruptcy Code is designed generally to maximize the returns to creditors of the debtor or to rehabilitate the debtor, usually without regard to the impact of the bankruptcy on parties or systems not before the court. A regulatory resolution regime may allow, and sometimes may encourage, the regulators to give weight to particular creditors (such as depositors) or to exter-

nal factors²³ (such as the impact on the economy and financial markets).²⁴ The OLA, for example, relies for its implementation on a determination based on the likely impacts of a covered financial company's default on financial markets and the economy.²⁵ This allows regulators to take actions in a regulatory resolution regime that are intended to limit the impact of the troubled institution's insolvency on entities other than its creditors or on the economy and the financial system.²⁶

A second key difference is how the process is developed and clarified. The process under the Bankruptcy Code is judicial and relies primarily on case law precedent for clarification and interpretation of the Bankruptcy Code's provisions. Regulatory resolution regimes, however, are generally developed by agencies that have the ability to issue regulations to implement statutory provisions. Regulatory resolutions may be subject to judicial review to the extent authorized by the statute, however, and are also the subject of possible case law.

A third key difference is in the mechanisms for funding the process. A Chapter 11 reorganization is often funded with debtor-in-possession financing (DIP financing), which normally involves a private source of funding that obtains priority over the debtor's pre-petition creditors as an administrative expense or, by court order, with even higher priority.²⁷ The DIP financing provision of the Bankruptcy Code is designed to permit the debtor to continue operating to allow time to restructure its liabilities.²⁸ A regulatory resolution regime often authorizes the adminis-

mine that compliance with the least-cost requirement "would have serious adverse effects on economic conditions or financial stability" and action or assistance other than the least-costly method would "avoid or mitigate such adverse effects."
12 U.S.C. section 1832(c)(4)(G).

²¹ See 12 U.S.C. section 1821(c)(7).

²² See generally Dodd-Frank Act section 203.

²³ The "systemic risk exception" in the FDIA is an example of taking market impact into account. See 12 U.S.C. section 1823(c)(4)(G).

²⁴ Rodgin Cohen and Morris Goldstein, *The Case for an Orderly Resolution Regime for Systemically-Important Financial Institutions* (PEW Financial Reform Project, Oct. 21, 2009).

²⁵ See generally Dodd-Frank Act section 203.

²⁶ Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Remarks on the *Squam Lake Report: Fixing the Financial System*, at 9 (June 16, 2010) ("A clear lesson from the events of the past few years—and a recommendation in the report with which we strongly agree—is that the government must not be forced to choose between the unattractive alternatives of bailing out a systemically important firm or having it fail in a disorderly and disruptive manner. The government instead must have the tools to resolve a failing firm in a manner that preserves market discipline—by ensuring that shareholders and creditors incur losses and that culpable managers are replaced—while at the same time cushioning the broader financial system from the possibly destabilizing effects of the firm's collapse").

²⁷ 11 U.S.C. section 364(a)–(d).

²⁸ See Robert R. Bliss and George G. Kaufman, *U.S. Corporate and Bank Insolvency Regimes: An Economic Comparison and*

tering receiver or another government entity to provide funding to finance the process.²⁹ The distinction in availability of funding can become important in times of systemic stress, when market confidence is diminished and DIP financing from private sources may be less likely to be available.

Effectiveness of the Bankruptcy Code in Systemic Situations

Section 216(a)(2)(A) of the Dodd-Frank Act requires the Board to include in its study “the effectiveness of Chapter 7 and Chapter 11 of the Bankruptcy Code in facilitating the orderly resolution or reorganization of systemic financial companies.”

Meaning of “Systemic” in This Context

The term “systemic financial companies” is used only in two sections of the Dodd-Frank Act: in section 216 and in section 217, both sections requiring the Board to study the Bankruptcy Code with respect to financial companies. The term is not defined, however, in either of these sections.

Whether a firm is a “systemic financial company” in the context of “effective” resolution under the Bankruptcy Code would likely depend on a number of factors, such as: the size and leverage of the firm, the nature of its transactions, its relationships with other financial firms (specifically its interconnectedness with other firms in the financial markets), and whether other firms would be able to provide the same types and levels of services as the firm in question. These criteria are consistent with criteria that Title I of the Dodd-Frank Act requires regulators to consider when designating financial firms as “systemically important” for purposes of enhanced prudential regulation.³⁰

Meaning of “Effectiveness” of the Bankruptcy Code

The term “effectiveness” is not defined in the Dodd-Frank Act or the Bankruptcy Code. The term appears both in section 216 as well as in section 202(e) of the Dodd-Frank Act, which requires separate studies, conducted by the Government Accountability Office (GAO) and the Administrative

Office, regarding the bankruptcy and orderly liquidation process for financial companies under the Bankruptcy Code. Specifically, section 202(e) requires studies of “the effectiveness” of Chapter 7 or Chapter 11 in facilitating the orderly liquidation or reorganization of financial companies, ways to maximize “the efficiency and effectiveness” of the Bankruptcy Court, and ways to make the orderly liquidation process under the Bankruptcy Code for financial companies “more effective.”³¹

By its nature, any resolution regime, including the Bankruptcy Code, must balance the interests of numerous parties with divergent interests, such as secured creditors, unsecured creditors, customers, shareholders, and the public. Consequently, the “effectiveness” of a change to the Bankruptcy Code will depend on the point of view of the party making the judgment. This study does not attempt to balance or rebalance these points of view or to judge effectiveness from any particular point of view, and instead reports the advantages and disadvantages of various changes as those advantages and disadvantages are noted or explained in the literature. This approach should allow a fuller debate about the benefits and costs of various changes, and provide the relevant legislative bodies with the perspectives needed to determine the appropriate balance that should be struck in considering changes to the Bankruptcy Code.

Commentators have made various arguments as to why the Bankruptcy Code either is or is not “effective” for the resolution of “systemic financial companies.” The arguments made by commentators for the effectiveness of the Bankruptcy Code for these companies include the following

³¹ In commenting on the legislative language that became section 202(e), the Judicial Conference of the United States observed that “the vagueness of, and/or lack of criteria for determining ‘effectiveness’ will hamper the ability of [the Administrative Office] and [GAO] to produce meaningful reports. Some would regard rapid payment of even small portions of claims as an effective resolution, while others would prefer a delayed payment of a greater share of a claim. There would also be significant disagreements between creditors holding different types of secured or unsecured claims as to the most effective resolution of an insolvent firm. Some would argue that effectiveness should be measured by the impact of the resolution on the larger economy, regardless of the impact on the creditors of the particular firm.” Letter from James C. Duff, Secretary, Judicial Conference of the United States, to the Hon. Patrick J. Leahy, Chairman, Committee on the Judiciary, United States Senate (Apr. 12, 2010), 156 Cong. Rec. S3688–89 (daily ed. May 13, 2010).

Evaluation, at 16 (Federal Reserve Bank of Chicago, Working Paper 2006–01, Jan. 10, 2006).

²⁹ See 12 U.S.C. section 1823(c), Dodd-Frank Act section 204(d).

³⁰ See Dodd-Frank Act section 113.

- the Bankruptcy Code provides legal certainty,³² offering a large body of established jurisprudence that is well-articulated in advance and is applied in a predictable manner, particularly with respect to the relatively predictable application of creditor priorities and the “absolute priority rule;”³³
- the Bankruptcy Code’s predictability helps ensure that risks are borne by those who contracted to bear them, encouraging appropriate risk-taking measures by the would-be debtor and appropriate risk-monitoring measures by creditors, ensuring a reduction of moral hazard and an increase in market discipline;³⁴
- the Bankruptcy Code provides the flexibility of permitting negotiations among stakeholders both before and after the filing of a petition;³⁵
- the Bankruptcy Code permits judicial review³⁶ by bankruptcy judges that have expertise in handling insolvency;³⁷
- the Bankruptcy Code provides a process for distinguishing between a viable company and a company that has undergone a “fundamental rather than a financial failure,” and a “market-based judgment” as to the viability of an insolvent firm;³⁸
- the Bankruptcy Code generally leaves in place those who are presumed to have the greatest expertise concerning the debtor’s operations and processes: the debtor’s management,³⁹ incentivizing early resolution of financial problems prior to the filing of a bankruptcy petition, because management retains some certainty that it will not be immediately replaced;⁴⁰ and
- the Bankruptcy Code transfers control of the debtor to creditors having a stake in the optimal reorganization of the firm.⁴¹

³² See, e.g., Kimberly Anne Summe, “Lessons Learned from the Lehman Bankruptcy,” in *Ending Government Bailouts As We Know Them* (2010), at 82 (certainty afforded to QFC termination pursuant to well-understood application of Bankruptcy Code “safe harbor” provisions), and at 89 (established jurisprudence); Thomas H. Jackson, “Chapter 11F: A Proposal for the Use of Bankruptcy to Resolve Financial Institutions,” in *Ending Government Bailouts As We Know Them* (2010), at 217 (provides certainty); Peter J. Wallison, *The Argument against a Government Resolution Authority*, at 15 (Pew Financial Reform Project, Aug. 18, 2009) (bankruptcy system provides a degree of certainty to creditors).

³³ See, e.g., Jackson, *Chapter 11F*, *supra* note 32, at 217 (“huge” body of bankruptcy law; follows “absolute priority rule” with “useful predictability”); Thomas H. Jackson and David A. Skeel, *Bankruptcy, Banks, and Nonbank Financial Institutions* (Wharton Fin. Inst. Cent. Workshop, Feb. 8, 2010), at 56 (bankruptcy’s rules, including priority rules, are well-articulated in advance), and at 64 (Bankruptcy Code provides clearly articulated and consistent rules and priorities); Kenneth Ayotte and David A. Skeel, “Bankruptcy or Bailouts?” 35 *J. Corp. L.* 469, 488 (2010) (because priority of claims is determined by bankruptcy rules, the predictability of creditor recoveries is greater); Wallison, *supra* note 32, at 11 (bankruptcy rules are known in advance so creditors are aware of their rights and risks); William F. Kroener, “Expanding FDIC-Style Resolution Authority,” in *Ending Government Bailouts As We Know Them* (2010), at 182 (bankruptcy provides clearer rules on creditor priorities).

³⁴ See, e.g., Jackson, *Chapter 11F*, *supra* note 32, at 220 (bankruptcy predictability helps to ensure ex post that risks remain where they belong which encourages appropriate risk-taking and risk-monitoring ex ante); Ayotte and Skeel, *supra* note 33, at 471–72 (bankruptcy does a better job of handling moral hazard concerns); Wallison, *supra* note 32, at 10 (bankruptcy assures that pre-petition creditors take some kind of loss, avoiding moral hazard and preserving market discipline), at 10–11 (bankruptcy rules are known in advance so creditors are aware of rights and risks), and at 15 (bankruptcy encourages creditors to monitor companies to which they lend, reducing moral hazard and encouraging market discipline).

³⁵ See, e.g., David A. Skeel, *The New Financial Deal* (2011), at 122 (bankruptcy relies on negotiations between debtor’s managers and its creditors and other stakeholders with clear rules and opportunities for judicial review throughout).

The arguments made by commentators for the ineffectiveness of Bankruptcy Code for systemic financial companies include the following

³⁶ *Id.* (bankruptcy relies on negotiations between debtor’s managers and its creditors and other stakeholders with clear rules and opportunities for judicial review throughout); Jackson and Skeel, *supra* note 33, at 56 (all actions taken in bankruptcy reorganization process have judicial oversight and advance judicial approval necessary for important decisions with distributional consequences).

³⁷ See, e.g., Summe, *supra* note 32, at 89 (bankruptcy court features well-regarded bench); Wallison, *supra* note 32, at 10 (bankruptcy judges develop expertise in all areas of insolvency and workouts, those in large cities are especially likely to have acquired the specialized knowledge necessary to resolve systemically important financial institutions), and at 11 (Lehman Brothers bankruptcy case shows that bankruptcy judges are able to handle the insolvency of a systemically important financial institution).

³⁸ See, e.g., Jackson, *Chapter 11F*, *supra* note 32, at 217–18 (bankruptcy sorts out financial failure from underlying failure); Wallison, *supra* note 32, at 11 (bankruptcy provides market-based judgment of whether a firm is worth saving because its creditors ultimately decide the firm’s prospects of returning to viability).

³⁹ See, e.g., Skeel, *supra* note 35, at 122 (bankruptcy relies on negotiation among debtor’s management, creditors, and other stakeholders).

⁴⁰ See, e.g., *id.*, at 140 (early resolution of problems incentivized because managers can retain control of debtor and have protection of exclusivity period).

⁴¹ See, e.g., Jackson, *Chapter 11F*, *supra* note 32, at 218 (bankruptcy shifts ownership to new group of residual claimants); Ayotte and Skeel, *supra* note 33, at 471 (bankruptcy allocates control to residual claimants), and at 483 (bankruptcy provides formal and informal mechanisms for creditors to exercise control, including through formal rights given to creditors’ committees, opportunities of creditors to object to asset sales, and indirect control over the debtor through negotiated covenants in DIP financing agreements).

- the Bankruptcy Code process takes too long for financial companies that, by their very nature, can suffer rapid and irretrievable loss of confidence and customers as well as rapid dissipation of asset values;⁴²
- the Bankruptcy Code has no “bridge” company mechanism as would be available under the OLA;⁴³
- the complexities of a systemic financial company, including the complexity of the financial instruments that are likely to be central in the insolvency of such a company, are beyond the general ability of bankruptcy judges to handle;⁴⁴
- filing a petition under the Bankruptcy Code causes rapid runs on short-term financial instruments that systemic financial companies hold in large quantities, leading to “fire sales” of assets precipitously sold en masse in stressed financial markets and causing write-downs of similar assets held by other

institutions, potentially creating further insolvencies;⁴⁵ and

- the Bankruptcy Code is focused on the interests of creditors, and has neither the goals nor the mechanisms to take externalities such as effects on outside parties or the financial system into account.⁴⁶

The Lehman Brothers Holdings, Inc. bankruptcy case⁴⁷ is used to support arguments about both the effectiveness and the ineffectiveness of the Bankruptcy Code for systemic financial companies. Proponents of the view that the Bankruptcy Code cannot be modified to liquidate or reorganize systemic financial companies in an orderly way often support their view by pointing to the Lehman Brothers bankruptcy as being both disorderly and a causal factor in the near collapse of financial markets in the fall of 2008. Similarly, proponents of the view that the Bankruptcy Code can function effectively for resolving systemic financial companies often support their view by pointing to the Lehman Brothers bankruptcy as being fairly smooth and having, at best, limited spillover effects. In general, there is no agreement in the legal and academic literature on whether the use of the Bankruptcy Code as the mechanism for handling the Lehman Brothers insolvency triggered the contagion that is associated with its bankruptcy filing. Similarly, there continue to be starkly contrasting views after the Lehman Brothers bankruptcy filing on the utility of specific provisions of Chapter 11 of the Bankruptcy Code when resolving large, complex financial companies.

⁴² See, e.g., Kroener, *supra* note 33, at 181–82 (indirectly suggesting that the lack of speed in bankruptcy process prevents preservation of value), and at 182 (value of assets can vary or dissipate given uncertainty about potential duration of automatic stay); Jackson, *Chapter 11F*, *supra* note 32, at 218 (judicial process like bankruptcy is too slow); Cohen and Goldstein, *supra* note 24, at 1 (bankruptcy court proceedings too slow), and at 3, 10 (potentially long delays in obtaining court approval of reorganization or liquidation plans; ability of creditors, management, and shareholders to participate in decisionmaking causes delays); Kenneth R. French et al., “Improving Resolution Options for SIFIs,” in *Squam Lake Report* (2010), at 97 (bankruptcy process ineffective for systemically important financial institutions because creditors and clients flee at the first sign of trouble); Edward R. Morrison, *Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?* at 13 (Columbia University Law School, Working Paper No. 362, Dec. 30, 2009) (by the time a systemically important financial institution is sufficiently distressed to consider a bankruptcy filing, its counterparties will have already made a run on its assets); Cohen and Goldstein, *supra* note 24, at 1 (limitations on creditor pursuit of claims in bankruptcy causes counterparties and employees to fail to do business with a systemically important financial institution as it approaches insolvency).

⁴³ See, e.g., Kroener, *supra* note 33, at 182 (no “bridge” solution in bankruptcy); *Too Big to Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform*: Hearing Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary, 111th Cong. 6 (Oct. 22, 2009) (testimony of Michael Barr, Assistant Secretary, U.S. Department of the Treasury) (suggesting that bankruptcy does not allow for creation of one or more bridge companies for systemically important financial institutions).

⁴⁴ See, e.g., Jackson, *Chapter 11F*, *supra* note 32, at 218 (presumption of insufficient expertise of bankruptcy judges to handle systemically important financial institution insolvency); Morrison, *supra* note 42, at 14 (expertise necessary to handle systemically important financial institution insolvency is beyond the ken of bankruptcy judges; bankruptcy judges not well-equipped to handle extensive international coordination aspects of global systemically important financial institution insolvency).

⁴⁵ See, e.g., John B. Taylor, “Systemic Risk in Theory and in Practice,” in *Ending Government Bailouts As We Know Them* (2010), at 46 (bankruptcy causes runs on repurchase agreements and fire sales of collateral underlying closed-out derivatives); Skeel, *supra* note 35, at 30 (bankruptcy leads to fire sales of dumped assets). Some analyses suggest that troubled institutions have gone to great lengths to avoid selling assets at fire sale prices during the most recent financial crisis. See, e.g., Nicole M. Boyson et al., *Crises, Liquidity Shocks, and Fire Sales at Financial Institutions* (Working Paper, June 2010).

⁴⁶ See, e.g., Kroener, *supra* note 33, at 181–82 (bankruptcy fails to take nonfirm general costs into account; no consideration of spillover systemic effects); Jackson, *Chapter 11F*, *supra* note 32, at 218 (bankruptcy process cannot deal with impacts of bankruptcy on other institutions); Ayotte and Skeel, *supra* note 33, at 489 (runs on Lehman Brothers commercial paper and “breaking the buck” at money market mutual funds after Lehman Brother’s bankruptcy show systemic concerns with systemically important financial institution bankruptcies); Cohen and Goldstein, *supra* note 24, at 1 (bankruptcy not focused on third-party effects and systemic risk), and at 3 (creditor stays in bankruptcy have adverse effects on financial markets).

⁴⁷ *In re Lehman Brothers Holdings, Inc.*, No. 08–13555 (Bankr. S.D.N.Y. 2008).

