CHAPTER 8

Revised Chapter 14 2.0 and Living Will Requirements under the Dodd-Frank Act

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The purpose of this brief chapter is to demonstrate that, if enacted and made part of US bankruptcy law, Chapter 14 2.0[1] as proposed will facilitate compliance by large financial companies with the provisions in Title I of the Dodd-Frank Act, 21 USC section165 (d), requiring the submission of credible resolution plans (so-called living wills). At the outset, it should be noted that the resolution plans required by Title I of Dodd-Frank are tested against bankruptcy law rather than orderly liquidation authority (OLA) under Title II in assessments of their credibility. Thus, as noted by Tom Jackson, "the effectiveness of bankruptcy law in being able to resolve SIFIs is critically important to the development of credible resolution plans under Title I."[2]

While bankruptcy thus remains the preferred option for resolution under Dodd-Frank, there are substantial impediments to the resolution of a nonbank financial company under existing bankruptcy law. Many of these are addressed by Chapter 14 2.0. This chapter provides a short, relevant summary of Chapter 14 2.0 as recently revised;

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1. The nomenclature "Chapter 14 2.0" is used for consistency. Variations, with somewhat different features and different names, were introduced in the Senate and passed by the House in the 113th Congress. The House version identified the proposal as subchapter V to Chapter 11 of the Bankruptcy Code, while the Senate version created a separate Chapter 14 but also repealed Orderly Liquidation Authority under Title II.

2. Statement of Thomas Jackson before the Subcommittee on Regulatory Reform, Commercial and Antitrust Law, House Judiciary Committee, March 26, 2014.

describes the living will provisions of the Dodd-Frank Act; notes the very early methodology the Federal Reserve and the FDIC appear to be using, at least to date, in applying those statutory provisions in their preliminary assessments communicated (only in early August 2014, after a considerable delay) to the eleven first-wave US filers on their second round of filings; indicates the extensive potential for remedial use of these provisions in the event any of the living wills (continue to) fall short in providing for credible and orderly bankruptcy resolution; and shows how Chapter 14 2.0 will modify the bankruptcy law in ways that facilitate resolution plans and determinations by the Federal Reserve and the FDIC of the "credibility" of such plans.

Chapter 14 2.0

As revised, Chapter 14 2.0 is intended to make the US bankruptcy laws work more effectively for large financial companies, addressing directly some of the problems arising during the Lehman Brothers bankruptcy and also providing an alternative structure that in appropriate circumstances will facilitate a single point of entry (SPOE) type of resolution. The changes to US bankruptcy law, set out in greater detail by Tom Jackson in chapter 2 in this volume, would also alter the operation of existing US law that references and incorporates US bankruptcy law, notably (for present purposes) the "living will" provisions in Title I of the Dodd-Frank Act. Those provisions, section 165(d) of the Dodd-Frank Act, require all covered financial intermediaries with assets equal to or in excess of $50 billion to periodically (annually, now that staggered regular submission schedules have been established) submit resolution plans (generally referred to as living wills) to the Federal Reserve and the FDIC.

The resolution plans are required to demonstrate in detail how the entire entity could be resolved in a "rapid and orderly resolution" without adverse systemic consequences under the bankruptcy (or other relevant) law in the event of material financial distress or failure. The plans as submitted may be determined by the Federal Reserve or the FDIC to be "not credible or not facilitating an orderly resolution under Title 11 [the bankruptcy laws]," in which case the statute further provides for successive rounds of resubmission. If these standards for credibility and facilitation ultimately remain unsatisfied after multiple successive submissions, then the Fed and the FDIC may require modification of operations and divestitures by the covered financial company. To date the agencies have been critical of the submissions on which they have publically commented. The FDIC (but not the Fed) in fact has found that *every* resolution plan from the largest eleven financial companies submitted in the second round of plan filings would fail the statutory test of credibility and facilitating resolution.[3]

Part of the purpose of the living will provision in Title I is to identify and address in advance the significant problems, now well-recognized, arising from the fact that US bankruptcy law as it now exists may not be well-suited for large financial companies. In part that is because these entities are organized juridically for regulatory, tax, geographic, and other reasons rather than by lines of business. Importantly, the judicial processes under bankruptcy operate too slowly in the often rapidly changing circumstances of a distressed and failing financial company, and the filing of bankruptcy generally allows the immediate termination and close-out of very short-term secured financial contracts. The principal example of these problems is, of course, what actually happened in the unplanned sudden Chapter 11 bankruptcy of Lehman Brothers—a serious liquidity run; gradual but untimely close-out of open financial contracts; freezing of collateral in foreign locations in a way that forestalled orderly bankruptcy proceedings in the United States, the home country of the parent entity; and a very lengthy period to evaluate and determine an appropriate (previously unplanned) resolution strategy. Thus, the difficulties of existing

3. Joint Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation press release, "Agencies Provide Feedback on Second Round Resolution Plans of 'First-Wave' Filers," August 5, 2014. Since that time, there have been some more positive indications, including a statement that noted improvements in the most recent submission by Wells Fargo & Co. (joint press release, "Agencies Jointly Provide Feedback on Wells Fargo's Second Resolution Plan and Move Resolution Plan Submission Date for Three Companies," November 25, 2014) and a statement by FDIC Chairman Martin J. Gruenberg that he was expecting progress in the next round of submissions (reported in Bloomberg News, December 11, 2014).

