

A Proposed Chapter 14
for
Large Financial Institutions

MAKING BANKRUPTCY WORK

Thomas H Jackson
for
The Resolution Project at Stanford University's Hoover Institution
Working Group on Economic Policy

The Lehman Bankruptcy

- ⦿ Was using bankruptcy the cause of the shock to the financial system?
- ⦿ Or was the shock caused by the decision not to rescue Lehman?
- ⦿ Or was the shock caused by the signal that other financial firms were likely to face the same negative forces as Lehman?

Lessons “Learned” from Lehman

- ⦿ For SIFIs, bankruptcy is too cumbersome, lacks necessary expertise, and is unsuitable for dealing with systemic consequences
- ⦿ But institutions shouldn’t be “bailed out,” either

The Road to Dodd-Frank Resolution

- ◎ Special need to deal with SIFIs
- ◎ Bankruptcy wasn't always appropriate
 - But many bankruptcy rules were
- ◎ Model of FDIC and failed depository banks provided a useful analogy
- ◎ “Bailouts” of shareholders, managers, and creditors should be avoided
 - Thus, a “failed” SIFI needed to have management replaced and the firm liquidated

Outline of Errors

- ⊙ Borrowing of all bankruptcy rules
 - Particularly those governing “qualified financial contracts”
- ⊙ Borrowing the model of FDIC resolution of depository banks
 - Not using the existing bankruptcy process
- ⊙ Requiring managers to be tossed out and the firm liquidated

The Role of Bankruptcy

- ⦿ Change residual owner to improve decision-making over use of assets
- ⦿ Resolve a “collective action” (“common pool”) problem in debt collection

Reorganization's Lynchpins

- ⦿ “Automatic stay” (Bankruptcy Code §362) to require creditors to act collectively
 - Ancillary rules such as those governing executory contracts (Bankruptcy Code §365)
- ⦿ Management is put under supervision of the bankruptcy court
 - Creditors’ committee
- ⦿ “Reach-back” provisions to prevent opt-out
 - Preference law (Bankruptcy Code §547) for creditors
 - Fraudulent conveyance law (Bankruptcy Code §548) for shareholders

QFCs in Bankruptcy (and Dodd-Frank Title II)

- ◎ Too many special rules
 - Many end up not being so “special,” particularly for repos
 - Others seem unwarranted upon an analysis of attributes and ideas such as monitoring
 - Analysis of attributes does suggest some needed modification to bankruptcy’s rules
 - Sale of cash-like collateral
 - Short (three day; on day) stay on termination of derivatives
 - Expansion of preference law’s “two-point net improvement test”
- ◎ See David Skeel’s presentation yesterday!

The Error of the FDIC Resolution Model for SIFIs

- ◎ Depository Banks: The FDIC “in control”
 - Commercial banks are special in the payment system
 - FDIC, because of deposit insurance, is the real residual owner
 - Prompt resolution is essential

The Error of the FDIC Resolution Model for SIFIs

- ◎ Depository banks vs. SIFIs
 - In Depository Banks, depositors often not seasoned players
 - Government isn't the effective residual owner outside the depository bank context
 - FDIC model doesn't "scale up" well, even for large depository banks

A Common “First Reaction” to Bankruptcy

- ⦿ Existing exclusions
 - Depository banks, insurance companies, commodity and securities brokers
- ⦿ The 1979 Chrysler bailout
 - Assumption about consumer firms in bankruptcy

Objections to Bankruptcy

- ⦿ Too slow to deal with large financial institutions
- ⦿ Lack of judicial expertise with respect to complex financial institutions
- ⦿ No representative for institutions facing systemic consequences

How to Make Bankruptcy Work for SIFIs

- ◎ Why bother?
 - A judicial process, with rules known in advance and buttressed by precedent, public proceedings, and transparency
- ◎ Better than achieving important social and financial goals without use of a government resolution process without these features
 - Not flawless—e.g., the Chrysler bankruptcy—but more likely to constrain bailouts and distortions through statutory priorities and easily-available appellate review than agency resolution

The Basics: Areas of Changes

- ⦿ The creation of a new Chapter 14
- ⦿ The commencement of a Chapter 14 case
- ⦿ A role for the primary regulator
- ⦿ DIP funding for possible prepayments to certain creditors
- ⦿ The treatment of Qualified Financial Contracts
 - See earlier and David Skeel's presentation yesterday

Fit With Other Existing Reform

- ◎ Living wills
- ◎ Trading of many derivatives on exchanges
 - Both facilitate rapid resolution of derivatives portfolios

Creation of a New Chapter 14

- ◎ Special “overlay” chapter for the largest financial institutions
 - Minimum asset size of \$100 billion for combined enterprise
 - Filed concurrently with either a Chapter 7 (liquidation) or Chapter 11 (reorganization)
 - Chapter 14’s rules and procedures take precedence

Creation of a New Chapter 14

- ⦿ Chapter 14 cases are assigned to one of a pre-designated group of Article III district judges in the Second or DC circuit
 - No ability to refer a Chapter 14 case to bankruptcy judges
 - Ability to appoint a special master, with expertise, from a pre-designated panel
- ⦿ Alternative: pre-designated bankruptcy judges
 - Plus: More bankruptcy expertise
 - Minus: Less signal of judicial independence

Commencing a Chapter 14 Case

- ◎ Allow entire large financial institution to enter Chapter 14
 - For such firms, eliminate exclusions for domestic and foreign insurance companies, stockbrokers, and commodity brokers
 - But follow rules such as those for the treatment of customer accounts
 - Allow SIPC and CFTC to be a party to the proceeding
 - No change in current resolution practice of the FDIC over depository banks

Commencing a Chapter 14 Case

- ◎ Allow primary regulator to commence an involuntary Chapter 14 case
 - Include, as “grounds,” that the covered financial institution’s assets are less than its liabilities, at fair valuation, or that it has an unreasonably small capital
 - No need to wait until such time as the institution “is generally not paying ... debts as [they] become due,” §303(h)(1), which, for a financial institution, is likely to be too late

Primary Regulator in Chapter 14

- ◎ The regulator of the business of the covered financial institution, or of any subsidiary, would have standing to be heard or to raise relevant motions
 - Included would the right of the primary regulator to file motions for the use, sale, or lease of property under §363

Primary Regulator in Chapter 14

- ⦿ No exclusive period for the debtor-in-possession to file a plan of reorganization
- ⦿ Primary regulator can file a plan of reorganization

Debtor-in-Possession Financing

- ◎ DIP financing available for partial or complete payouts to some or all creditors
 - Burden of proof on necessity
 - Showing that such payout is likely less than would otherwise be received in bankruptcy
 - Demonstration of no favoritism or undermining of absolute priority rule

Debtor-in-Possession Financing

- ⦿ If the government provides the DIP funds, a showing that no private funds on reasonably comparable terms was available
- ⦿ If such payouts in fact exceed the amounts that would have been distributed in bankruptcy, the DIP funder's claim is subordinated to that extent to the claims of other creditors of the same class

Qualified Financial Contracts

- ◎ As discussed previously (and yesterday)

DISCUSSION