Special Judges or Panels for Financial Companies

Section 216(a)(2)(B) of the Dodd-Frank Act requires the Board to include in its study “whether a special financial resolution court or panel of special masters or judges should be established to oversee cases involving financial companies to provide for the resolution of such companies under the Bankruptcy Code, in a manner that minimizes adverse impacts on financial markets without creating moral hazard.”

History of Bankruptcy Courts

The Bankruptcy Act of 1898 originally established the position of bankruptcy “referees,” to be appointed by U.S. district court judges, to serve as administrators for bankruptcy cases. With the passage of several statutes, most importantly the Chandler Act of 1938,⁴⁸ the judicial responsibilities of referees in bankruptcy were expanded, and referees assumed more of the bankruptcy work previously performed by U.S. district court judges. In 1973, the first federal rules of bankruptcy procedure were issued, increasing the duties of referees in bankruptcy proceedings and changing the referee office title from “referee in bankruptcy” to “United States Bankruptcy Judge.”⁴⁹ At this point, the referee system disappeared. Then, in 1978, Congress enacted what is now known as the Bankruptcy Code, which conferred even broader jurisdiction on bankruptcy courts.⁵⁰

In 1984, the Bankruptcy Code was amended to give the federal district courts exclusive jurisdiction over bankruptcy matters.⁵¹ A district court may, by order, “refer” all bankruptcy matters to the bankruptcy court in its district.⁵² Nearly all bankruptcy proceedings are handled by the bankruptcy courts pursuant to such orders. District courts have issued standing orders of reference referring all bankruptcy cases in a district to the district’s bankruptcy court.

⁴⁸ Chandler Act, chapter 575, 52 Stat. 840 (1938) (repealed 1978).

⁴⁹ Paulette J. Delk, “Special Masters in Bankruptcy: The Case against Bankruptcy Rule 9031,” 67 *Mo. L. Rev.* 29 (Winter 2002).

⁵⁰ See Lawrence P. King, “The History and Development of the Bankruptcy Rules,” 70 *Am. Bankr. L. J.* 2175 (1996); Delk, *supra* note 49, at 44–48.

⁵¹ See 28 U.S.C. section 1334(a).

⁵² 28 U.S.C. section 157(a).

Proposal for a Special Panel of Judges in Financial Company Bankruptcy Cases

Some commentators argue that a special panel of judges should be created to hear bankruptcy cases involving those financial companies with \$100 billion or more in combined assets, or involving financial companies generally.⁵³ One such proposal recommends adding a new provision to Title 28 of the U.S. Code that would create designated district court judges in the Second and D.C. Circuits to hear bankruptcy cases involving large financial company debtors.⁵⁴ Under this proposal, which is part of a larger proposal to create a new chapter or subchapter of the Bankruptcy Code for such large financial companies, the designated judges would have exclusive jurisdiction over cases involving such large financial company debtors and would be prohibited from referring or delegating such cases to bankruptcy judges. They could, however, assign “special masters” from a designated panel to hear the case and all proceedings under the case to the same extent that a bankruptcy judge could hear the case under current law.⁵⁵ This proposal for a special court of district judges to hear such cases, together with special masters appointed by those judges, assertedly is needed to “ensure complete independence from any perception of influence by the financial institution, the government, or a particularly significant creditor.”⁵⁶

Proposal to Permit Special Masters in Bankruptcy Proceedings

Several proposals advocate permitting the appointment of special masters in bankruptcy cases generally.⁵⁷ The rules for district courts and the rules for bankruptcy courts take different approaches to the question of the appointment of special masters. Rule 53 of the Federal Rules of Civil Procedure (FRCP), applicable to cases heard in U.S. district courts, authorizes district judges to appoint special masters

⁵³ See, e.g., Skeel, *supra* note 35, at 169–70; Jackson, *Chapter 11F*, *supra* note 32, at 232; Jackson and Skeel, *supra* note 33, at 62–64; Thomas H. Jackson, *Bankruptcy Code Chapter 14: A Proposal*, at 29 (Hoover Institution Resolution Task Force, 2011).

⁵⁴ Jackson, *Chapter 14*, *supra* note 53, at 6.

⁵⁵ *Id.*, at 6–7.

⁵⁶ *Id.*, at 6.

⁵⁷ There is a body of literature that supports the use of special masters in highly technical and scientific cases such as patent matters. These arguments lend support to the appointment of a special master in complex bankruptcy cases. See, e.g., Jay P. Kesan and Gwendolyn G. Ball, *A Study of the Role and Impact of Special Masters in Patent Cases* (Federal Judicial Center 2009).

in federal civil proceedings and to specify their duties.⁵⁸ Rule 9031 of the Federal Rules of Bankruptcy Procedure (FRBP), applicable to cases heard under the Bankruptcy Code, prohibits the appointment of special masters in bankruptcy proceedings. The origin of FRBP Rule 9031 is unclear; the Bankruptcy Code itself is silent on the issue of special masters. Some commentators posit that, if the drafters of the Bankruptcy Code had specific and strong reasons why special masters should not be appointed in bankruptcy cases, “it is likely that they would have drafted an express statutory provision as opposed to a procedural rule” to exclude special masters.⁵⁹ Nevertheless, FRBP Rule 9031 represents a departure from the general federal court practice of permitting the appointment of special masters in federal cases.

Some commentators contend that the management tool of a special master would aid in fostering the bankruptcy system goal to “secure the expeditious and economical administration of every case under the [Bankruptcy] Code and the just, speedy, and inexpensive determination of every proceeding therein.”⁶⁰ In general, special masters in federal cases are private attorneys, retired judges, or academics selected to assist in the handling of a case because of exceptional conditions or complex issues. One proposal recommends amending the FRBP to provide for special masters to be appointed by bankruptcy judges in rare cases where the court is faced with complex and sophisticated questions of law and fact and where a special master may be able to contribute to complex and difficult computations, discovery matters, and settlement negotiations.⁶¹ This proposal contends that special masters can assist in the “administration of justice” and efficiency of case management, as well as in providing expertise in complex cases where such expertise is not possessed by the generalist judge.⁶² One commentator suggests that, with particular reference to claims determinations, a special master “may obviate the need for oral hearing . . . save time and expense, and expedite bankruptcy proceedings for other debtors who need

the attention of the bankruptcy judge.”⁶³ In this way, a special master can provide assistance on unique issues to streamline the efficiency of the case.⁶⁴

These proposals also advocate appointing special masters in rare cases where special masters “may provide the expertise when the court’s machinery is insufficient by itself.”⁶⁵ According to these proposals, the busy caseload most bankruptcy judges face today provides little opportunity to develop an in-depth understanding of the complexities and nuances of a large, complex bankruptcy proceeding.⁶⁶ These proposals assert that special masters can contribute significantly in the discovery phase in such cases by managing pretrial discovery.⁶⁷ The proposals also suggest that special masters can contribute to multinational bankruptcy cases where there are a number of parties, extensive discovery and evidence, and foreign and domestic experts involved in the discovery phase.⁶⁸ In addition, these proposals contend that special masters can have an effective role in settlement matters, because “special masters have the luxury to incorporate and introduce a wide range of flexible proposals. Without the time or the resources possessed by the private sector, courts and judges sometimes may fail to provide litigants with the high-degree of creativity or innovative procedures or ideas.”⁶⁹

Judicial Conference Consideration of Special Masters in Bankruptcy Proceedings

The Advisory Committee on Bankruptcy Rules⁷⁰ has consistently recommended retaining FRBP Rule

⁵⁸ Fed. R. Civ. P. 53.

⁵⁹ Delk, *supra* note 49, at 29, 56.

⁶⁰ R. Spencer Clift, “Should the Federal Rules of Bankruptcy Procedure be Amended to Expressly Authorize United States District and Bankruptcy Courts to Appoint a Special Master in an Appropriate and Rare Bankruptcy Case or Proceeding?” 31 *U. Mem. L. Rev.* 353, 399 (2001).

⁶¹ *Id.*, at 355.

⁶² Delk, *supra* note 49, at 50–52.

⁶³ David Kaufman, “Procedures for Estimating Contingent or Unliquidated Claims in Bankruptcy,” 35 *Stan. L. Rev.* 153, 173 (1982).

⁶⁴ Delk, *supra* note 49, at 50–54.

⁶⁵ Clift, *supra* note 60, at 373.

⁶⁶ *Id.*, at 376.

⁶⁷ *Id.*, at 372–75.

⁶⁸ *Id.*, at 375; see also *In re Dow Corning Corp.*, 244 B.R. 634 (Bankr. E.D. Mich. 1999).

⁶⁹ Clift, *supra* note 60, at 377–78.

⁷⁰ The federal judiciary is authorized to prescribe the rules of practice and procedure for the federal courts, and the rules of evidence for the federal courts, subject to the ultimate legislative right of the Congress to reject, modify, or defer any of the rules. The authority and procedures for promulgating rules are set forth in the Rules Enabling Act. 28 U.S.C. sections 2071–77. The Judicial Conference of the United States is also required by statute “to carry on a continuous study of the operation and effect of the general rules of practice and procedure.” 28 U.S.C. section 331. The Judicial Conference’s Committee on Rules of Practice and Procedure, commonly referred to as the “Standing Committee,” has authorized the appointment of five advisory

9031, despite calls for revising the rule to allow for the appointment of special masters in bankruptcy proceedings. That Committee specifically reviewed the issue of special masters in bankruptcy in 1996,⁷¹ and rejected the suggestion of special masters because a special master was too similar to the bankruptcy referee, and because it was already possible to appoint trustees and examiners under the Bankruptcy Code to play similar roles.⁷²

Some commentators assert that allowing bankruptcy courts to appoint special masters would raise policy concerns with respect to the bankruptcy system itself. According to these arguments, the appointment of special masters in bankruptcy cases may lead to the court giving greater deference to findings of a special master than to those of an examiner.⁷³ While a bankruptcy court might appoint a special master to determine issues of both fact and law, it would typically appoint an examiner only to make recommendations based on the examiner's assessment of facts. Since an examiner in a bankruptcy case does not make findings of fact or conclusions of law, the bankruptcy court is not bound by the examiner's findings and is not obligated to take action on the examiner's report. In essence, an examiner assists the bankruptcy court but makes no determinative findings, whereas a special master typically is authorized by the court to make determinations of both fact and law.⁷⁴ Therefore, according to such commentators, special masters are not necessary since the bankruptcy courts can appoint examiners to perform a range of enumerated duties.

Still others argue that the appointment of special masters in general, whether in district courts or bankruptcy courts, raises other issues of concern.⁷⁵ These

committees to assist the Standing Committee in dealing with specified legal areas. The Advisory Committee on Bankruptcy Rules is the advisory committee appointed to deal with bankruptcy rules. See Administrative Office of the U.S. Courts, "The Federal Rules of Practice and Procedure" (Oct. 2010), available at www.uscourts.gov/RulesAndPolicies/FederalRulemaking/RulemakingProcess/SummaryBenchBar.aspx.

⁷¹ Clift, *supra* note 60, at 379, 389; see also Advisory Committee on Bankruptcy Rules, March 21–22, 1996, Meeting Agenda Materials, Introductory Items, at 13 (Minutes of Sept. 7–8, 1995); Advisory Committee on Bankruptcy Rules, Meeting (Minutes of Sept. 26–27, 1996).

⁷² Advisory Committee on Bankruptcy Rules, Meeting (Minutes of Sept. 26–27, 1996).

⁷³ Select Advisory Committee on Business Reorganization, "Second Report," 60 *Bus. Law.* 277, 317–23 (Nov. 2004).

⁷⁴ *Id.*, at 317.

⁷⁵ Linda Silberman, "Judicial Adjuncts Revisited: The Proliferation of Ad Hoc Procedure," 137 *U. Pa. L. Rev.* 2131, 2158 (June 1989) ("My point is not that special masters cannot be

commentators point out that litigants may challenge the appointment of a special master and that, where special masters take on burdensome discovery tasks and issue opinions or rulings, these matters are then often outside the purview of direct control by the judge. Special masters also, according to these commentators, may add to the "bureaucratization and proliferation" of the system, especially given that examiners and trustees are already authorized. Some commentators argue that the appointment of special masters in complicated cases has become so routine as to be "an almost Pavlovian response," suggesting that the appointment of special masters in every complicated case may not be justified.⁷⁶

Statutory Changes to Accommodate Financial Companies

Introduction

Section 216(a)(2)(C) of the Dodd-Frank Act requires the Board to include in its study "whether amendments to the Bankruptcy Code should be adopted to enhance the ability of the Bankruptcy Code to resolve financial companies in a manner that minimizes adverse impacts on financial markets without creating moral hazard." As noted above, some commentators argued during consideration of the Dodd-Frank Act that the Bankruptcy Code provided an effective mechanism for handling insolvent financial companies, including insolvent systemic financial companies. In particular, some asserted that targeted amendments to the Bankruptcy Code with respect to financial companies would make the Bankruptcy Code sufficiently effective for handling the insolvencies of financial companies, even systemic financial companies, such that the OLA provisions in the Dodd-Frank Act need not be enacted. Proposals were introduced proposing to amend the Bankruptcy Code either as an alternative to, or in conjunction with, the OLA.⁷⁷ The final legislation, however, contained the OLA, but did not contain any amendments to the Bankruptcy Code. Nevertheless, some

helpful in particular cases, but that there has developed an almost Pavlovian response to the complicated case—delegation to a special master. A rethinking of traditional rulemaking philosophy, which has been marked by informal management techniques, excessive delegation, broad discretion, and transubstantive application, seems to me a welcome alternative."

⁷⁶ *Id.*, at 2158.

⁷⁷ See, e.g., Consumer Protection and Regulatory Enhancement Act, H.R. 3310, 111th Cong. (1st Sess. 2009); see also Bankruptcy Integrity and Accountability Act, S. Amdt. 3832 to S. 3217, 156 *Congr. Rec.* S3260–62 (daily ed. May 5, 2010).

proposals assert that appropriate amendments to the Bankruptcy Code for financial companies should still be considered even in light of the enactment of the OLA, because such amendments would help to make the Bankruptcy Code even more effective for financial companies and thereby reduce the perceived need to use the exceptional powers of the OLA.

Proposals to amend the Bankruptcy Code for handling insolvent financial companies, including insolvent systemic financial companies, generally fall into seven categories. One of these categories—proposals to establish a special court or panel or group of special masters to handle financial company insolvencies—is the subject of the preceding section of this study.⁷⁸ Two additional categories of amendments—proposals to change the current treatment of QFCs in bankruptcy and other insolvency law,⁷⁹ and proposals to establish a new chapter or subchapter of the Bankruptcy Code for financial companies⁸⁰—are the subjects of subsequent sections of this study. The remaining four categories are generally as follows

1. amendments that would authorize a financial company's primary regulator to take various actions in a bankruptcy proceeding involving that financial company;
2. amendments that would facilitate handling a financial company and all of its related affiliates and subsidiaries in a unified bankruptcy proceeding;
3. amendments involving the types and uses of financing in bankruptcies of financial companies; and
4. amendments involving section 363 of the Bankruptcy Code relating to the use, sale, or lease of estate property outside of the ordinary course of business.

These categories of amendments will be discussed in turn.

⁷⁸ See "Special Judges or Panels for Financial Companies" section on pages 8–10.

⁷⁹ See "Treatment of Qualified Financial Contracts" section on pages 15–18; see also Jackson, *Chapter 14, supra* note 53, at 31.

⁸⁰ See "New Chapter or Subchapter of the Bankruptcy Code for Financial Companies" section on pages 18–20; see also Jackson, *Chapter 11F, supra* note 32, and Jackson, *Chapter 14, supra* note 53.

Involvement of Primary Regulator of Financial Company in Bankruptcy

Proposed Bankruptcy Code amendments involving the primary regulator of a financial company consist generally of three different types. These types of proposed amendments would give the primary regulator authorization to: commence an involuntary proceeding against a financial company, have standing in the bankruptcy case, and file a plan of reorganization for the financial company at any time after the filing of the petition.

Authorize the Primary Regulator to Commence an Involuntary Proceeding against a Financial Company; and Expand the Grounds upon Which the Primary Regulator May File Such a Petition

Under section 303(b) of the Bankruptcy Code, three creditors holding non-contingent undisputed claims against a person may commence an involuntary petition against that person under Chapter 7 or Chapter 11.⁸¹ An involuntary petition cannot be based on "balance sheet insolvency" of the debtor—that is, based on an entity's liabilities exceeding its assets. Rather, section 303(h) of the Bankruptcy Code authorizes the filing of an involuntary petition against an entity based on "cash flow insolvency," namely, based on the entity generally not paying its debts as they come due.⁸²

A financial company's primary regulator is in a better position, according to some commentators, than many of the financial company's creditors to know the true financial condition of the financial company. Authorizing the primary regulator to commence an involuntary proceeding against a financial company may, according to these arguments, permit the financial company to be placed into a reorganization or liquidation more promptly than if the financial company's creditors were to do so. This may have the potential to preserve asset value and operations necessary to maintain a going concern value for the financial company. In addition, according to these proposals, by the time three creditors of a financial company begin negotiating whether to file an involuntary petition against the financial company it will

⁸¹ 11 U.S.C. section 303(b).

⁸² 11 U.S.C. section 303(h).

be too late to do so, because the financial company's customers and short-term creditors will have fled at the very suggestion of insolvency.

Accordingly, some commentators propose that the Bankruptcy Code be amended to authorize a financial company's primary regulator to file an involuntary petition against a financial company.⁸³ Some of these proposals also suggest that the grounds upon which an involuntary petition may be filed be expanded where a financial company and its primary regulator are concerned. Specifically, some proposals suggest that a financial company's primary regulator should be authorized to file an involuntary petition against the financial company not only when the financial company is generally not paying its debts when they come due, but upon three additional grounds as well. First, a primary regulator should be authorized to file an involuntary petition against a financial company based on "balance sheet insolvency," that is, when the liabilities of the financial company exceed its assets at fair market valuation.⁸⁴ Second, a primary regulator should be authorized to file an involuntary petition against a financial company based on the financial company having unreasonably small capital.⁸⁵ Third, a primary regulator should be authorized to file an involuntary petition against a financial company based on the intention of the primary regulator to resolve the financial company.⁸⁶

Authorize the Primary Regulator of a Financial Company, or the Primary Regulator of Any Subsidiary of the Financial Company, to Have Standing in the Bankruptcy Case

There is currently no specific authorization for the primary regulator of a financial company to appear in a bankruptcy proceeding of that financial company. Some commentators argue that the absence of standing for a financial company's primary regulator in a bankruptcy proceeding involving that financial company deprives the Bankruptcy Court, and the bankruptcy proceedings generally, of the specialized expertise that the primary regulator has with respect

to the financial company. Accordingly, some commentators propose that the Bankruptcy Code be amended to grant a financial company's primary regulator, or the primary regulator of a subsidiary of the financial company, standing to appear in the case and to file motions and be heard.⁸⁷ In particular, there are specific proposals to authorize SIPC⁸⁸ and the Securities and Exchange Commission (SEC)⁸⁹ to have standing in cases involving broker-dealers, whether the broker-dealer is the debtor or a subsidiary of the debtor financial company.

