STATEMENT

of

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On behalf of the

NATIONAL BANKRUPTCY CONFERENCE

Before the

SUBCOMMITTEE ON REGULATORY REFORM,
COMMERCIAL AND ANTITRUST LAW

Of the

COMMITTEE ON THE JUDICIARY

U.S. HOUSE OF REPRESENTATIVES WASHINGTON, D.C.

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# EXPLORING CHAPTER 11 REFORM: CORPORATE AND FINANCIAL INSTITUTION INSOLVENCIES; TREATMENT OF DERIVATIVES

[1] Chair of the Capital Markets Committee, National Bankruptcy Conference. Partner and General Counsel, Millstein & Co., L.P. The views expressed in this testimony are expressed solely on behalf of the National Bankruptcy Conference and do not necessarily represent the views of Ms. Vris or of Millstein & Co., L.P. or any of its members or clients.

The National Bankruptcy Conference (the "Conference") appreciates the opportunity to participate in this hearing. The Conference is a voluntary, non- profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws.

The Conference has recognized that a failing systemically important financial institution (SIFI) faces extraordinary challenges when it becomes a debtor under the Bankruptcy Code. In the bankruptcy circumstances considered unique to a SIFI, the debtor is a parent holding company whose chief assets are equity in regulated banks and broker dealers with operations both here and, in the case of global SIFIs (G-SIFIs), internationally. When the parent files, its regulated subsidiaries are likely to be seized by domestic and foreign regulators; depositors may demand their deposits and short term financing throughout the corporate family ceases to roll over, both increasing the need for liquidity and eliminating ready access to it; and remaining assets are sold, some rapidly. In these circumstances, value and liquidity throughout the entire corporate group dissipate quickly to the detriment of all constituents, and the resulting instability and “fire sale” of assets may threaten market confidence in other SIFIs and the assets they hold.

Contributing to this dynamic, a group of provisions in the Bankruptcy Code referred to as safe harbor provisions permit (generally) counterparties to short-term repo financings, swaps and other derivatives to terminate agreements, set off obligations and seize collateral. Ordinarily, once a company becomes a debtor, the automatic stay under the Bankruptcy Code prevents parties from taking any of these actions, preserving asset value for the benefit of all creditors ratably in accordance with legal priorities. However, actions by counterparties to derivatives, or Qualified

Financial Contracts (QFCs) (a term used elsewhere but not in the Bankruptcy Code), are to a meaningful degree exempt from the automatic stay. This freedom to act is firmly embedded in international forms for global transactions of this nature. In addition to being a party to derivatives itself, the parent holding company for the SIFI may have also guaranteed its subsidiaries' derivative obligations. As a consequence, a bankruptcy filing by the parent SIFI who is also a guarantor typically triggers a default under each of its subsidiaries' derivative obligations, permitting the counterparty to demand cash collateral from the subsidiary or even to terminate the derivative prematurely, generating termination obligations for the subsidiary. With access to capital constrained by the parent filing, these new demands can cause a subsidiary which is otherwise financially sound to buckle. It is only a matter of time before the failure of the guarantor parent assures either the seizure (for the regulated banking entities) or filing (for the other entities) of most if not all of its subsidiaries.

The Conference has considered ways in which the Bankruptcy Code could be modified to avoid the meltdown described above without unduly interfering with the global derivatives market.[2] I have attached to my opening statement three resources reflecting the views of the Conference on these issues. The first is a letter from the Conference in January this year submitted to Senators Cornyn and Tommey in response to S. 1861 entitled the "Taxpayer Protection and Responsible Resolution Act ("TPRRA"). The letter recommended modifications to the TPRRA, some technical and some substantive, and identified in more detail than here the challenges a SIFI faces. The other is testimony I presented on behalf of the Conference to the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 in May of last year. The testimony summarized

[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") has created a mechanism for resolution of SIFIs outside of bankruptcy and created other measures designed to minimize the impact of a failed SIFI on the financial system generally. Notably, though, it did not alter the Bankruptcy Code for SIFIs.

prior recommendations the Conference had given the House Judiciary Committee to amend the safe harbor provisions in the Bankruptcy Code. For reference, I have also included the Conference's 2010 letter to Representative Conyers in his capacity as Chairman of the Committee on the Judiciary with a more detailed description of the recommended amendments to the safe harbor provisions. These attachments constitute the Conference's testimony today.