bankruptcy law present a heightened risk that the living wills under Dodd-Frank will be ineffective and there could be the need for (over) use of Title II OLA because the bankruptcy laws do not accommodate financial companies. There is general belief that the extremely negative results in the Lehman Brothers bankruptcy can be avoided or substantially mitigated by the use of OLA under Title II of Dodd-Frank.[4] Chapter 14 2.0 is designed to address that matter directly and make the use of bankruptcy easier and more effective for covered financial companies. If the bankruptcy laws were revised as proposed in Chapter 14 2.0 to better accommodate large financial companies, more credible living wills under Title I could minimize or even avoid the need to use OLA under Title II.[5] In fact, such a change would actually provide a path for bringing Title I and Title II provisions into better coordination.

Proposed Chapter 14 2.0 addresses the shortcomings in the US bankruptcy laws for financial companies in a number of ways. First, in addition to normal reorganization provisions, there are provisions which allow a two-entity reorganization via a sale transaction with notice to relevant parties. Second, and significantly, there are provisions for this sale transaction to occur on a very accelerated basis—over a weekend, if necessary. Third, there are provisions that preserve financial contracts for a brief period, so as to avoid their immediate termination and close-out by counterparties with the consequential possible loss of value. Further, unlike OLA under Title II, there is the

4. An FDIC assessment of the Lehman matter contends that under Title II orderly liquidation procedures, general unsecured creditors might have received "approximately $0.97 for every claim of $1.00." See "The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act," *FDIC Quarterly* 5, no. 2 (2011): 31.

5. Jeffrey Lacker, President of the Federal Reserve Bank of Richmond, recognized this in a recent speech, "Rethinking the Unthinkable: Bankruptcy for Large Financial Institutions," National Conference of Bankruptcy Judges, Chicago, October 10, 2014: "Another provision of the Dodd-Frank Act, however, provides a much more promising strategy for ending 'too big to fail.' Section 165(d) in Title I requires large and complex financial institutions to create resolution plans, also known as 'living wills.'"

bankruptcy assurance of equal treatment of similarly situated creditors. There is a provision designed to ensure that judges with experience and expertise in financial matters preside over the Chapter 14 cases. And the proposed Chapter 14 contemplates accommodating a single-point-of-entry approach similar to what has been developed and planned by the FDIC for use in the exercise of OLA under Title II.[6]

The difficulties with existing bankruptcy law, apparent from the ongoing Lehman experience, have been recognized by the Fed and the FDIC in their comments,[7] issued after a very long period of silence, on the most recent round of living wills submitted by the largest ("first wave") financial intermediaries. The Fed public statement was highly critical of the resolution plans of the largest financial intermediaries, while the FDIC explicitly determined that *none* of the plans submitted by any of the eleven "first wave" filers would be "credible" or would "facilitate resolution." The details of these plans remain confidential and only very short summaries have been released publicly, so additional analysis and assessment here are not possible. Among the major problems identified by the agencies, according to their joint press release, were unrealistic assumptions about international cooperation and about investor and counterparty actions, including actions to terminate financial contracts, as well as possible limitations on the availability of back-office shared services and the absence of any organizational simplification. In effect, this is seen by some as an interim determination by the regulators that the problem of "too big to fail" (TBTF) may not really have been solved by Dodd-Frank, and it may be necessary to (frequently) default from ordinary bankruptcy to OLA under Title II. FDIC Vice Chairman Thomas Hoenig has even called for the repeal of Title I of the Dodd-Frank Act if bankruptcy is found to be impossible for the largest banks.[8]

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6. Additional advantages of Chapter 14 2.0 are set out in detail in Tom Jackson's chapter in this volume.

7. Fed/FDIC press release, "Agencies Provide Feedback on Second Round Resolution Plans."

8. Thomas Hoenig, quoted in "Kill Living Wills If Banks Can't Go Through Bankruptcy," Bloomberg News, September 18, 2014.

While the FDIC and the Fed have not been explicit publicly about the possible detailed fixes to any continued shortcomings of the plans, some guidance is available from what the European Banking Authority has made public with respect to changes that might be sought in circumstances where resolution plans are deemed insufficient or unworkable.[9] These include, among others, changes to financing arrangements and operational structure and changes in business activities and divestitures. All of these are the types of changes contemplated generally by the express provisions of section 165(d), though to date the Fed and the FDIC have been far less explicit than the European Banking Authority on the matter.

Chapter 14 2.0 would directly address the difficulties that first-wave filers have encountered (and which presumably will be encountered by other financial institutions required to file living wills) because satisfaction of the statutory standard—specifically, to reorganize in a credible manner under the bankruptcy law—would be facilitated. In sum, Chapter 14 2.0 would improve pre-failure resolution planning and significantly add to the tools available to address possible contagious panic.

9. European Banking Authority, "Draft Guidelines on the specification of measures to reduce or remove impediments to resolvability and the circumstances in which each measure may be applied under Directive 2014/59/EU," July 9, 2014.