Authorize the Primary Regulator to File a Plan of Reorganization for the Financial Company at Any Time after the Filing of the Petition

Section 1121(b) of the Bankruptcy Code provides that only the debtor has the right to file a plan of reorganization in a Chapter 11 bankruptcy proceeding during the first 120 days after the entry of an order for relief.⁹⁰ This period of time, referred to as "the exclusivity period," is designed to allow the debtor some time to prepare such a plan free of interference from the introduction of competing plans filed by creditors.

Given the special expertise of a financial company's primary regulator, some commentators argue that the primary regulator should be allowed to file a plan of reorganization in a financial company Chapter 11 case without regard to the exclusivity period. Waiting for the expiration of the exclusivity period, or even waiting for the primary regulator to file a motion to shorten the exclusivity period, could be excessive in the case of a financial company bankruptcy because of the particular speed with which a financial company's customers and counterparties can withdraw from dealings with the company. Accordingly, some commentators propose amending the Bankruptcy Code to authorize the primary regulator to file a plan of reorganization in a financial company's Chapter 11 case at any time, including at the commencement

⁸³ Jackson, *Chapter 11F*, *supra* note 32, at 227; Morrison, *supra* note 42, at 13–14; Jackson, *Chapter 14*, *supra* note 53, at 29.

⁸⁴ Jackson, *Chapter 14*, *supra* note 53, at 30.

⁸⁵ *Id.*

⁸⁶ Jackson, *Chapter 11F*, *supra* note 32, at 228. Some or all of these grounds serve as a basis for placing an insured depository institution into receivership under federal and some state laws.

⁸⁷ Jackson, *Chapter 11F*, *supra* note 32, at 238; Jackson, *Chapter 14*, *supra* note 53, at 30.

⁸⁸ Jackson, *Chapter 14*, *supra* note 53, at 29.

⁸⁹ The SEC may appear and be heard in a Chapter 11 case, but may not appeal from any judgment, order, or decree in such a case. 11 U.S.C. section 1109(a). As noted *supra*, however, broker-dealers are not eligible to be debtors under Chapter 11.

⁹⁰ 11 U.S.C. section 1121(b).

of a voluntary case or any time at or after the entry of an order for relief in an involuntary case.⁹¹

Handling a Financial Company and All of Its Related Entities in a Unified Bankruptcy Proceeding

The subsidiaries or affiliates of a debtor generally do not become debtors themselves under the Bankruptcy Code upon the filing of a bankruptcy petition by the parent (or by an affiliate). The debtor's subsidiaries and affiliates are free, of course, to file their own bankruptcy petitions (assuming that they are eligible debtors under the Bankruptcy Code), but the cases are separate cases and are heard and adjudicated separately. By virtue of a process referred to as "administrative consolidation," a Bankruptcy Court may arrange to hear all related cases together for administrative purposes. It is generally rare for a Bankruptcy Court to order "substantive consolidation," a procedure whereby all of the related bankruptcy cases are merged into one large bankruptcy case and where the corporate separateness of the individual subsidiaries and affiliates vis-à-vis the debtor and each other is not respected.⁹²

Where financial companies are concerned, insolvency proceedings can become highly fragmented. A financial holding company, and many of its unregulated subsidiaries, would generally be eligible under the Bankruptcy Code to file either for Chapter 11 (reorganization) or Chapter 7 (liquidation). An insured depository institution subsidiary of the company, however, would be subject to resolution by the FDIC under the FDIA, while a broker-dealer subsidiary of the company would be resolved under the joint operation of SIPA and Chapter 7 (but not Chapter 11) of the Bankruptcy Code. An insolvent insurance company subsidiary would be resolved under the applicable state law pertaining to the insurance company and would be administered by a state insurance commissioner. This jurisdictional separation of the various related entities with respect to insolvency proceedings creates an unnecessarily complicating state of affairs for financial company insolvencies according to some commentators. Furthermore, the inability of broker-dealers and commodities brokers to file for reorganization under Chapter 11 is itself cited as a complication, since it creates disincentives

for broker-dealers and commodities brokers to attempt a resolution or restructuring given that their only choice is to liquidate. These provisions are also seen as deleterious by some because they preclude any attempts to preserve the value of such a company for reorganization on its own or as part of a larger reorganization of its parent company.

Accordingly, some commentators propose to amend the Bankruptcy Code to allow a more unified handling of insolvency proceedings for financial companies and their related entities. Some of these proposals suggest, for example, that where a financial company has "ineligible" subsidiaries (such as insured depository institutions or insurance companies or broker-dealers or commodities broker subsidiaries), then those subsidiaries should be allowed to file bankruptcy petitions and be handled together with the related financial company (or companies) before the same Bankruptcy Court.⁹³ Other suggestions include keeping the exclusion from eligibility for insured depository institutions but ignoring the other exclusions for subsidiary broker-dealers, insurance companies, and commodities brokers so that those subsidiaries would be eligible to be resolved together with the parent financial company.⁹⁴ Still other proposals suggest that the authority of SIPC to handle customer accounts in the event of the insolvency of a broker-dealer should remain in place, but that the broker-dealer itself should otherwise be permitted to be resolved, and in particular to be reorganized under Chapter 11 of the Bankruptcy Code.⁹⁵

Types and Uses of Financing

Section 364 of the Bankruptcy Code authorizes a post-petition creditor to receive priority in the distribution of the assets of the bankruptcy estate superior to all other creditors of the estate (other than creditors holding administrative claims).⁹⁶ These provisions are intended to make it possible for a debtor to obtain funding to finance its reorganization notwithstanding pre-petition encumbrances on the debtor's assets. There is no specific provision in the Bankruptcy Code, however, that authorizes government entities to extend credit on this "super-priority" basis.⁹⁷ In addition, there is no provision authorizing

⁹¹ Jackson, *Chapter 11F*, *supra* note 32, at 239; Jackson, *Chapter 14*, *supra* note 53, at 30.

⁹² See, e.g., 2 Alan N. Resnick and Henry J. Sommer, *Collier on Bankruptcy* 105.09[1][d] (16th ed. 2011).

⁹³ Jackson, *Chapter 11F*, *supra* note 32, at 229.

⁹⁴ Jackson, *Chapter 14*, *supra* note 53, at 29.

⁹⁵ Jackson, *Chapter 14*, *supra* note 53, at 29; Skeel, *supra* note 35, at 168.

⁹⁶ 11 U.S.C. section 364.

⁹⁷ Assuming the governmental entity otherwise had the requisite authority to extend such credit.

the use of post-petition financing for the purpose of making partial or advance payments to some or all of a debtor's creditors if that is deemed necessary to the progress of the debtor's resolution.

With respect to financial company debtors, some commentators suggest that the lack of clarity on permissible uses of post-petition financing makes the Bankruptcy Code less effective for financial companies. For example, it may not be possible for a financial company debtor to obtain DIP financing from a commercial source, as could be the case when financial conditions generally make it impossible for a commercial entity to make such credit available. Therefore, some commentators argue that the Bankruptcy Code should explicitly authorize a government entity to extend credit to the debtor, and should explicitly provide for the appropriate priority of the government's claim in such a case. In addition, some commentators argue that a financial company debtor may require DIP financing not for its immediate operational needs, but in order to make pre-payments to certain classes of creditors to induce those creditors to continue to do business with the debtor. Again, the inability of the Bankruptcy Code clearly to authorize such a use of DIP financing is seen as a complication in the use of the Bankruptcy Code for financial companies.

Accordingly, some commentators propose amending the Bankruptcy Code expressly to authorize a government lender to provide DIP financing to a financial company debtor.⁹⁸ In addition, some commentators propose amendments under which DIP financing, whether from a government or a commercial source, is explicitly authorized for the purpose of providing partial or complete payouts to some or all creditors of the debtor.⁹⁹ In such cases, these proposals recommend that the amendments provide that the debtor must make the requisite evidentiary showing that such terms are necessary to the reorganization, that the creditors in question will not receive more by virtue of the payout than they would have received in an ordinary Chapter 7 liquidation of the debtor, and other specific evidentiary showings designed to protect the integrity of the transaction.¹⁰⁰

⁹⁸ Jackson, *Chapter 11E*, *supra* note 32, at 239; Jackson, *Chapter 14*, *supra* note 57, at 30.

⁹⁹ *Id.*

¹⁰⁰ *Id.*

Changes to Bankruptcy Code Section 363

Section 363 of the Bankruptcy Code authorizes the debtor-in-possession (or a Chapter 11 or Chapter 7 trustee of the debtor) to seek an order of the Bankruptcy Court authorizing the use, sale, or lease of property of the estate other than in the ordinary course of business.¹⁰¹ This "363 sale" authority was used in the Lehman Brothers bankruptcy case for the sale of Lehman Brothers assets (specifically, its broker-dealer subsidiary) to Barclays. The 363 sale authority was also used in the Chrysler bankruptcy case. In the case of some financial companies, such as insured depository institutions, broker-dealers, or insurance companies, it may be the company's primary regulator that has arranged for a sale of the company (or its assets) to a third party. There is no provision in the Bankruptcy Code, however, for a government entity or a primary regulator of a financial company to file a motion for an order approving a 363 sale.

Such sales have sometimes been criticized as being the equivalent of a plan of reorganization, but lacking all of the procedures and creditor protections otherwise required to confirm a plan of reorganization.¹⁰² These procedures include the requirement that a plan proponent file a disclosure statement about the plan's operation along with the plan itself.¹⁰³ In addition, creditors have the opportunity to object to the disclosure statement or to the plan itself, and plan confirmation requires certain levels of creditor approval (in terms of classes of creditors and aggregate amounts of claims).¹⁰⁴ In certain cases, a 363 sale has been viewed as allowing substantially the same outcome as a confirmed plan of reorganization, such as where more than half of the stock or half of the debt of the buyer will be held by creditors or stockholders of the debtor company.¹⁰⁵

Accordingly, some commentators propose to amend the Bankruptcy Code to permit the primary regulator of a debtor financial company to have the same authority as a debtor-in-possession or a trustee to file a motion for an order approving a 363 sale of the

¹⁰¹ 11 U.S.C. section 363(b).

¹⁰² See, e.g., 2 Alan N. Resnick and Henry J. Sommer, *Collier on Bankruptcy* 363.02[3] (16th ed. 2011); Elizabeth B. Rose, Note, "Chocolate, Flowers, and § 363(b): The Opportunity for Sweetheart Deals without Chapter 11 Protections," 23 *Emory Bankr. Dev. J.* 250 (2006).

¹⁰³ 11 U.S.C. section 1125.

¹⁰⁴ 11 U.S.C. section 1126.

¹⁰⁵ See generally Mark J. Roe and David A. Skeel, "Assessing the Chrysler Bankruptcy," 108 *Mich. L. Rev.* 727 (2010).

debtor or the debtor's assets.¹⁰⁶ Other proposals would amend the Bankruptcy Code to preclude certain kinds of 363 sales from occurring, such as where more than half of the stock or the debt of the would-be buyer is held by creditors or stockholders of the "old" company.¹⁰⁷

Minimizing Impacts on Financial Markets without Creating Moral Hazard

Section 216(a)(2)(C) requires the Board to study the extent to which proposed amendments to the Bankruptcy Code for financial companies might "minimiz[e] adverse impacts on financial markets without creating moral hazard." There is little in the existing literature, however, that weighs such proposals against each of these two concerns. There appears generally to have been more attention given in the literature to the extent to which the foregoing proposals might minimize impacts on financial markets than there has been to how those proposals might mitigate the creation of moral hazard per se. Authorizing greater involvement by a financial company's primary regulator in a financial company's bankruptcy could be seen by some to have the potential both to minimize adverse impacts on financial markets and to increase moral hazard. Allowing a government entity to provide DIP financing, for example, could arguably minimize adverse impacts on financial markets to the extent that a governmental entity is the only entity actually able to provide funding to the debtor. This situation is likely to arise when financial markets are already stressed and fragile, or when the size of the debtor makes obtaining private DIP financing unlikely. At the same time, however, the ability to provide government DIP financing could also be seen as a backdoor bailout, thereby increasing moral hazard. Similarly, directing or allowing a trustee in bankruptcy to consider adverse impacts on financial markets may address concerns about the effects of bankruptcy on financial stability, but may also be viewed as increasing moral hazard to the degree that creditors receive more payments than expected or payments according to different priorities than normal under the Bankruptcy Code. Conditions intended to reduce the moral hazard implications—such as assessments on financial companies or others (such as creditors) that are beneficiaries of such DIP financing, or the replacement of the financial company's management—could be seen by some, but not by all, as addressing at least some moral hazard con-

cerns. Nevertheless, the extent to which the foregoing proposals might minimize adverse impacts on financial markets while avoiding the creation of moral hazard is not prominently addressed in the existing literature.

Treatment of Qualified Financial Contracts

Introduction

Section 216(a)(2)(E) of the Dodd-Frank Act requires the Board to include in this study "whether amendments should be made to the Bankruptcy Code, the Federal Deposit Insurance Act, and other insolvency laws to address the manner in which qualified financial contracts of financial companies are treated."

Treatment of Certain Financial Market Transactions under the Bankruptcy Code

QFCs receive special treatment under the Bankruptcy Code. The special treatment, called the "safe harbor provisions" of the Bankruptcy Code, exempts these transactions from some of the Bankruptcy Code's principal debtor protections. For example, the safe harbor provisions exempt QFCs from the bankruptcy "automatic stay," the provision of the Bankruptcy Code that automatically prevents creditors and others holding claims against a debtor from taking any action on the claim upon the filing of a voluntary petition. The safe harbor provisions also exempt QFCs from the "trustee avoiding powers," that is, from the provisions of the Bankruptcy Code that allow a trustee (or a debtor-in-possession) to recover certain transfers of the debtor's assets that were made within 90 days of filing the bankruptcy petition ("preferential transfers") or certain "constructive fraudulent conveyances" (or "fraudulent transfers").¹⁰⁸ Because of the safe harbor provisions, the non-defaulting QFC counterparty of the debtor can take actions to exercise its contractual rights to close out, terminate, net, and apply collateral for these transactions.

¹⁰⁶ Jackson, *Chapter 14*, *supra* note 53, at 30.

¹⁰⁷ Skeel, *supra* note 35, at 172.

¹⁰⁸ See 11 U.S.C. sections 362(b)(17), (27), 560 (allowing liquidation of collateral in the counterparty's possession notwithstanding automatic stay); 11 U.S.C. sections 546(g), (j) (exempting QFCs from preferential transfer and constructive fraudulent transfer provisions); *see also* 11 U.S.C. sections 553(a), 560 (automatic option to set off); 11 U.S.C. sections 555, 559, 560, 561 (allowing counterparty to terminate, net, and seize collateral).

Congress enacted the safe harbor provisions of the Bankruptcy Code for QFCs because of concerns about systemic risk. Congress was concerned that, without the safe harbor provisions, other market participants who had entered into QFCs with the debtor would be exposed to such a high degree of uncertainty leading to a lack of liquidity that it would pose a potential for systemic risk. Specifically, there was concern that spillover effects from the initial insolvency could be transmitted through QFCs and significantly impair both the debtor's counterparties and the real economy more broadly.¹⁰⁹

Proposals to Amend the QFC Safe Harbor Provisions of the Bankruptcy Code

Several commentators propose changing or eliminating the safe harbor provisions for QFCs under the Bankruptcy Code. Those proposing partial or total elimination of the safe harbor provisions base their arguments on the principle of treating like transactions similarly,¹¹⁰ on concerns over moral hazard,¹¹¹ and on concerns about systemic risk.¹¹² These proposals argue that similar types of contracts should be treated under the Bankruptcy Code in a similar manner unless there is a compelling reason not to do so. Under this argument, certain QFCs such as repurchase agreements and some types of swaps are the equivalent of secured loans, and should receive the same treatment as secured loans under the Bankruptcy Code. Also under this argument, derivative contracts are similar to other executory contracts,

that is, contracts that have not yet been performed or executed, and therefore should receive the same treatment as other executory contracts under the Bankruptcy Code. In the case of QFCs, some commentators argue that the exemption from the automatic stay coupled with provisions that are triggered upon the debtor's insolvency through ipso facto clauses (which are standard in derivative contracts) elevates the status of QFCs in bankruptcy relative to similar contracts that are not classified as QFCs without a compelling reason for the distinction.¹¹³

Proposals for changing or eliminating the QFC safe harbor provisions also argue that those provisions have negative impacts on incentives and market discipline. According to these arguments, the exemptions from the automatic stay and trustee avoiding powers change the incentives for QFC counterparties to monitor the debtor prior to bankruptcy. Since QFC counterparties know that they can take action against the debtor on their QFC-related claims at a time when non-QFC creditor claims are stayed, QFC counterparties are likely to reduce their level of monitoring and are less likely to fully price changes in the risk of the debtor. Therefore the safe harbor provisions, according to these commentators, reduce market discipline and lead to increased risk-taking by counterparty firms and to increased risk in the financial system.

Proposals for changing or eliminating the QFC safe harbor provisions also contend that the provisions increase, rather than decrease, systemic risk because of the associated incentive effects. According to these arguments, preferential treatment of QFCs under the Bankruptcy Code changes the incentives for QFC counterparties to monitor and impose discipline on the debtor. Instead, actions that a counterparty might take to contain risk (for example, increased risk premiums, limiting exposure at default) are replaced, in part, by collateral calls as the financial distress of the debtor grows. This behavior can lead to the equivalent of counterparty runs (involving the termination of contracts and the liquidation of collateral) when the debtor files for bankruptcy. Collateral runs, according to these arguments, can both destabilize the debtor and have spillover effects on other creditors, other non-creditor firms and financial markets in general.¹¹⁴ In effect, according to these arguments, the QFC safe harbor provisions fail

¹⁰⁹ The treatment of QFCs for banks under the FDIA and for systemic financial companies under OLA is similar to that under the Bankruptcy Code with one important exception: QFCs are subject to a one business day automatic stay upon the appointment of the FDIC as receiver under both the FDIA and the OLA. During this one-day stay, the FDIC has the power to transfer QFCs to a third party, including a bridge institution. Contracts transferred to a third party, including a bridge institution, may not be considered in default under the ipso facto clauses of the contracts. The FDIC's ability to transfer QFCs to third parties during the one-day stay is only limited by the requirement that all contracts under the same master agreement must receive the same treatment. See 12 U.S.C. section 1821(e)(8)–(11).

