

A Proposed Chapter 14  
for  
Large Financial Institutions

# MAKING BANKRUPTCY WORK

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# Chapter 14 Premise

- A judicial process, with rules known in advance and buttressed by precedent, public proceedings, and transparency

# 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

# 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

# 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

# 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

# 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

- ⦿ Distinguish (most) repos from (most) derivatives/swaps
  - Most repos will have the attributes of secured transactions under UCC Article 9
  - Most swaps will have the attributes of executory contracts under §365
    - Distinction for swaps that function as loans

# QFCs – Repos

- ◎ Repos, as with other secured loans, cannot be “assumed” and are deemed breached upon the commencement of bankruptcy
  - No real change to existing rules
- ◎ If counterparty is in possession of cash-like or highly-marketable securities, it can sell the collateral immediately
  - Right, upon petition, to sell similar collateral even if in the possession of the debtor

# QFCs – Swaps

- ⦿ Three-day stay on termination of swaps by counterparty
  - Permits debtor (limited) time to assume swaps
  - Valuations will be assisted by living wills and by increased trading of swaps on exchanges and through clearing-houses
- ⦿ Terms of a master agreement regarding cross-terminations are respected
  - As a result, the debtor must assume or reject all swaps subject to a master agreement—no “cherry picking”



# QFCs – Swaps

- Master agreement could cross-link swaps, but not repos *and* swaps (since repos are automatically “breached”)
- Upon termination, a swap counterparty has comparable collateral sale rights to repo counterparties

# QFCs and Preference Law

- While focus is on preference law, current rules protecting counterparties from all trustee avoiding powers (except actual fraud) would be removed
- Apply principle of “two-point net improvement test” (for inventory and receivables) to swaps secured by similar “pool like” collateral
  - E.g., “all” the debtor’s mortgage-backed securities

# DISCUSSION