¹¹⁰ See, e.g., David A. Skeel and Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy* (U. Penn. Inst. for Law & Econ. Research Paper No. 11–06, 2011); Jackson, *Chapter 14*, *supra* note 53.

¹¹¹ See Skeel and Jackson, *supra* note 110, at 4–5; see also Mark J. Roe, *Bankruptcy's Financial Crisis Accelerator: The Derivatives Players' Priorities in Chapter 11* (Harvard Public Law Working Paper No. 10–17, 2010).

¹¹² See, e.g., Roe, *supra* note 111, at 9–12; Brian G. Faubus, Note, "Narrowing the Bankruptcy Safe Harbor for Derivatives to Combat Systemic Risk," 59 *Duke L. J.* 801–42 (2010); Stephen J. Lubben, "The Bankruptcy Code without Safe Harbors," 84 *Am. Bankr. L. J.* 123–44 (2010).

¹¹³ See Skeel and Jackson, *supra* note 110, at 22.

¹¹⁴ See Skeel, *supra* note 35, at 19–39; see Skeel and Jackson, *supra* note 110, at 35; see Roe, *supra* note 111, at 13–15.

to lower systemic risk in the financial system,¹¹⁵ and simply replace one systemic risk transmission mechanism with another.

Some critics of the QFC safe harbor provisions call for a full repeal.¹¹⁶ Other critics, however, appear to argue in favor of more narrow amendments. For example, some propose retaining the exemption from the automatic stay for QFCs where the collateral is cash or cash-like assets but imposing a limited automatic stay for other types of QFCs.¹¹⁷ According to these commentators, exempting QFCs where the underlying collateral consists of cash or cash-like assets is appropriate because the collateral securing these contracts is not related to the going concern value of the firm. Furthermore, they note that cash and cash-like collateral is liquid, with little controversy over its value. Finally, they argue that, even with the exemption from the automatic stay in place, counterparties in repurchase agreement transactions continued to aggressively monitor borrowers.¹¹⁸

Although there appears to be some consensus in proposals to retain the safe harbor provisions for QFCs with cash or cash-like collateral, there appears to be greater diversity among proposals for changing the treatment of other types of QFCs (non-cash QFCs). Some proposals would remove all of the safe harbor provisions for non-cash QFCs,¹¹⁹ while others would impose an automatic stay of limited duration on non-cash QFCs.¹²⁰ Those proposing a limited automatic stay argue that doing so would limit the risk to counterparties associated with market movements that could affect the value of their claim and limit hedge uncertainty. Some also argue that a limited automatic stay would improve transaction consistency by making the Bankruptcy Code treatment of

QFCs more consistent with the treatment of QFCs under the FDIA and the OLA. During the limited stay, according to these proposals, the debtor would have the right to net, transfer, affirm, or reject contracts, but would be required to treat all QFCs under the same master agreement identically to eliminate “cherry-picking” (that is, selective assumption and rejection) of QFCs by the debtor. After the limited stay expired, QFC counterparties could exercise all of their contract rights.¹²¹

Proposals to Retain the QFC Safe Harbor Provisions of the Bankruptcy Code

Supporters of the QFC safe harbor provisions present four general arguments for continuing the special treatment of QFCs in bankruptcy.¹²² These proposals are generally framed in terms of opposing the wholesale repeal of the QFC safe harbor provisions, however, and therefore do not address all of the proposals for amendments described above.

Those arguing for retaining the QFC safe harbor provisions claim that the provisions prevent systemic spillover effects associated with tying up collateral in bankruptcy. For QFCs, and especially for repurchase agreements, they argue, subjecting such contracts to the automatic stay could produce spillover effects that might result in financial markets and firms becoming illiquid. They argue that particularly in the case of the market for U.S. Treasury securities, the largest segment of the market for repurchase agreements, freezing of the market could interfere with the U.S. government’s ability to manage its debt issuances and with the Federal Reserve’s ability to implement monetary policy.

Supporters of the existing QFC safe harbor provisions also contend that the special status of QFCs in bankruptcies has implications for market risk. They argue that the elimination of the QFC safe harbor provisions could increase uncertainty in markets because these financial market transactions, especially derivatives, are critical tools used to manage and hedge financial risks. According to these arguments, dealer banks, relying on derivatives to manage their own risks and to serve as market-makers, enter

¹¹⁵ For arguments in favor of the special treatment of QFCs in bankruptcy that are not related to systemic risk, see Franklin R. Edwards and Edward R. Morrison, “Derivatives and the Bankruptcy Code: Why the Special Treatment?” 22 *Yale J. Reg.* 91, 110–13 (2005).

¹¹⁶ See, e.g., Stephen J. Lubben, “Repeal the Safe Harbors,” 18 *Am. Bankr. Inst. L. Rev.* 319–36 (2010).

¹¹⁷ See Edwards and Morrison, *supra* note 115, at 25 (arguing against imposing the automatic stay where cash or cash-like collateral is involved); Jackson, *Chapter 14*, *supra* note 53; Skeel and Jackson, *supra* note 110, at 26–31 (repurchase agreements, swaps, and other derivatives secured by cash or cash-like assets should be exempt from the automatic stay).

¹¹⁸ See Skeel and Jackson, *supra* note 110, at 27–28.

¹¹⁹ See Jackson, *Chapter 11F*, *supra* note 32, at 232–36.

¹²⁰ See Skeel and Jackson, *supra* note 110, at 34; Jackson, *Chapter 14*, *supra* note 53, at 22–23. The choice of three days for the automatic stay seems to be an attempt to choose a time period that balances of the costs to non-defaulting QFC counterparties with the benefits to the debtor.

¹²¹ See Skeel and Jackson, *supra* note 110, at 39–41 (advocating reinstating a limited form of the avoidance provisions of the Bankruptcy Code for non-cash QFCs).

¹²² See Harold S. Novikoff and Sandeep C. Ramesh, “Special Bankruptcy Code Protections for Derivative and Other Financial Market Transactions,” *ALI-ABA Bus. L. Course Materials J.* (Oct. 2009) at 37–41 (summarizing arguments).

into positions in order to transfer risks from ultimate buyers to ultimate sellers. Changes in interest rates and other market-risk factors can cause the value of derivatives to fluctuate quite a bit from day to day. If the stay were to be imposed, according to these arguments, the defaulting firm's counterparties might be forced to bear unhedgeable uncertainty—they would not be allowed to terminate their contracts with the defaulting firm, and would not know if or when some, all, or none of the amounts due to them under the contracts would be paid. If market movements caused the value of the contracts to the non-defaulting parties to increase, they continue, the non-defaulting parties would not be allowed to receive any more collateral from the defaulting firm to cover the increase in exposure.

The third principal argument advanced by those supporting the retention of the existing QFC safe harbor provisions asserts that there are only limited benefits associated with eliminating them. The automatic stay, according to these commentators, helps to coordinate creditor negotiations while preserving the going concern value of the debtor in reorganization. According to these arguments, the universe of firms that are large dealers in over-the-counter derivatives and counterparties that might be reorganized under Chapter 11 of the Bankruptcy Code may not be very large. For example, insolvent banks would be resolved under the FDIA. Covered financial companies might under exceptional circumstances be resolved under the OLA, although it is not possible to be certain before the fact which financial companies will be subject to resolution under the OLA because of the extraordinary circumstances and determinations required for its application.¹²³ Securities broker-dealers and commodities brokers are both prohibited from filing for reorganization under Chapter 11. Insurance companies are resolved under applicable state law, while hedge funds and private investment funds are most often liquidated rather than reorganized. Therefore, according to these arguments, the benefits associated with repealing the QFC safe harbor provisions are unlikely to exceed the costs since the universe of entities to which the repealed provisions might apply is small.

Finally, supporters of retaining the QFC safe harbor provisions assert that markets should be allowed to protect themselves without undue interference from the Bankruptcy Code. According to these commenta-

tors, reinstating the automatic stay and trustee avoidance provisions of the Bankruptcy Code with respect to QFCs interferes with the ability of counterparties to protect themselves through enforcement of ISDA master agreements and contractual rights to seize and liquidate collateral in the event of a counterparty default.¹²⁴

New Chapter or Subchapter of the Bankruptcy Code for Financial Companies

Introduction

Section 216(a)(2)(E) of the Dodd-Frank Act requires the Board to include in this study “the implications, challenges, and benefits to creating a new chapter or subchapter of the Bankruptcy Code to deal with financial companies.” Prior to the enactment of the Dodd-Frank Act, some commentators supported either the establishment of a separate resolution authority for non-bank financial companies, especially systemic financial companies,¹²⁵ and/or changes to the Bankruptcy Code¹²⁶ to better accommodate the resolution of these companies.¹²⁷ Additional academic literature published subsequent to the enactment of the Dodd-Frank Act,¹²⁸ as well as some public comments received in response to the

¹²⁴ See Novikoff and Ramesh, *supra* note 122, at 40.

¹²⁵ See, e.g., Richard J. Herring, “Why and How Resolution Policy Must Be Improved,” in *The Road ahead for the Fed* (2009), at 171; *Too Big to Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform*: Hearing Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary, 111th Cong. 18 (Oct. 22, 2009) (testimony of Michael Krimminger, Special Advisor for Policy, Federal Deposit Insurance Corporation); see Cohen and Goldstein, *supra* note 24.

¹²⁶ See *Too Big to Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform*: Hearing Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary, 111th Cong. 63 (Oct. 22, 2009) (testimony of Harvey R. Miller) (arguing against the concept of a resolution authority).

¹²⁷ This was the topic of Congressional hearings as well. See generally *Too Big to Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform*: Hearing Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary, 111th Cong. 1 (Oct. 22, 2009).

¹²⁸ See Thomas H. Jackson et al., “Resolution of Failed Financial Institutions: Orderly Liquidation Authority and a New Chapter 14—Studies by the Resolution Project at Stanford University’s Hoover Institution Working Group on Economic Policy” (hereinafter Hoover Institution Working Group) (containing a preface and four papers supporting changes to the Bankruptcy Code in the form of a new Chapter 14); see also Skeel and Jackson, *supra* note 110.

¹²³ See “Reorganization, Liquidation, Resolution” subsection on pages 3–4.

Board's Request for Information,¹²⁹ together argue that certain amendments to the Bankruptcy Code might facilitate non-bank financial firm resolution more effectively under the Bankruptcy Code.

Proposals for a New Chapter or Subchapter

One proposal, advanced prior to the enactment of the Dodd-Frank Act, suggests a special "overlay" chapter for the largest financial companies—those with a minimum asset size of \$100 billion.¹³⁰ The new chapter or subchapter would be intended to be complementary to the OLA in the Dodd-Frank Act, consistent with the "living will" provisions of Title I of the Dodd-Frank Act, and specifically designed with characteristics of financial companies in mind.

A threshold question is whether amendments to the Bankruptcy Code to enhance its application to insolvent financial companies should be made all in one chapter or in the various substantive sections of the Bankruptcy Code to which those amendments would pertain. According to proponents of a new chapter or subchapter of the Bankruptcy Code for certain financial companies, placement of such amendments in a single chapter would permit financial companies to file under the new "Chapter 14" concurrently with filing for a Chapter 7 liquidation or Chapter 11 reorganization, permitting the entire large financial company to be liquidated or reorganized under the provisions of "Chapter 14." The primary regulator would also be authorized to commence an involuntary proceeding against a financial company under this new chapter.¹³¹ The substantive changes that would constitute part of a new proposed chapter or subchapter of the Bankruptcy Code are discussed in the preceding sections of this study. Accordingly, this section reviews specifically the extent to which such substantive changes should be set forth in a new chapter or subchapter, rather than reviewing the substantive changes themselves.

Benefits and Challenges in Creating a New Chapter or Subchapter

Those proposing a new chapter or subchapter to the Bankruptcy Code claim two primary benefits to such a structure. First, they claim that "[b]ecause of the special procedural and substantive rules that are perceived to be needed to make bankruptcy a robust alternative to government agency resolution for the nation's largest financial institutions, there needs to be a mechanism, within the Bankruptcy Code, for (a) incorporating the vast majority of common Bankruptcy Code provisions in Chapters 1, 3, and 5, as well as 7 or 11, while (b) ensuring that those special procedural and substantive rules govern—and amend or override certain common Bankruptcy Code provisions—for such financial institutions."¹³² Second, they suggest that such an approach is needed to allow more easily for consideration of these cases by Article III judges instead of by bankruptcy judges as part of a proposal to have such judges hear financial company bankruptcy cases.¹³³

The Bankruptcy Code currently provides for separate chapters and subchapters for certain categories of debtors. Chapter 9 provides for the reorganization of municipalities (which includes cities and towns, as well as villages, counties, taxing districts, municipal utilities, and school districts) and Chapter 12 provides for the adjustment of debts of family farmers and fishermen. In addition, the Bankruptcy Code features subchapters applicable to the liquidation of "stockbrokers" (broker-dealers), commodities brokers, and clearing banks, and a subchapter for the reorganization of railroads.¹³⁴ The subchapter applicable to broker-dealers permits only a Chapter 7 liquidation, as opposed to a Chapter 11 reorganization.¹³⁵ These broker-dealer subchapter provisions can be stayed, and then dismissed upon the filing of an application for a protective decree under the Securities Investor Protection Act of 1970. The subchapter applicable to commodities brokers¹³⁶ grants the Commodity Futures Trading Commission a right to be heard,¹³⁷ and the subchapter applicable to clearing

¹²⁹ Public comments in response to the Board's notice and request for information are located at www.federalreserve.gov/generalinfo/foia/index.cfm?doc_id=OP-1418&doc_ver=1.

¹³⁰ Hoover Institution Working Group, *supra* note 128.

¹³¹ See "Authorize the Primary Regulator to Commence an Involuntary Proceeding against a Financial Company; and Expand the Grounds upon Which the Primary Regulator May File Such a Petition" subsection on pages 11–12.

¹³² Jackson, *Chapter 14*, *supra* note 53, at 2–4 (suggesting that a new bankruptcy process is needed for financial institutions that builds on Chapters 7 and 11).

¹³³ See "Special Judges or Panels for Financial Companies" section on pages 8–10.

¹³⁴ Chapter 11, Subchapter IV, "Railroad Reorganization," 11 U.S.C. sections 1161–74.

¹³⁵ 11 U.S.C. sections 741–53.

¹³⁶ Subchapter IV, Chapter 7, 11 U.S.C. sections 761–67.

¹³⁷ 11 U.S.C. section 762(b).

banks¹³⁸ makes the conservator or receiver designated by the Board the trustee for the debtor.¹³⁹ It also grants the Board or a Federal Reserve Bank the right to appear and be heard on any issue in a case under that subchapter.¹⁴⁰

The last time a chapter specifically applicable to a particular class of debtors was added to the Bankruptcy Code was in 1986, in response to a farm foreclosure crisis triggered by widespread stress in the agricultural sector.¹⁴¹ At the time, Chapter 13 was not well suited for farmers because it required filers to have “regular income”¹⁴² and no more than \$100,000 in unsecured debts and \$350,000 in secured debts.¹⁴³ Most farmers had seasonal income and debt exceeding one or both of the Chapter 13 limits, making Chapter 13 unavailable to them. Chapter 11, on the other hand, was designed for large business reorganizations. While family farmers had more debt than individuals, they held far less than most large businesses. The small amount of debt farmers carried (relative to large businesses) made Chapter 11’s reorganization structure—forming creditors’ committees to approve the plan—too expensive and complex to use effectively.¹⁴⁴ The aspects of Chapter 11 and Chapter 13 that made it impossible for most family farmers to use could not be altered without completely changing the scope of Chapter 13’s simplified rules and Chapter 11’s protections designed for debtors with large, complex debts—both of which were central to the design of each chapter. Chapter 12 resolved these issues by largely mirroring the simplified provisions of Chapter 13 while relaxing the debt and income restraints on filing, and by mirroring provisions of Chapter 11 to recognize that family farmers’ balance sheets are larger and more complex than those of a typical consumer.

Some proposals advocating a new chapter or subchapter of the Bankruptcy Code for financial companies focus primarily on large financial companies, those more likely to be designated systemic financial companies whose resolution could be the subject of the OLA provisions of the Dodd-Frank Act. To the extent the new chapter proposals assumed that bankruptcy was the sole option (rather than the presumptive option) for such companies, the existence of the OLA might reduce the need perceived by at least some commentators for a new chapter or subchapter of the Bankruptcy Code. With respect to any financial company that would be defined as eligible to file under a proposed new chapter or subchapter, there may be a risk that financial companies could exploit or manipulate the extent to which they fall inside or outside the definition of “financial company” so as to “game” the application or non-application of the system.¹⁴⁵

There would appear to be challenges or costs as well to a new chapter or subchapter of the Bankruptcy Code for financial companies, whether systemic or not. For example, the existing literature does not address the potential for additional administrative costs associated with establishing a new chapter of the Bankruptcy Code as compared to amending those provisions of the Bankruptcy Code where the subject matter arises.

Whether or not financial company amendments to the Bankruptcy Code should be made in a new chapter or subchapter, or in various places throughout the Bankruptcy Code, appears to be only sparsely addressed in existing literature.¹⁴⁶ This lack of discussion may be because the literature focuses on the content of the particular bankruptcy reforms or suggestions rather than on whether those provisions should be placed in a new chapter or subchapter. It may also be the case that proposals for sets of sub-

¹³⁸ Subchapter V, Chapter 7, 11 U.S.C. sections 781–84.

¹³⁹ 11 U.S.C. section 782(a)(2).

¹⁴⁰ 11 U.S.C. section 784.

¹⁴¹ For a description of the factors leading up to the farm foreclosure crisis, see Thomas J. Fitzpatrick and James B. Thomson, *Stripdowns in Bankruptcy: Lessons from Agricultural Bankruptcy Reform* (Federal Reserve Bank of Cleveland Economic Commentary, 2010–9) (2010).

¹⁴² See 11 U.S.C. section 101(30).

¹⁴³ See 11 U.S.C. section 109(e) (as of the time of publication, these limits, adjusted pursuant to statutory mandate, are \$250,000 and \$750,000, respectively).

¹⁴⁴ Jerome Stam, *Do Farmers Need a Separate Chapter in the Bankruptcy Code?*, USDA Agriculture Information Bulletin No. 724–09 (1997); Jerome Stam and Bruce Dixon, *Farmer Bankruptcies and Farm Exits in the United States, 1899–2002*, USDA Agriculture Information Bulletin No. 788 (2004).

¹⁴⁵ For a discussion of the extent to which companies formerly “gamed” the application of the former Chapter X of the Bankruptcy Act, see D. Skeel, *Debt’s Dominion: A History of Bankruptcy Law in America* (2003).

¹⁴⁶ See, e.g., Hoover Institution Working Group, *supra* note 128; see also Robert R. Bliss and George G. Kaufman, “Resolving Insolvent Large Complex Financial Institutions: A Better Way,” 128 *Banking L. J.* 339 (April 2011) (arguing that a new, “optimal resolution regime” for large complex financial institutions should take place via a “modified or hybrid” Chapter 11); see also *Too Big to Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform (Part II)*: Hearing Before the Subcomm. on Courts and Competition Policy of the H. Comm. on the Judiciary, 111th Cong. 105 (Nov. 17, 2009) (testimony of Charles W. Calomiris) (arguing for a hybrid approach).

stantive reforms or changes are advanced under the rubric of a call for a new chapter or subchapter as a convenient way to summarize the changes rather than as an explicit desire for a new chapter or subchapter.

Conclusion

There is disagreement among commentators as to whether the Bankruptcy Code is currently an effective mechanism for the resolution of systemic financial companies, and both sides of this argument use the history of the Lehman Brothers bankruptcy case to support their positions. As noted earlier in this review, many scholars, practitioners, and others have argued that Congress should amend the Bankruptcy Code to make it better suited for financial companies generally or for systemic financial companies in particular. A number of specific amendments to the Bankruptcy Code have been advanced to address specific issues raised by the resolution of financial companies, covering a range of substantive provisions and issues. Some propose that assigning specified district court or bankruptcy court judges for

such cases is necessary or that the Bankruptcy Code should authorize special masters particularly experienced with respect to financial companies to be appointed in such cases. Particular attention has been given by commentators to the treatment of QFCs in bankruptcy and other insolvency law, such as the FDIA. Finally, some commentators have asserted that there should be a new chapter or subchapter of the Bankruptcy Code for financial company bankruptcies, either as a convenient vehicle for the foregoing proposed amendments or because the mechanism of a new chapter or subchapter itself is necessary or appropriate. Although virtually all of these proposals were advanced while Congress was considering the legislation that became the Dodd-Frank Act, many commentators assert that various amendments to the Bankruptcy Code are still needed even after passage of the Dodd-Frank Act. Should Congress choose to consider amending the Bankruptcy Code as it applies to financial companies, these arguments and others to be raised in light of the enactment of the Dodd-Frank Act form a foundation for further exploration and consideration of the efficacy of the Bankruptcy Code as a method for resolving financial companies.



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Preface: Implementing the Dodd-Frank Act

The Board of Governors of the Federal Reserve System (the Board) is responsible for implementing numerous provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). The Dodd-Frank Act requires, among other things, that the Board produce reports to the Congress on a number of potential reform topics.

See the Board's website for an overview of the Dodd-Frank Act regulatory reform effort (www.federalreserve.gov/newsevents/reform_about.htm) and a list of the implementation initiatives recently completed by the Board as well as several of the most significant initiatives that the Board expects to address in the future (www.federalreserve.gov/newsevents/reform_milestones.htm).

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Study on International Coordination Relating to Bankruptcy Process for Nonbank Financial Institutions

Table of Defined Terms

Basel Committee on Banking Supervision	Basel Committee
Basel Committee's CBRG – <i>Report and Recommendations of the Cross-border Bank Resolution Group</i>	CBRG Report
Board of Governors of the Federal Reserve System	Board or Federal Reserve Board
Chapter 15 of the U.S. Bankruptcy Code	Chapter 15
Cross-border Bank Resolution Group	CBRG
Dodd-Frank Wall Street Reform and Consumer Protection Act	Dodd-Frank Act
European Commission	Commission
European Union	EU
Federal Deposit Insurance Corporation	FDIC
Federal Reserve Board and the Federal Reserve Banks, collectively	Federal Reserve
Financial Stability Board	FSB
FSB – <i>Reducing the Moral Hazard Posed by Systemically Important Financial Institutions: FSB Recommendations and Time Lines</i>	FSB Moral Hazard Report
FSB – <i>Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability: Report of the Financial Stability Board to G20 Finance Ministers and Central Bank Governors</i>	FSB Progress Report
Financial Stability Forum	FSF
FSF – <i>Principles for Cross-Border Cooperation on Crisis Management</i>	FSF Principles
Fortis Group	Fortis
Group of Twenty	G-20
Institute of International Finance	IIF
IIF – <i>Addressing Priority Issues in Cross-Border Resolution</i>	IIF Addressing Priority Issues Submission
IIF – <i>A Global Approach to Resolving Failing Financial Firms: An Industry Perspective</i>	IIF Global Approach Report
International Monetary Fund	IMF
IMF – <i>Resolution of Cross-Border Banks—A Proposed Framework for Enhanced Coordination</i>	IMF Paper
IMF – <i>The Too-Important-to-Fail Conundrum: Impossible to Ignore and Difficult to Resolve</i>	IMF Discussion Note
Securities and Exchange Commission	SEC
Switzerland Commission of Experts	Swiss Commission
Switzerland – <i>Final Report of the Commission of Experts for Limiting the Economic Risks Posed by Large Companies</i>	Swiss Report
Systemically Important Financial Institutions	SIFIs
United Kingdom	UK
UK Independent Commission on Banking	UK Banking Commission
UK Independent Commission on Banking – <i>Interim Report Consultation on Reform Options</i>	UK Report
United Nations	UN
UN Commission on International Trade Law	UNCITRAL
<i>UNCITRAL Model Law on Cross-Border Insolvency</i>	Model Law
<i>UNCITRAL Practice Guide on Cross-Border Insolvency Cooperation</i>	UNCITRAL Practice Guide
United States Bankruptcy Code	Bankruptcy Code

Executive Summary

Section 217 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) directs the Board of Governors of the Federal Reserve System (the Board), in consultation with the Administrative Office of the United States Courts, to conduct a study regarding international coordination relating to the resolution of systemic financial companies under the United States Bankruptcy Code (Bankruptcy Code) and applicable foreign law.¹ The act requires the following issues to be studied:

1. The extent to which international coordination currently exists
2. Current mechanisms and structures for facilitating international cooperation
3. Barriers to effective international coordination
4. Ways to increase and make more effective international coordination of the resolution of financial companies, so as to minimize the impact on the financial system without creating moral hazard

The financial services sector in the United States has grown more global in recent decades. Currently, U.S.-based bank holding companies with \$50 billion or more in consolidated assets own, in aggregate, over 6,000 foreign entities.² These U.S.-operated foreign entities include over 550 foreign branches and engage in a variety of activities including investment advice and investment banking and securities dealing (over 200 entities), commercial banking (over 100 entities), insurance (over 120 entities), trust, fiduciary, and custody activities (over 190 entities), and acting as financial vehicles (over 1000 entities).³ These foreign entities are a part of the larger international financial services system involving a host of regulatory, supervisory, and legal regimes, which were tested during the recent international financial crisis.

The recent financial crisis prompted a variety of national and international efforts to explore, analyze, and address the weaknesses exposed by the crisis. The

¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010) section 217. The Board is also required by section 216 of the act to conduct a study, in consultation with the Administrative Office of the United States Courts, regarding the resolution of financial companies under Chapter 7 and Chapter 11 of the Bankruptcy Code. *Id.* at section 216.

² This number excludes those U.S. bank holding companies with foreign parents.

³ National Information Center Structure, Bank Holding Company Surveillance Financial Table 1Q2011.

failures of, and government interventions in, several large global financial institutions brought into focus issues related to the coordination of the resolutions of cross-border financial firms.

The mechanisms to resolve distressed financial firms are generally local in nature, while firms' enterprise-wide operations may be global in nature. The development of a framework for the resolution of cross-border financial institutions is a component of initiatives to address the growing number of financial firms that operate on an international or global basis. International consensus favors a framework for international coordination to address the resolutions of cross-border financial institutions. The underlying premise of the international consensus is that proper coordination among national and international authorities will mitigate the extent to which a disorderly collapse of a cross-border financial firm could cause systemic damage and expose taxpayers to losses.

This study will describe the initiatives undertaken by the following official and private sector groups⁴:

1. Financial Stability Board (FSB)
2. Basel Committee on Banking Supervision (Basel Committee) and the Cross-border Bank Resolution Group (CBRG)
3. European Commission
4. United Nations (UN) Commission on International Trade Law (UNCITRAL)
5. International Monetary Fund (IMF)
6. Institute of International Finance

While this study will provide overviews of the efforts by the parties listed above, the initiatives undertaken by the FSB and the Basel Committee will be described in detail because of their specific focus on the cross-border resolution of systemically important financial institutions (SIFIs)⁵ and the active involvement of the Federal Reserve Board and the Federal Reserve Banks (collectively, Federal Reserve) in these multilateral initiatives. This study will also provide an overview of U.S.-specific efforts, including the Dodd-

⁴ This study also provides an overview of the efforts in the United Kingdom (UK) and Switzerland as examples of country-specific initiatives. The discussion is provided in [Appendix A](#).

⁵ SIFI is a commonly used term, but is not used in all of the papers. This study will only use "SIFI" in situations where the papers use the term.

Frank Act, Chapter 15 of the Bankruptcy Code, and the initiatives of U.S. financial regulatory agencies.

The papers described in this study express a preference for private and/or prophylactic measures to avoid or minimize the impact of a cross-border financial institution's insolvency on the larger financial system. There is no expectation that all future insolvencies of multinational SIFIs can be avoided. The ultimate shared goal is, therefore, an effective cross-border resolution mechanism that minimizes the impact of such a failure on the public purse and the financial system as a whole. As such, some of the suggested frameworks have as their basis the stipulation that resolution measures do not depend on public funds.

Current coordination of insolvencies is ongoing on regional levels, such as the European Union. Broader initiatives to analyze and provide recommendations regarding coordination specific to systemic financial companies are also underway. The scope of these initiatives and the level of participation by various countries and international organizations provide insight into the extent to which international coordination currently exists. The groups that will be discussed in this study, such as the FSB and the Basel Committee, provide forums and collect data from member countries and organizations that provide details into individual country efforts and approaches. Numerous countries participate in the international efforts as both home and host country authorities, contributing their viewpoints and providing insight into their approaches to resolution.

Currently, the mechanisms and structures to facilitate international cooperation are largely at the national levels. For example, Chapter 15 of the Bankruptcy Code, which is modeled after a United Nations model law, provides a mechanism for the resolution of certain international insolvencies within U.S. courts. While certain regional arrangements exist and international efforts are underway to address cross-border insolvency cooperation, there is no definitive framework for the coordinated resolution of cross-border financial groups or financial conglomerates, specifically of those that are considered SIFIs. This study describes the mechanisms that are currently in place, and provides overviews on the suggestions to further facilitate cooperation.

The barriers to effective international coordination are numerous, and will be described further in this study. In general, the barriers to the coordination of

cross-border insolvencies include disparities in, and conflicts between, national laws, including priority of creditor claims, and the difficulties in applying a stay or suspension of actions against the debtor or its assets across borders. The coordination for a SIFI resolution is further complicated by the larger number of legal entities involved, the numerous regulatory regimes that are implicated, and the possible use of public funds to avoid a disorderly collapse.

The recommendations to improve international coordination include the development of resolution plans or frameworks, the development of cooperation and coordination agreements regarding resolution plans among the relevant authorities, and increased access to and sharing of information by regulatory authorities in times of stress. The suggestions of each of the parties are summarized in this study.

This study's conclusion will summarize the proposals and how they address each of the issues listed in the Dodd-Frank Act.

Official Sector Parties—Background Financial Stability Board

The FSB was established in April 2009 as the successor to the Financial Stability Forum (FSF), which was founded in 1999 by the Group of Seven Finance Ministers and central bank governors. The mandate of the FSB, broadly speaking, is to promote global financial stability. The FSB includes international standard-setting bodies and a range of national authorities responsible for financial stability, and operates by consensus. Membership in the FSB was expanded in 2009 to include emerging market countries from the Group of Twenty (G-20).⁶ The United States actively participates in the FSB.

Basel Committee on Banking Supervision

The Basel Committee⁷ was established by the central bank governors of the Group of Ten countries at the

⁶ Current FSB member jurisdictions are Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Mexico, The Netherlands, Republic of Korea, Russia, Saudi Arabia, Singapore, South Africa, Spain, Switzerland, Turkey, the United Kingdom, and the United States.

⁷ Basel Committee members are Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Luxembourg, Mexico, the Netherlands, Republic of Korea, Russia, Saudi Arabia, Singapore,

end of 1974 to fill supervisory gaps exposed by problems in a number of internationally active banks. The Basel Committee formulates supervisory standards and recommendations of best practices that are intended to guide individual national authorities in the implementation of regimes best suited to each national system. The Basel Committee's conclusions and recommendations do not have legal force. The Basel Committee created the Cross-border Bank Resolution Group (CBRG) at the end of 2007 to review and analyze existing resolution policies and legal frameworks and to develop a better understanding of the possible barriers to cooperation. The CBRG's initiatives are discussed further in this study. The U.S. banking agencies are active participants in the ongoing efforts of the Basel Committee and the CBRG.

European Commission

The European Commission (Commission) is the European Union's (EU) executive body and is responsible for proposing legislation. The Commission has outlined an EU framework for crisis management in the financial sector with a goal of a legislative proposal for a harmonized EU regime for crisis prevention and bank recovery and resolution. The coordination of such initiatives within the EU is based, in part, on a harmonized legal and regulatory framework applicable to EU member countries.

UN Commission on International Trade Law

The UN established UNCITRAL in 1966 to develop a framework to further the harmonization of international trade law. The United States is a member of UNCITRAL. UNCITRAL's Working Group V (Insolvency) is engaged in ongoing efforts in the development of an international framework for coordination of cross-border corporate insolvency proceedings.

International Monetary Fund

The IMF is an intergovernmental organization comprised of 187 countries, including the United States. The IMF released a proposed framework in 2010 for the coordination of cross-border bank resolutions, which will be further discussed in the “[International Monetary Fund](#)” section on page 9.

South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

Financial Stability Board Initiatives

The FSB has undertaken a number of initiatives in response to the financial crisis. It has published a list of principles for cooperation in crisis management, and has provided recommendations regarding the supervision of SIFIs. As part of its overall work on SIFIs and to address institutions that are considered “too big to fail,” the FSB is studying the issues posed by cross-border resolutions of SIFIs and has set forth a mid-2011 to end of 2012 timeline for completion of the various actions related to cross-border resolutions.⁸

Principles for Cross-Border Cooperation

In April 2009, the FSF (predecessor of the FSB) released the *Principles for Cross-Border Cooperation on Crisis Management* (FSF Principles).⁹ The high-level principles were developed and endorsed by members of the FSF and committed the relevant authorities to cooperate in making advanced preparations for dealing with and managing financial crises. The principles call for an awareness of the impact that interventions may have on the public purse, and acknowledge that international cooperation is necessary to resolve cross-border financial crises.

The principles are divided between preparation for and management of financial crises. In preparing for financial crises, the principles call on the authorities to

1. develop common support tools for managing a cross-border financial crisis;
2. meet at least annually to consider the specific issues and barriers to coordinated action that may arise in handling severe stress at specific firms;
3. ensure that all countries in which the firm has systemic importance are kept informed of the arrangements for crisis management developed by the primary authorities;
4. share, at minimum, information including the firm's group structure, inter-linkages between the

⁸ The complete timeline is set forth in the Annex to the FSB's paper *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions: FSB Recommendations and Time Lines* (Basel: FSB, October 20, 2010), www.financialstabilityboard.org/publications/r_101111a.pdf.

⁹ Financial Stability Forum, *Principles for Cross-Border Cooperation on Crisis Management* (Basel: FSF, April 2, 2009), www.financialstabilityboard.org/publications/r_0904c.pdf.

firm and the financial system, the firm's contingency funding plans, and potential impediments to a coordinated solution;

5. ensure that firms are capable of supplying information that may be required by authorities to manage a financial crisis;
6. encourage firms to maintain contingency plans and procedures for use in a wind-down situation;
7. ensure that firms maintain robust, updated funding plans that may be used in stressed market scenarios; and
8. seek to remove any practical barriers to efficient, internationally coordinated resolutions.¹⁰

In managing a financial crisis, the principles urge authorities to

1. strive to find internationally coordinated solutions that take account of the impact of the crisis on the financial systems and economies of other countries;
2. share national assessments of systemic implications;
3. share information as freely as practicable with relevant authorities from an early stage;
4. if a fully coordinated solution is not possible, discuss as promptly as possible national measures with other relevant authorities; and
5. share plans for public communication with the appropriate authorities.¹¹

Reducing Moral Hazard Posed by SIFIs

In its October 2010 report, *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions: FSB Recommendations and Time Lines* (FSB Moral Hazard Report), the FSB focused on the systemic and moral hazard risks associated with SIFIs whose failures would cause significant disruption to the global financial system.¹² The FSB Moral Hazard Report recommends that all FSB jurisdictions have in place a policy framework to “reduce the risks and

externalities associated with” the domestic and global SIFIs in their jurisdictions.¹³

The FSB Moral Hazard Report recommends that a policy framework combine

1. a resolution framework and other measures so that all financial institutions can be safely and quickly resolved;
2. a requirement that SIFIs have higher loss absorber capacity to reflect the greater risks that they pose to the global financial system;
3. more intensive supervisory oversight for financial institutions that may pose systemic risk;
4. robust core financial market infrastructures to reduce the contagion risk from the failure of individual institutions; and
5. other requirements as determined by national authorities.¹⁴

As a baseline, the FSB Moral Hazard Report stipulates that any effective approach to address “too big to fail” institutions must have an effective resolution framework, and that a SIFI resolution must be a viable option.¹⁵ In short, a SIFI must be allowed to fail. A national regime must provide national authorities with tools to intervene in a failing institution to continue performance of the firm's essential functions, such as maintaining access to depositor funds, and to transfer and sell viable portions of the firm and apportion losses in a fair and predictable manner.¹⁶ The report concludes that, currently, the “complexity and integrated nature of group structures and operations, with multiple legal entities spanning national borders and business lines, make rapid and orderly resolutions under current regimes virtually impossible.”¹⁷

The G-20 leaders at the FSB's Seoul Summit in November 2010 endorsed the FSB's policy framework outlined in the FSB Moral Hazard Report, including the work processes and timelines set out in it. With respect to the efforts related to SIFI resolutions, the FSB is expected to provide, in mid-2011, criteria for assessing the resolvability of globally active SIFIs. The FSB also is expected to set forth the key attributes of effective resolution regimes, includ-

¹⁰ *Id.* at 2–3.

¹¹ *Id.* at 3–4.

¹² Financial Stability Board, *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions: FSB Recommendations and Time Lines* (Basel: FSB, October 20, 2010), www.financialstabilityboard.org/publications/r_101111a.pdf.

¹³ *Id.* at 2.

¹⁴ *Id.*

¹⁵ *Id.* at 3.

¹⁶ *Id.*

¹⁷ *Id.* at 4.

ing the minimum level of legal harmonization and legal preconditions needed to make cross-border resolutions effective. The FSB, in consultation with the CBRG, expects to conduct thematic peer reviews on key attributes of resolution regimes by the end of 2012.

The FSB provides periodic reports to the G-20 regarding progress in the implementation of its recommendations. In its April 2011 report, the FSB notes that work toward the implementation of recommendations in the FSB Moral Hazard Report is progressing.¹⁸ Specifically, the FSB has established a steering group to oversee the work-stream on resolutions and to develop the key attributes of effective resolution regimes. The FSB's Cross-Border Crisis Management Group is monitoring the development of global SIFI recovery and resolution plans, and is developing elements for effective recovery plans along with a framework to assess the resolvability of individual SIFIs.¹⁹

In addition, various work-streams are underway to analyze issues such as obstacles to, and essential elements of, cross-border cooperation agreements. U.S. banking agencies are actively participating in the FSB's Cross-Border Crisis Management Group.

Other FSB Initiatives

FSB member countries have responded to a survey conducted by the FSB, which details each country's policy developments and implementations that have taken place since 2008.²⁰ The responses were as of September 2010. Each country detailed its progress in addressing various FSB recommendations, including addressing cross-border resolutions of SIFIs. The FSB will conduct an additional survey of national implementation progress and will publish the results around November 2011.

¹⁸ Financial Stability Board, *Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability: Report of the Financial Stability Board to G20 Finance Ministers and Central Bank Governors* (Basel: FSB, April 10, 2011) (FSB Progress Report), www.financialstabilityboard.org/publications/r_110415a.pdf.

¹⁹ *Id.* at 3.

²⁰ Each country's response is separately linked at www.financialstabilityboard.org/publications/r_101111b.htm. The United States, for example, reported that the institution-specific crisis management groups for major U.S. banking organizations continue to meet on a multi- and bilateral basis to address outstanding recovery and resolution issues. U.S. firms have submitted recovery plans to applicable U.S. regulators, and such information will help inform the regulators in developing and maintaining firm-specific resolution plans.

Basel Committee on Banking Supervision Initiatives

The Basel Committee approved the CBRG's mandate in December 2007 to analyze relevant countries' resolution policies for a better understanding of potential barriers and possible improvements to cooperation in the resolution of cross-border banks. During the first half of 2008, the CBRG collected descriptions from countries represented on the CBRG²¹ on issues such as national laws and policies on the resolution of cross-border banks. The CBRG used the responses to identify significant impediments to effective cross-border resolutions of banks. In December 2008, it published an interim report summarizing the existing resolution approaches and identifying differences that may lead to conflicts in cross-border resolutions.

In December 2008, the Basel Committee asked the CBRG to expand its scope to analyze the "developments and processes of crisis management and resolutions during the financial crisis with specific reference to case studies of significant actions by relevant authorities."²² The CBRG conducted case studies of four financial institutions whose experiences during the financial crisis illustrated the problems associated with cross-border crisis management frameworks.²³ The CBRG sought to identify concrete and practical steps to facilitate cross-border crisis management and resolutions. Its recommendations are intended to "strengthen national resolution powers and their cross-border implementation"²⁴ and are also intended to complement the FSB's *Principles for Cross-Border Cooperation on Crisis Management* by providing practicable approaches to implement the principles.

The result of these efforts was the CBRG's *Report and Recommendations of the Cross-border Bank Resolution Group* (CBRG Report).²⁵ In the CBRG Report, the CBRG proposed the following 10 recommendations:

²¹ U.S. members of the CBRG include the Board, the Federal Reserve Bank of New York, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

²² Basel Committee on Banking Supervision, *Report and Recommendations of the Cross-Border Bank Resolution Group* (Basel: CBRG, March 2010) at 8, www.bis.org/publ/bcbs169.htm.

²³ A summary of the case studies is provided in [Appendix B](#).

²⁴ See www.bis.org/publ/bcbs169.htm.

²⁵ See *supra* footnote 22.

1. National authorities should have appropriate tools to address all types of financial institutions in difficulty so that an orderly resolution can be achieved.
2. Each jurisdiction should establish a national framework to coordinate the resolution of the legal entities of financial groups and financial conglomerates within its jurisdiction.
3. National authorities should seek the convergence of national resolution tools.
4. National authorities should consider the development of procedures to facilitate the mutual recognition of crisis management and resolution proceedings.
5. Supervisors should work closely with relevant home resolution authorities to understand how group structures and their individual components will be resolved in a crisis.
6. The contingency plans of all systemically important cross-border financial institutions and groups should address a period of severe financial distress, and provide a plan to preserve the firm as a going concern, and facilitate the rapid wind-down of the firm, if necessary.
7. Different national authorities should have a clear understanding of their respective responsibilities for regulation, supervision, liquidity provision, crisis management, and resolution.
8. Jurisdictions should promote the use of risk mitigation techniques that reduce systemic risk and enhance the resiliency of critical financial or market functions during a crisis.
9. National resolution authorities should have the legal authority to temporarily delay immediate operation of contractual early termination provisions in order to complete a transfer of financial market contracts.²⁶
10. National authorities should consider clear options or principles for exit from public intervention.²⁶

²⁶ CBRG Report at 1–3 (summary of recommendations).

CBRG Report—Issues Raised

The CBRG Report recommendations listed above are discussed in detail in the report, and are intended to address the issues that were identified in the financial crisis. The CBRG Report notes the actions taken during the financial crisis were *ad hoc*, limited by time constraints, and involved a significant amount of public support.²⁷ The CBRG Report drew from case studies of the following cross-border financial crises that illustrated the shortcomings of current frameworks: (1) Fortis Group (Belgium, the Netherlands); (2) Dexia (Belgium); (3) Kaupthing (Iceland); and (4) Lehman Brothers (the United States). These case studies presented certain common issues related to the insolvencies of cross-border financial firms, but also raised issues unique to each institution and relevant jurisdictions. An overview of each case study is provided in [Appendix B](#).

Currently, there is no international insolvency framework for financial firms. The current territorial²⁸ approach to the resolution of cross-border financial firms is due to the absence of a viable international framework, and the reality that legal systems and fiscal responsibilities are national in nature.²⁹ National interests are “most likely to drive decisions particularly where there is an absence of pre-existing standards for sharing the losses from a cross-border insolvency.”³⁰

The CBRG Report explores various options for reform derived from its recommendations. One option is the implementation of a broad and enforceable agreement on the sharing of financial burdens by stakeholders in different jurisdictions, but it acknowledges that such an agreement on the mechanisms for sharing financial burdens appears

²⁷ CBRG Report at 3.

²⁸ The concept of the “territorial” approach, and its counterpart, the “universal” approach, are discussed throughout the literature on international resolutions. Broadly speaking, the “territorial” approach, at its purest, would rely on territorial notions of sovereignty such that parties would have full jurisdiction over all assets within its jurisdiction, but cannot act outside of its jurisdiction. The “universal” approach, at its purest, would require that states agree in advance to one jurisdiction handling the main insolvency proceeding and all other jurisdictions would merely aid the main jurisdiction. Each concept has been modified throughout various proposals. *See, e.g.*, Thomas C. Baxter, Joyce M. Hansen, and Joseph H. Summer, “Two Cheers for Territoriality: An Essay on International Bank Insolvency Law,” *American Bankruptcy Law Journal*, vol. 78 (Winter 2004), pp. 57–91; IMF Paper at 10.

²⁹ CBRG Report at 4.

³⁰ *Id.* at 16.

unlikely in the short term.³¹ The alternative and opposite option is a ring-fencing³² approach of supervision and a territorial approach to resolution,³³ but the CBRG Report notes that this could be counterproductive since ring-fencing in one jurisdiction may lead to stresses on the financial group's legal entities in other jurisdictions. A "middle ground" approach would acknowledge the likelihood of ring-fencing by national authorities in a crisis but implement reforms to promote national resiliency during crisis management and resolution.³⁴ The reforms would include "enhancing the effectiveness of existing risk mitigation processes, including netting, collateral arrangements, and segregation."³⁵

The June 2010 Toronto Summit of the G-20 leaders endorsed the recommendations made in the CBRG Report and the G-20 leaders expressed their commitment to implementing its recommendations. A number of jurisdictions have adopted legislation or are considering legislation to enhance their resolution regimes based on the CBRG's recommendations.³⁶ The CBRG continues to study the issues in conjunction with the initiatives currently underway at the FSB. In July 2011, the Basel Committee released a report summarizing its progress on the development of national resolution policies and frameworks since the CBRG Report was issued.³⁷

European Commission

In an October 2010 communication, the Commission outlined a framework for crisis management in the financial sector based on seven objectives.³⁸ In

January 2011, the Commission published a consultation paper outlining the technical details of a possible EU framework for bank recovery and resolution that gives effect to the seven objectives outlined in the October 2010 communication.³⁹ The Commission indicated that it would adopt a legislative proposal to harmonize the EU regime for crisis prevention and bank recovery in 2011. The Commission stated that it will then examine the need for further harmonization of bank insolvency regimes within the European communities, with an aim toward publishing a report with further legislative proposals by the end of 2012.

In general, the framework outlined by the Commission is intended to apply to all credit institutions and certain investment firms, and envisions granting authorities certain emergency powers for early intervention and to restructure or resolve financial institutions. Accordingly, each EU member state will be required to identify a resolution authority to exercise resolution powers. The framework requires recovery plans from credit institutions that preclude access to public financial support. In addition, the parent financial holding companies will be required to draft a group recovery plan for the consolidated organization. The framework also contemplates providing supervisors powers of early intervention that include requiring the institution to take steps to raise funds, restricting or limiting the business and operations, and requiring the use of net profits to strengthen the capital base. The framework proposes giving resolution authorities resolution tools including authority regarding the sale of business, bridge banks, asset separation, and debt-write down or conversion.

In addition, the EU has in place Directive 2001/24/EC of the European Parliament and of the Council of the EU⁴⁰ that provides for the winding up of credit institutions with branches in other EU member states, and specifies that the winding-up will be subject to a single bankruptcy proceeding in the credit institution's home state. In 2007, the

³¹ *Id.* at 4–5. The CBRG Report notes that the challenges to developing mechanisms for sharing financial burdens of future resolutions would make any short term agreement unlikely.

³² To "ring-fence" is often understood as to separate certain assets or liabilities of a company within a given jurisdiction for the benefit of local creditors.

³³ CBRG Report at 5.

³⁴ *Id.*

³⁵ *Id.* at 6.

³⁶ Two such jurisdictions, the UK and Switzerland, are discussed further in Appendix A. Other jurisdictions include Canada, France, Germany, Japan, Luxembourg, and the Netherlands.

³⁷ Basel Committee on Banking Supervision, *Resolution Policies and Frameworks—Progress So Far* (Basel: CBRG, July 2011), www.bis.org/publ/bcbs200.pdf.

³⁸ European Commission communication, *An EU Framework for Crisis Management in the Financial Sector* (October 20, 2010), http://ec.europa.eu/internal_market/bank/docs/crisis-management/framework/com2010_579_en.pdf. The seven objectives are (1) put prevention and preparation first; (2) provide credible resolution tools; (3) enable fast and decisive action; (4) reduce moral hazard; (5) contribute to a smooth resolution

of cross-border groups; (6) ensure legal certainty; and (7) limit distortions of competition.

³⁹ European Commission (DG Internal Market and Services) working document, *Technical Details of a Possible EU Framework for Bank Recovery and Resolution* (January 6, 2011), http://ec.europa.eu/internal_market/bank/docs/2011/crisis_management/consultation_paper_en.pdf.

⁴⁰ Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding up of credit institutions, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2001:125:0015:0023:EN:PDF>.

Commission launched a public consultation on the directive to determine whether it could be extended to cross-border banking groups.⁴¹ The results of the consultation will be included in the Commission's report on the implementation of the directive due at the end of 2011.

UN Commission on International Trade Law

In 1997, UNCITRAL adopted the Model Law on Cross-Border Insolvency (Model Law) that applies to the insolvency of a single firm with a presence in foreign jurisdictions.⁴² The Model Law focuses on the legislative framework needed to facilitate cooperation and coordination on cross-border insolvency cases, but it does not apply to groups with legally distinct subsidiaries or affiliates. It is also not intended to apply to entities that are subject to special insolvency regimes, such as banks or insurance companies.⁴³ In 2005, the Bankruptcy Code was amended to include Chapter 15, which incorporated the Model Law, with certain modifications.⁴⁴ Further discussion of Chapter 15 is provided in the "Chapter 15 of the U.S. Bankruptcy Code" section on page 14.

The UNCITRAL *Practice Guide on Cross-Border Insolvency Cooperation* (UNCITRAL Practice Guide) is the result of further work undertaken on coordination and cooperation in cross-border insolvency cases.⁴⁵ Adopted by UNCITRAL on July 1, 2009, the UNCITRAL Practice Guide provides "information for practitioners and judges on practical aspects of cooperation and communication in cross-border insolvency cases, specifically in cases involving insolvency proceedings in multiple States."⁴⁶ It outlines various international initiatives

and possible forms of cooperation that may be used when creating a framework to address cross-border insolvencies.

Drawing on case studies and practical experience, the UNCITRAL Practice Guide discusses in detail the use of cross-border insolvency agreements, or similar arrangements, to facilitate the cooperation and coordination of multiple insolvency proceedings in different states. It also provides, at length, suggested language and approaches to drafting such agreements. According to the UNCITRAL Practice Guide, cross-border insolvency agreements have reduced the cost of litigation as parties are able to focus on the conduct of the proceedings, and not disputes such as conflicts of law.⁴⁷

The UNCITRAL Practice Guide notes that such agreements have been successfully used in insolvency proceedings, including those that involve multiple plenary proceedings.⁴⁸ For example, in the insolvency proceedings for Lehman Brothers Holdings Inc., which involved more than 75 insolvency proceedings and 16 jurisdictions worldwide, the parties agreed to a statement of intentions and guidelines⁴⁹ that covered communication among insolvency representatives and among courts and creditor committees, comity, notice, asset preservation, claims, reorganization plans, amendment, execution and application.⁵⁰

International Monetary Fund

The IMF released *Resolution of Cross-Border Banks—A Proposed Framework for Enhanced Coordination*⁵¹ (IMF Paper) in response to calls from G-20 leaders to develop an international framework for cross-border bank resolution. The IMF Paper addresses issues related to the resolution of international financial groups, noting that many cross-border banks exist within financial groups whose activities extend beyond deposit-taking and lending,

⁴¹ An overview of the consultation is provided at http://ec.europa.eu/internal_market/bank/windingup/index_en.htm.

⁴² UN Commission on International Trade Law, *UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment* (New York: UN), www.uncitral.org/pdf/english/texts/insolven/insolvency-e.pdf.

⁴³ *Id.* at Chapter 1, Article 1(2).

⁴⁴ UN Commission on International Trade Law, *Developments in Insolvency Law: Adoption of the UNCITRAL Model Law on Cross-Border Insolvency*, 38th session (Vienna: UNCITRAL, July 4–15, 2005), <http://daccess-dds-ny.un.org/doc/UNDOC/GEN/V05/856/74/PDF/V0585674.pdf?OpenElement>.

⁴⁵ UN Commission on International Trade Law, *Practice Guide on Cross-Border Insolvency Cooperation* (New York: UN, 2010), www.uncitral.org/pdf/english/texts/insolven/Practice_Guide_Ebook_eng.pdf.

⁴⁶ *Id.* at 1.

⁴⁷ *Id.* at 28.

⁴⁸ *Id.*

⁴⁹ The case study notes that the parties were unable to reach a formal signed insolvency agreement because not all would be able or willing to sign an agreement. However, they were permitted to adhere to the terms of the agreement without formal signatures. As such, the agreement became a statement of intentions and guidelines rather than a legally enforceable agreement.

⁵⁰ UNCITRAL Practice Guide at 123–4.

⁵¹ International Monetary Fund, *Resolution of Cross-Border Banks—A Proposed Framework for Enhanced Coordination* (Washington, D.C.: IMF, June 11, 2010), www.imf.org/external/np/pp/eng/2010/061110.pdf.

and that some of the most systemically risky groups are investment banks and broker-dealers. The IMF Paper observed that while international financial groups operate globally, the mechanisms for addressing their failures are local, and do not apply at an enterprise-wide level. The IMF Paper describes the various barriers to coordination, including the lack of authority for supervisors to share information, the absence of a minimum level of legal and regulatory harmonization, the multiplicity of regulatory actors, and the territorial approaches taken by national authorities to prioritize their own stakeholders.⁵²

The IMF Paper sets forth the following four elements⁵³ for a framework for enhanced coordination:

1. Amendment of national laws so as to require national authorities to coordinate their resolution efforts with their counterparts in other jurisdictions
2. Core-coordination standards⁵⁴
3. A specification of the principles that would guide the burden sharing process
4. Coordination procedures designed to enable resolution actions in the context of a crisis to be taken as quickly as possible and to have cross-border effect

The IMF Paper argues for “the establishment of a pragmatic framework for enhanced coordination, which would be subscribed to by countries that are in a position to satisfy the elements” listed above.⁵⁵ The approach would establish such a framework through a nonbinding multilateral understanding.

With the framework in hand, the IMF Paper notes that the ability of subscribing countries to coordinate rapidly and effectively will be “enhanced if there is an established set of procedures that will serve as a road map” during a crisis.⁵⁶ The IMF Paper suggests that the home country authorities should design the overall resolution strategy, including the type of proceeding, to be initiated in the home and host jurisdictions, and should play the

lead role in the conduct of the proceedings.⁵⁷ The procedural road map would have to acknowledge, however, that while the home country accepts a leadership role, the host jurisdiction may need to act independently if doing so is consistent with domestic financial stability and the interests of creditors.⁵⁸

The IMF Paper notes that in the near term, “a limited group of countries that already meet the standards” could “begin to cooperate amongst themselves.”⁵⁹ If these countries represent the world’s main financial centers, then this coordination may propel other countries to adhere to these standards over time.

In May 2011, the IMF released a staff discussion note, *The Too-Important-to-Fail Conundrum: Impossible to Ignore and Difficult to Resolve* (IMF Discussion Note),⁶⁰ that discussed orderly resolutions of SIFIs as part of a larger framework on how to address risks posed by SIFIs’ complexity and interconnectedness, and moral hazard issues associated with SIFIs viewed as “too important to fail.” The discussion on resolution reiterated points made in the IMF Paper, and noted that additional work is needed to “produce methodologies and criteria to assess institutions’ resolvability and the consistent implement of [recovery and resolution plans] across different jurisdictions.”⁶¹

Private-Sector Initiatives

Institute of International Finance

The IIF is a global association of financial institutions.⁶² Its membership includes commercial and investment banks, insurance companies, and investment management firms. The IIF’s activities in cross-border resolutions are led by its Cross-Border Resolution Working Group. In May 2010, the IIF submitted to the FSB its report, *A Global Approach to Resolving Failing Financial Firms: An Industry*

⁵² *Id.* at 9.

⁵³ *Id.* at 3–4.

⁵⁴ The “core-coordination standards” include a harmonization of national resolution rules, robust supervision (including through consolidated supervision), and institutional capacity to implement an international solution. *Id.* at 4.

⁵⁵ *Id.* at 3.

⁵⁶ *Id.* at 25.

⁵⁷ *Id.* at 26.

⁵⁸ *Id.* at 25.

⁵⁹ *Id.* at 27. The IMF Paper does not specify which countries currently meet the standards.

⁶⁰ Yñci Ötoker-Robe, et al., *The Too-Important-to-Fail Conundrum: Impossible to Ignore and Difficult to Resolve*, IMF Staff Discussion Note (Washington, D.C.: IMF, May 27, 2011), www.imf.org/external/pubs/ft/sdn/2011/sdn1112.pdf.

⁶¹ *Id.* at 20.

⁶² See www.iif.com/.

Perspective (IIF Global Approach Report).⁶³ The IIF Global Approach Report followed up in May 2011 with its submission to the FSB, *Addressing Priority Issues in Cross-Border Resolution* (IIF Addressing Priority Issues Submission),⁶⁴ which built upon the IIF's prior works.

IIF Global Approach Report

The IIF Global Approach Report notes the need to create an international framework on cross-border resolution, and proposes the establishment of "a high-level international task force acting under a G-20 mandate" to develop the framework.⁶⁵ While acknowledging that it "will never be possible to have complete confidence" that failures of major firms would not have systemic consequences, or that government intervention would not be needed, the IIF Global Approach Report asserts that a "great deal" can be done to minimize such failures and the need for government interventions, and that in doing so, market discipline will be strengthened and moral hazard reduced.⁶⁶

The IIF Global Approach Report is comprised of the following discussions: (1) recovery and resolution planning; (2) special resolution regimes; (3) national self-sufficiency approaches to regulation and supervision; (4) resolution of cross-border financial firms; and (5) funding resolutions.

The industry, and the IIF, view recovery and resolution planning "very positively," and believe that if "done well, recovery and resolution planning can play a very positive role in ensuring that financial firms are able to exit the market without causing systemic disturbance."⁶⁷ The IIF Global Approach Report does not support the notion of "living wills" whereby firms draft instructions for their own insolvency and liquidation, stating that living wills presume a "static state of the world that can be relied

on for planning purposes."⁶⁸ The IIF Global Approach Report instead considers an approach in which firms make available information regarding their businesses to the authorities such that the authorities have a complete understanding of the firms.⁶⁹ The IIF Global Approach Report makes additional proposals regarding resolution planning, including permitting firms to structure their organizational and legal structures to reflect business models; using identified improvements as the basis for a dialogue with appropriate supervisors, without introducing national ring-fencing around group entities; and ensuring the confidentiality of the plans.⁷⁰

With respect to the creation of special resolution regimes, the IIF Global Approach Report notes that the following principles governing the design of such regimes should be followed:

1. No financial firm should be considered too big to fail.
2. A more resilient system and a change in creditor behavior and counterparty risk management based on the assumption that all firms can fail and that creditors will not be protected from loss are required.
3. Recourse to a special resolution regime should be infrequent.
4. If it is determined that allowing a firm to fail using normal insolvency procedures would lead to systemic consequences, then powers should be available to take steps to maintain systemic stability.
5. Such powers should be tailored to prevailing circumstances.
6. There must be no expectation that shareholders and unsecured, insured creditors will be protected from loss.
7. Private sector solutions should be pursued whenever possible.

⁶³ Institute of International Finance, *A Global Approach to Resolving Failing Financial Firms: An Industry Perspective* (Washington, D.C.: IIF, May 2010), www.iif.com/press/press+148.php. The IIF Report notes that it and the proposals within this report should not be considered a final report, but that the proposals provide a roadmap for progress.

⁶⁴ Institute of International Finance, *Addressing Priority Issues in Cross-Border Resolution*, (Washington, D.C.: IIF, May 2011), www.iif.com/regulatory/.

⁶⁵ IIF Global Approach Report at 9.

⁶⁶ *Id.* at 9 and 13.

⁶⁷ IIF Global Approach Report at 15, 19.

⁶⁸ *Id.* at 20.

⁶⁹ *Id.*

⁷⁰ *Id.* at 21–22.

8. Resolution regimes should operate effectively to manage the exit of cross-border financial entities.⁷¹

The IIF Global Approach Report discusses in detail the scope of such a regime,⁷² when such a regime should be used,⁷³ and the key features of such a regime.⁷⁴

The IIF member firms expressed concerns regarding approaches to regulation or supervision that “seek to achieve enhanced national resilience by reinforcing national boundaries.”⁷⁵ The IIF Global Approach Report states that “[r]egulatory or supervisory requirements to adopt particular structures to support ring-fencing jurisdictions should be avoided.”⁷⁶ In the industry’s view, the development of resolution regimes capable of ensuring that firms, including internationally active firms, are able to exit the market in an orderly manner would “obviate the need for ring-fencing and other approaches that risk increasing fragmentation of the global financial system.”⁷⁷

The development of mechanisms for the resolution of cross-border financial firms, which the IIF views as desirable, requires what the IIF Global Approach Report describes as “significant marshalling of political will.”⁷⁸ To reach political agreement on a framework for the resolution of such firms, IIF believes that a high-level international task force composed of finance ministries, justice ministries, central banks, and regulators at senior levels is required. The IIF Global Approach Report advocates a “multifaceted approach” involving a “convergence of national regimes, coordination of resolution proceedings [and] further consideration of

the achievement of equitable cross-border outcomes.”⁷⁹

The discussion in the IIF Global Approach Report on the resolution funding regime presupposes a reformed financial system that is more resilient to systemic risk, and the introduction of a framework for resolution that facilitates the orderly exit of all financial firms.⁸⁰ The key principles underpinning the resolution funding approach are

1. avoiding failures in the first place should be the main priority;
2. rigor in imposing loss on equity and nonequity capital providers and on uninsured, unsecured creditors;
3. seeking private sector solutions wherever possible; and
4. to the extent that costs arise after losses have been absorbed and after appropriate steps have been taken to maximize the firm’s assets, no expectation that these costs be borne by taxpayers.⁸¹

The IIF Global Approach Report stresses that shareholders and providers of capital must bear the majority of losses associated with failure.⁸² Any additional costs that arise as necessary to preserve financial stability should not include payments to protect such stakeholders against losses. These additional costs should be incurred only to effect the orderly exit and wind-down of the firm.

According to the IIF Global Approach Report, a majority of the industry considers *ex post* solutions desirable since they avoid the moral hazard that may arise from a standing “bail-out” fund. An *ex post* approach would place the responsibility for meeting the cost of avoiding systemic events with the sections of the industry responsible for creating the problem and/or those likely to benefit from the solution.⁸³

IIF Addressing Priority Issues Submission

The IIF efforts are ongoing as it continues to develop a more complete industry perspective and proposals. Its Cross-Border Resolution Working

⁷¹ *Id.* at 24.

⁷² The IIF Global Approach Report recommends that special resolution regimes be available to all firms that have the potential to be systemically important. *Id.* at 24–25.

⁷³ The IIF Global Approach Report urges that a regime be utilized only when the failure of a firm would cause major dislocations to the financial system if the firm’s resolution were governed by existing insolvency laws, with a criteria governing the “triggering” of intervention by the authorities. *Id.* at 25–27.

⁷⁴ The IIF Global Approach Report describes key features of such a regime as including (1) protected transactions and contracts; (2) transfer of assets, liabilities, and contracts; (3) delay of termination clauses; and (4) the powers to preserve value. *Id.* at 27–31.

⁷⁵ *Id.* at 33.

⁷⁶ *Id.* at 16.

⁷⁷ *Id.* at 35.

⁷⁸ *Id.* at 37.

⁷⁹ *Id.* at 16.

⁸⁰ *Id.* at 43.

⁸¹ *Id.* at 44.

⁸² *Id.* at 44–45.

⁸³ *Id.* at 12.

Group has submitted additional papers to the FSB building on previous submissions, including the May 2011 submission, IIF Addressing Priority Issues Submission. The IIF Addressing Priority Issues Submission identifies three priority areas for further investigation: (1) resolution planning for the maintenance of critical functions; (2) “bail-in” mechanisms; and (3) key cross-border issues.⁸⁴

“Critical functions” are determined by their systemic relevance. The IIF would apply the following criteria to define a “critical function”:

1. The function is a critical part of the financial system infrastructure.
2. Users of the service could not reasonably be expected to have put alternative, fall-back options in place *ex ante*.
3. The service cannot be substituted in a timely manner.
4. The service is essential to the financial system and the economy and its failure would cause severe trauma.⁸⁵

While it may be important that firms be able to extract their critical functions in the event of failure, the IIF Addressing Priority Issues Submission reiterated the industry’s view that a firm’s organizational and legal structures should reflect its business model.⁸⁶ To that end, the IIF Addressing Priority Issues Submission states that firms are responsible for providing clear explanations to authorities on how their critical functions may be isolated and transferred in the event of a failure.⁸⁷

A “bail-in” would allow a firm to be recapitalized by, for example, converting a certain proportion of its debt into equity. In general, the industry’s view is that existing debt should not be retrospectively subject to bail-ins, and that bail-in techniques should be prospective.⁸⁸ The submission sets forth draft principles that may support the development of a bail-in regime in various jurisdictions. The submission argues that bail-in measures should be deployed only where it is determined that there is a significant

risk of loss of value such as was seen in the failure of Lehman Brothers.⁸⁹ Designated authorities would be able to exercise “bail-in powers”—power to dilute shareholders or write-off shares of the firm, and power to alter the terms and conditions of subordinated debt of the firm, including the conversion of such debt into equity—at a time that is as close to possible as when the firm would otherwise become insolvent or go into bankruptcy.⁹⁰

Finally, the IIF Addressing Priority Issues Submission discusses key aspects in resolving cross-border firms, with an underlying premise that groups should have the ability to run their business to optimize the “group interest” and that “material disbenefits” would follow from attempts to require firms to adopt particular structures or organizational approaches.⁹¹ The IIF Addressing Priority Issues Submission argues that while a “group interest” perspective may be useful in running a business across numerous legal entities, during times of crisis, tensions between the group interests and legal-entity interests will arise.⁹² The IIF Addressing Priority Issues Submission argues that, while the work currently being undertaken by the FSB on firm-specific crisis management agreements may help alleviate the tensions, such agreements must be legally effective so that they are reliable and enforceable during times of crisis.⁹³ The IIF Addressing Priority Issues Submission further suggests features that should be incorporated into firm-specific agreements, such as a recognition that the home resolution regime will be applied, appropriate depositor protection, requirement for close cooperation among resolution authorities, and an absence of obstacles to the transfer of assets and collateral between jurisdictions.⁹⁴

U.S.-Specific Initiatives

In addition to its participation in the international initiatives discussed above, various branches of the U.S. government have taken steps to address issues

⁸⁴ IIF Addressing Priority Issues Submission at 14.

⁸⁵ *Id.* at 16.

⁸⁶ *Id.* at 17.

⁸⁷ *Id.* at 18. For example, financial firms should be able to clearly describe the function in question, identify how the function is provided by the firm, and identify how the functions may be separated and transferred from the firm.

⁸⁸ *Id.* at 20.

⁸⁹ *Id.* at 22.

⁹⁰ *Id.* at 22. The IIF Addressing Priority Issues Submission states that the primary scope of the bail-in powers would be limited to subordinated debt, and only as a last resort, subject to clear criteria, will it be necessary to bail-in unsecured senior debt.

⁹¹ *Id.* at 12.

⁹² *Id.* at 28.

⁹³ *Id.* at 29 and 31.

⁹⁴ *Id.* at 30.

raised by the potential failure of multi-national SIFIs.

Dodd-Frank Act

The United States responded to the financial crisis with the Dodd-Frank Act, which was passed in 2010. Its provisions are responsive to and consistent with the international coordination initiatives. For example, Title II of the Dodd-Frank Act establishes an orderly liquidation authority, which provides for the resolution of financial institutions if their failures are deemed to have broad systemic consequences for the United States.⁹⁵ Title II permits the FDIC to be appointed as receiver for a nonbank financial firm, the failure of which may cause systemic risk to the U.S. economy. The FDIC may also transfer the firm's assets, liabilities, and operations to a bridge financial institution established by the FDIC.⁹⁶ The Dodd-Frank Act also requires nonbank financial companies supervised by the Board and bank holding companies to make periodic reports regarding such company's plan for its rapid and orderly resolution under the Bankruptcy Code in the event of a financial distress or failure.⁹⁷

Chapter 15 of the U.S. Bankruptcy Code

Chapter 15 of the Bankruptcy Code⁹⁸ (Chapter 15) is based on the UNCITRAL Model Law.⁹⁹ Adopted in 2005, Chapter 15 applies to cases filed on or after October 17, 2005. Chapter 15 applies where

1. a foreign court or foreign representative seeks assistance in the United States in connection with a foreign bankruptcy proceeding;
2. a U.S. or foreign representative on behalf of a U.S. bankruptcy case seeks assistance from a for-

foreign country in connection with a U.S. bankruptcy case;

3. a foreign proceeding and a U.S. bankruptcy case with respect to the same debtor are pending concurrently; or
4. foreign creditors or other interested foreign parties desire to commence a U.S. bankruptcy case or participate in a pending U.S. case or proceeding.¹⁰⁰

Like the Model Law, Chapter 15 does not apply to entities subject to special resolution regimes such as banks and insurance companies.¹⁰¹ Likewise, Chapter 15 does not apply to a foreign bank that operates a branch or agency in the United States.

Chapter 15 provides a comprehensive structure for the U.S. recognition, cooperation, and grant of deference to foreign insolvency proceedings. With Chapter 15, the United States has adopted a “modified universalist” approach to international bankruptcy law.¹⁰² This approach takes the view that “there should be a single main case for an international business in its home country,” but permits a “non-home country court to open secondary insolvency cases to supplement the home country dominant case for a debtor.”¹⁰³ Under Chapter 15, a “foreign representative”¹⁰⁴ may seek recognition in U.S. courts of a “foreign proceeding.” A “foreign proceeding” is the insolvency proceeding in a foreign country.¹⁰⁵ If a U.S. court recognizes that a foreign proceeding is a “foreign main proceeding,”¹⁰⁶ certain provisions of the Bankruptcy Code, such as the automatic stay imposed by section 362, automatically apply to the debtor and its U.S. assets.¹⁰⁷ In addition, the foreign representative may operate the debtor's business and may exercise the rights and powers of a trustee under and to the extent per-

⁹⁵ Dodd-Frank Act, Title II.

⁹⁶ *Id.* at section 210(a)(1)(D).

⁹⁷ Dodd-Frank Act section 165(d). For additional discussion on resolution plans in the context of the Dodd-Frank Act, see, e.g., The Pew Charitable Trusts, *Standards for Rapid Resolution Plans* (May 2011), <http://pewfr.articulatedman.com/admin/document/files/Standards-for-Rapid-Resolution-Plans.pdf>.

⁹⁸ 11 U.S.C. sections 1501–32.

⁹⁹ Samuel L. Bufford, *United States International Insolvency Law 2008–2009* (New York: Oxford University Press, 2009), p. 2. For additional discussions on cross-border insolvencies involving United States enterprises, The American Law Institute has developed proposed principles and procedures for managing the default of a company with its assets, creditors, and operations in one or more NAFTA countries. The American Law Institute, *Transnational Insolvency: Cooperation Among the NAFTA Countries—Principles of Cooperation Among the NAFTA Countries* (New York: Juris Publishing, Inc., 2003).

¹⁰⁰ 11 U.S.C. section 1501(b); see also Bufford, *United States International Insolvency Law*, p. 75.

¹⁰¹ 11 U.S.C. section 1501(c).

¹⁰² Bufford, *United States International Insolvency Law*, p. 24.

¹⁰³ *Id.* at 22–23.

¹⁰⁴ 11 U.S.C. section 1515. A “foreign representative” is any person or body authorized in the foreign proceeding to administer the reorganization or liquidation of the debtor's assets or act as representative of such foreign proceeding. 11 U.S.C. section 101(24).

¹⁰⁵ 11 U.S.C. section 101(23).

¹⁰⁶ A “foreign main proceeding” is a foreign proceeding pending in the country where the foreign debtor has its “center of main interest.” 11 U.S.C. section 1502(4). The “center of main interest” is where the debtor's registered office is located. 11 U.S.C. section 1516.

¹⁰⁷ 11 U.S.C. section 1520(a).

mitted under the Bankruptcy Code.¹⁰⁸ Further, the court and the parties would look to the foreign main proceeding for guidance in determining the proper course of conduct for the Chapter 15 case.

U.S. Banking Regulators

As noted in this study, all three U.S. banking regulators and supervisors—the Federal Reserve, the FDIC, and the Office of the Comptroller of the Currency—are active participants in the international efforts underway, including in the FSB and the Basel Committee. The FDIC, the receiver for failed U.S. banks, has entered into Memoranda of Understanding with international counterparts, such as the Bank of England, to promote greater coordination in the resolution of cross-border firms.¹⁰⁹ The FDIC is also collaborating with the Basel Committee, the IMF, the European Forum of Deposit Insurers, the World Bank, and the Commission to develop and finalize the Methodology for Compliance Assessment of the *Core Principles for Effective Deposit Insurance Systems*.¹¹⁰

Further, the FDIC and the Board published proposed rules regarding resolution plans under section 165(d) of the Dodd-Frank Act, which requires nonbank financial companies supervised by the Board and bank holding companies with assets of \$50 billion or more to report the resolution plan, also called a “living will,” of such a company for its rapid and orderly resolution under the Bankruptcy Code in the event of material financial distress or failure.¹¹¹ The proposed rule notes that such resolution plans will help regulators to better understand a firm’s business and how that entity may be resolved, and will also enhance the regulators’ understanding of foreign operations in an effort to develop a comprehensive and coordinated resolution strategy for a cross-border firm.¹¹²

Conclusion

The overarching theme of the papers presented in this study is the need for an international coopera-

tive resolution framework that can safely and quickly resolve a globally active SIFI (or cross-border financial institution) in a way that mitigates major disruptions to the financial system and without taxpayer support. The four issues raised in section 217 of the Dodd-Frank Act are implicitly and explicitly discussed in the papers surveyed.

Current International Coordination

Coordination of the resolution of cross-border financial institutions can be seen at certain regional levels, such as in the European Union. Efforts at international coordination in bankruptcy proceedings have also occurred between parties through private agreements and protocols, and between countries through adopting the Model Law or similar provisions. Since the recent financial crisis, international public sector groups such as the FSB and the Basel Committee have been working on numerous initiatives to address financial stability and, as outlined in this study, the international coordination of cross-border insolvencies is one such initiative. Such efforts are ongoing and dynamic, with additional information and materials expected in the coming months.¹¹³

Current Mechanisms and Structures for Facilitating International Cooperation

Existing international groups, including standard-setting bodies like the Basel Committee, international financial institutions such as the IMF, and coordinating bodies like the FSB, have added cross-border resolution to their agendas and are actively working to develop better mechanisms to facilitate international cooperation. The ongoing efforts have generated proposals that include input from various parties and countries. The United States banking agencies are active participants in these efforts.

Current mechanisms and structures to facilitate international cooperation in cross-border bankruptcies are largely at the national level. Notably, some countries have adopted the Model Law, which provides a mechanism for the resolution of certain international insolvencies under local law (as is the case with Chapter 15). However, the Model Law’s application is limited by the number of jurisdictions that have adopted it, the exemption of certain types of institutions, and each jurisdiction’s interpretation

¹⁰⁸ *Id.* at section 1520(a)(3).

¹⁰⁹ Federal Deposit Insurance Corporation, *FDIC and Bank of England Announce Enhanced Cooperation in Resolving Troubled Cross-Border Financial Institutions*, press release, January 22, 2010, www.fdic.gov/news/news/press/2010/pr10013.html.

¹¹⁰ See FSB U.S. Report on Monitoring Progress at 17, www.financialstabilityboard.org/publications/r_110401x.pdf.

¹¹¹ 76 *Fed. Reg.* 22,648 (April 22, 2011).

¹¹² *Id.* at 22,649.

¹¹³ See, e.g., FSB Progress Report (outlining upcoming FSB reports and recommendations).

of the Model Law. Protocols and cross-border agreements between parties also have been used as mechanisms to facilitate international cooperation in insolvency proceedings. However, such an agreement can be limited in both its scope and its effectiveness if certain parties in an insolvency proceeding does not participate in the agreement.

Barriers to Effective International Coordination

The barriers to effective international coordination are varied and numerous. As the CBRG Report notes, current legal and regulatory arrangements are not designed to address the insolvency of financial groups operating in multiple, separate legal entities.¹¹⁴ Insolvency proceedings of cross-border firms involve multiple legal entities, courts, and regulatory actors with different policies and objectives. As was pointed out by several papers, national insolvency regimes may greatly differ in their approaches and policy goals and often are designed to deal with domestic failures and to protect domestic stakeholders.¹¹⁵ Legal and regulatory regimes differ across borders giving rise to conflicts of law such that there is no universally agreed approach to certain insolvency issue.¹¹⁶ National interests may often trump other considerations. As pointed out by certain papers, the possible use of public funds would add another layer of complexity.¹¹⁷

¹¹⁴ CBRG Report at 4, 15. *See also* FSB Moral Hazard Report at 3–4; IIF Addressing Priority Issues Submission at 27; IMF Paper at 7–8.

¹¹⁵ CBRG Report at 4; IIF Global Approach Report at 33–34, 37; IMF Paper at 5, 8–9.

¹¹⁶ IMF Paper at 9; UNCITRAL Practice Guide at 9–10.

¹¹⁷ *See, e.g.*, IMF Paper at 12; IIF Global Approach Report at 43–44.

Ways to Increase and Make More Effective International Coordination without Creating Moral Hazard

The papers discuss various recommendations to improve international coordination. As pointed out by some of the papers, SIFIs viewed to be “too big to fail” create moral hazard risks.¹¹⁸ As such, virtually all of the proposals advocate the development of resolution plans for the resolution of such groups so that they may be allowed to fail in an orderly manner.¹¹⁹ Some papers presented in this study express a preference for private rather than public measures to reduce moral hazard and to avoid or minimize the impact of a cross-border financial institution’s insolvency on the larger financial system.¹²⁰ To further improve coordination, parties such as the FSB and the Basel Committee also advocate the adoption by national authorities of a common set of resolution tools, enhanced recovery and resolution planning for individual institutions, and increased access to and sharing of information between relevant authorities.¹²¹ The goal of such measures is to simplify proceedings and provide for quicker and less costly cross-border resolutions with greater cooperation between groups.

¹¹⁸ *See generally* FSB Moral Hazard Report; IIF Global Approach Report; IMF Discussion Note.

¹¹⁹ *See generally* CBRG Report; FSB Moral Hazard Report; IIF Global Approach Report; IIF Addressing Priority Issues Submission; IMF Paper.

¹²⁰ *See, e.g.*, IIF Global Approach Report at 43–47; IMF Paper at 23.

¹²¹ FSF Principles at 3, CBRG Report at 34–35.

Appendix A—Country-Specific Initiatives Overview

In response to the recent financial crisis, individual countries have undertaken various initiatives, specifically the passage of legislation, to address weaknesses exposed in the crisis. These initiatives acknowledged that the regulatory and legal regimes in place did not adequately account for the complexity of many failing institutions. This appendix reviews the initiatives undertaken by the United Kingdom and Switzerland as examples of ongoing efforts.

UK Independent Commission on Banking

The UK Independent Commission on Banking (UK Banking Commission) was established in 2010 to “consider structural and related non-structural reforms to the UK banking sector.”¹²² In April 2011, the UK Banking Commission released its *Interim Report Consultation on Reform Options* (UK Report) setting forth its views on possible reforms and seeking responses to those views, but excluding any final conclusions on any of the matters presented.

The UK Report presents the UK perspective of the recent financial crisis. It observes that UK bank leverage increased significantly, making UK banks more vulnerable to losses.¹²³ Further, when the losses were incurred, banks’ liability structures “proved to be poor at absorbing them.”¹²⁴ The UK was severely affected by the crisis, with a rise in unemployment, a sharp deterioration of public finances, and state intervention in and ownership of the Royal Bank of Scotland and Lloyds Banking Group.¹²⁵ The UK is currently creating a number of new bodies to enhance the supervision of financial service entities and strengthen the stability of the financial system, and the regulatory framework is expected to be in place by the end of 2012.¹²⁶

¹²² UK Independent Commission on Banking, *Interim Report Consultation on Reform Options* (London: UK Independent Commission on Banking, April 2011), at 11, <http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf>.

¹²³ *Id.* at 20.

¹²⁴ *Id.* at 21.

¹²⁵ *Id.* The UK government acquired ownership stakes in the Royal Bank of Scotland and Lloyds Banking Group in October 2008, resulting in an 80 percent and 40 percent state ownership of each, respectively.

¹²⁶ *Id.* at 58.

The UK Report presents options for reform to reduce the probability and impact of bank failures “by increasing the loss-absorbing capacity of banks and by structural reform to create some degree of separation between retail banking and wholesale and investment banking.”¹²⁷ The UK Banking Commission advocates an approach that includes a combination of internal ring-fencing within universal banks¹²⁸ to isolate retail banking, and higher capital requirements together with measures to “make bank debt effectively loss-absorbing.”¹²⁹ The UK Report anticipates that the ring-fencing approach may simplify and reduce the costs of a failing universal bank, allow the UK system to better absorb shocks, and curtail perceived government guarantees.¹³⁰ The UK Report explores various types of loss-absorbing capacities including common equity, increasing the effective loss-absorbency of bank debt (“bail-in”), contingent capital, and depositor preference that subordinates the claims of other senior unsecured creditors to those of depositors.¹³¹

The UK Report is focused on solutions for the UK financial system, but it incorporates the initiatives of other international parties such as the Basel Commission and the FSB. It is not the final view of the UK Banking Commission, but it solicits views, evidence, and analysis of its proposals. The UK Banking Commission is expected to publish its final report in September 2011.

Switzerland

The Swiss Federal Council, which is the seven-member executive council that comprises the Swiss government, established a Commission of Experts (Swiss Commission) on November 4, 2009, to review the economic risks posed by large companies and make recommendations regarding the “too big to fail” issue. On September 30, 2010, the Swiss Commission released the *Final Report of the Commission of Experts for limiting the economic risks posed by large companies* (Swiss Report).¹³²

¹²⁷ *Id.* at 63.

¹²⁸ The UK Report notes that the activities of “universal banks” can generally be divided into retail and wholesale/investment banking, and the ring-fencing approach would be with respect to the retail banking activities. *Id.* at 77. *Cf. supra* at footnote 32.

¹²⁹ UK Report at 63–64.

¹³⁰ *Id.* at 77.

¹³¹ *Id.* at 67–75.

¹³² Switzerland Commission of Experts, *Final Report of the Commission of Experts for Limiting the Economic Risks Posed by*

In addressing the “too big to fail” issue, the Swiss Report notes that a central notion in the discussion is that of “systemic importance.” It identifies the following conditions for a company to be considered “systemically important”:

1. The company performs services that are essential for the economy and are indispensable.
2. Other market participants cannot replace the company’s systemically important services within a time frame that is acceptable for the economy as a whole.¹³³

Given the importance of companies that are considered “too big to fail” to an economy, such companies benefit from implicit state guarantees that may create harmful incentives. The Swiss Report identifies four core measures to remove such incentives and distortions of competition, and to avoid government rescues of such companies. The measures, which are discussed in detail in the Swiss Report, are

1. Capital—the capital measure includes a minimum requirement to maintain normal business activities, a buffer that allows banks to absorb losses, and progressive components that ensure that systemically important banks have higher levels of solvency;
2. Liquidity—the liquidity measure requires banks to have sufficient liquidity to cover its outflows

Large Companies (September 30, 2010), www.sif.admin.ch/dokumentation/00514/00519/00592/index.html?lang=en.

¹³³ *Id.* at 12.

for one month under a stress scenario created by the regulatory authorities;

3. Risk diversification—the risk diversification measure defines the maximum risk that an institution may incur with single counterparties, with an objective to reduce the degree of interconnectedness within the banking sector; and
4. Organization—the organization measures are designed to ensure the continuation of systemically important functions in the event of insolvency.¹³⁴

With respect to capital, the Swiss Report’s commentary on the draft Swiss Banking Act notes that the use of convertible capital, in which debt can be converted into equity (“bail-in”), may be useful in a crisis situation.¹³⁵ By converting debt into capital, the “costs that would otherwise have to be borne by third parties, including the government, are transferred to outside creditors.”¹³⁶ The new provisions should create a legal framework to facilitate the recognition of foreign bankruptcy orders by simplifying the process for recognizing such orders and other insolvency measures ordered by foreign authorities in Switzerland.¹³⁷ The Swiss Report also notes that Switzerland is working with countries to coordinate insolvency measures.¹³⁸

¹³⁴ *Id.* at 21–43.

¹³⁵ *Id.* at 86.

¹³⁶ *Id.* A recent Swiss legislative amendment provides for the authority to impose a debt-to-equity conversion in the context of formal reorganization proceedings.

¹³⁷ *Id.* at 44.

¹³⁸ *Id.*

Appendix B—Case Studies

The CBRG Report presents case studies of the following cross-border financial crises that illustrated the shortcomings of current frameworks: (1) Fortis Group; (2) Dexia; (3) Kaupthing; and (4) Lehman Brothers. These case studies presented certain common issues related to the insolvencies of cross-border financial firms, but also raised issues unique to each institution and jurisdiction. An overview of each case study is provided in this appendix. The overview summarizes only the materials provided in the CBRG Report.

Fortis Group

Fortis Group¹³⁹ (Fortis) was a Belgian/Dutch financial conglomerate with subsidiaries in Belgium, the Netherlands, and Luxembourg. The consolidating and coordinating supervisor was in Belgium, and Fortis was considered systemically important in each of the three countries in which it had subsidiaries.

Fortis' financial difficulties are traced to its 2007 acquisition of ABN AMRO. Due to the financial crisis in 2008, Fortis was unable to strengthen its financial position to finance or integrate the acquisition. In June 2008, doubts increased in the market as to whether Fortis could realize its acquisition plans, and Fortis' market share price began to deteriorate, thereby causing a loss of liquidity.

In September 2008, Fortis clients began to withdraw deposits and Fortis lost access to the overnight interbank market. Fortis turned to the National Bank of Belgium's Marginal Lending Facility of the Eurosystem. Public intervention followed and the Dutch and Belgian governments purchased or increased their holdings of shares of Fortis entities. BNP Paribas also took a majority stake in certain Fortis entities. The sales were transacted and finalized under Belgian law.

The Fortis case involved interventions along national lines, without the use of statutory resolution mechanisms. The Fortis case demonstrated that, in a situation where a firm needed to be quickly stabilized while maintaining the current business as a going concern, formal supervisory crisis management tools may be limited. Disclosure that such tools have been used may undermine mar-

ket confidence or trigger termination events in contracts. Dutch and Belgian authorities also assessed Fortis' situation differently, which led to differences in the sense of urgency.

Dexia

Dexia¹⁴⁰ is the result of a merger between a Belgian and a French bank, and had a significant presence in Luxembourg. Dexia faced financing difficulties in 2008. In September 2008, Dexia's board of directors authorized the increase of the bank's capital by EUR 6.4 billion, portions of which were provided by Belgian and French public and private sector investors and Luxembourg. In October, Belgium, France, and Luxembourg agreed to facilitate Dexia's access to financing, and additional Belgian and French public guarantees were announced the following month.

The Dexia case did not involve the use of statutory resolution mechanisms. Authorities in each of Belgium, France, and Luxembourg agreed to share the burden to ensure that Dexia had continued financing, and to provide time for the sale of certain operations and the retrenching of others. The CBRG Report concludes that tensions caused by the centralization of liquidity management within a cross-border group can be overcome by adequate cooperation between the relevant central banks, and that home and host authorities' clearly stated support to the cross-border group can overcome timing issues related to the resolution process.

Kaupthing

Kaupthing,¹⁴¹ an Icelandic bank, had active branches and subsidiaries in 13 jurisdictions: Austria, Belgium, Denmark, Dubai, Finland, Germany, the Isle of Man, Luxembourg, Norway, Qatar, Sweden, Switzerland, and the UK. In 2007, approximately 70 percent of Kaupthing's operating profits originated outside of Iceland.

In 2008, Icelandic banks faced mounting problems, causing the Iceland government to take control of the banks or put them into receivership. Iceland's central bank lent Kaupthing EUR 500 million, but despite government assurances that Kaupthing would not require the same measures as other Icelandic banks, Kaupthing depositors in the UK with-

¹³⁹ See CBRG Report at 10–11 for the entire Fortis case study.

¹⁴⁰ See CBRG Report at 11–12 for the entire Dexia case study.

¹⁴¹ See CBRG Report at 12–14 for the entire Kaupthing case study.

drew their funds en masse. Kaupthing's UK supervisor, the Financial Services Authority, determined that Kaupthing no longer met the conditions for operating as a credit institution, and therefore should be closed to new business. The UK government also transferred the remaining Kaupthing deposits in the UK to a different bank, and the UK government became Kaupthing's creditor. Despite these developments, Kaupthing continued to provide assurances to its European supervisors that it had enough liquidity to continue to pursue its daily business.

On October 9, 2008, the Icelandic Financial Supervisory Authority took control of Kaupthing. This act triggered a series of reactions from Kaupthing's various European supervisors, including a prohibition from receiving payments not intended for the payment of debts in Germany, the appointment of administrators and commissioners in Luxembourg and Switzerland, respectively, the financing by Finnish banks of a EUR 100 million payback to depositors in Finland, a loan from the Swedish central bank, and a freezing of Kaupthing's assets in the UK.

Ultimately, Kaupthing's growth had exceeded its home jurisdiction's ability to provide effective consolidated supervision or financial support. The case study demonstrates that the limitations of national resources and supervisory capacity affect the ability to respond to a crisis involving institutions that become too large for its home country supervisor. Cross-border expansions may create risks of unmanaged growth without effective supervision by home authorities.

Lehman Brothers

The Lehman Brothers group¹⁴² included 2,985 entities operating in approximately 50 countries. Its overseas entities were subject to host country regulation and in the United States its ultimate holding company was subject to supervision by the Securities and Exchange Commission under the Consolidated Supervised Entities program.

¹⁴² See CBRG Report at 14–15 for the entire Lehman Brothers case study.

Lehman Brothers faced a liquidity issue that led to varying results based on whether certain subsidiaries could obtain a source of liquidity. The Federal Reserve Bank of New York agreed to provide liquidity to the U.S. broker-dealer to facilitate an orderly wind-down that ultimately resulted in the purchase of certain assets and the assumption of certain liabilities by Barclays Capital. Lehman Brothers' London investment firm, however, relied on the holding company for liquidity, which became unavailable once the holding company filed for bankruptcy. The overall outcome is that the various Lehman Brothers entities that were not acquired, including the holding company and the London investment firm, are being wound down by insolvency officials in numerous jurisdictions.

Based on the Lehman Brothers case study, the CBRG Report identified the following factors relevant to effective crisis resolution:

1. In a situation where an acquirer for the entire firm can be identified, counterparties and other parties providing short-term funding will expect some guarantees so that they will continue to do business with the firm in the interim.
2. Government resources may be required to provide liquidity.
3. A prepared resolution plan may be useful to the authorities.
4. Monitoring by regulators and the interactions of insolvency regimes are important.
5. Regulators need to understand and monitor group structures and interdependencies.
6. In the event of a cross-border failure, the insolvency regimes applicable to the major entities will likely be separate proceedings with different policies, priorities, and objectives.
7. These differences make coordination and cooperation among insolvency officials a challenge. Insolvency officials need access to information and records that are part of an insolvency proceeding in another jurisdiction.

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