I also present a few observations summarized from the attached materials. First, SIFIs need liquidity to function, and a bankruptcy filing disrupts the ability of a SIFI to pump liquidity throughout its enterprise. Second, even the threat of a bankruptcy filing pulls liquidity and the ability to replace it rapidly away from a SIFI. Third, a bankruptcy filing can trigger the need for even more liquidity throughout the SIFI under its QFCs as counterparties act on their legal remedies largely free from the constraints of the automatic stay.

As stated in the Conference's 2014 letter to Senators Cornyn and Toomey in response to TPRRA (on page 2):

> The NBC generally supports the idea that resolution of [SIFIs] should be done in a manner that (i) maximizes value for stakeholders, (ii) minimizes systemic disruption and moral hazard, yet (iii) protects taxpayers from loss. We accordingly support the growing global consensus that financial firms should be required to maintain a sufficient stack of loss absorbing, contractually or structurally subordinated equity and debt that can be utilized to quickly recapitalize the enterprise . . . .

The Conference has not proposed a single set of modifications to the Bankruptcy Code to address all of these issues. It has recognized the single point of entry (SPOE) approach, which has been proposed both for out of court and bankruptcy resolutions, as a framework which can insulate the operating entities in the SIFI from the shock created by the parent bankruptcy filing.[3] The

[3] Fellow Conferee Donald S. Bernstein testified in his individual capacity before this Subcommittee on December 3, 2013 and in his testimony gave a detailed and excellent description of the SPOE approach. I would refer this

Bankruptcy Code can be effectively amended to permit a SIFI debtor (or regulators on its behalf) to transfer all of the equity it holds in its operating subsidiaries to a newly formed subsidiary, allowing new management to decide how best to handle the operating subsidiaries while allowing the parent to realize and distribute any equity value which might remain after stabilizing and resolving the situation at the operating subsidiaries, utilizing familiar and tested bankruptcy precepts. This SPOE structure assumes there will be coordination with regulators, both domestic and, for G-SIFIs, foreign. In fact, much of that coordination should occur before the bankruptcy filing. The modifications to the Bankruptcy Code to permit the SPOE transaction are not intended to – and cannot -- replace the need for communication with and the cooperation of relevant regulators.

To be effective and to permit the immediate and orderly transfer of assets which is core to the SPOE approach, any SPOE regime must include at least a temporary stay from counterparty actions under QFCs at the parent and subsidiary level. Even with the SPOE approach, though, the Conference considers some ability to access new capital for liquidity essential. The Conference believes that without this, regulators and the market generally will lack the confidence needed to preserve at least a minimal sense of calm without which all parties -- regulators, counterparties and other market participants – will race to seize assets and withdraw liquidity at all levels of the SIFI.

Once again, on behalf of the National Bankruptcy Conference I would like to thank the Chair and the rest of this Subcommittee for inviting the Conference to testify here today and for permitting us to submit our prior work as part of this testimony.

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Subcommittee to his testimony rather than attempt my own description here.

Attachments to Testimony of Jane Lee Vris

On behalf of the

National Bankruptcy Conference

Worldwide Web References

1. Letter from National Bankruptcy Conference dated January 29, 2014 to Senators Cornyn and Toomey regarding R. 1861 – Taxpayer Protection and Responsible Resolution Act

http://www.nationalbankruptcyconference.org/images/NBC%20Ltr%20re%20s%201861%20(Ch%2014).pdf

2. Statement of Jane Lee Vris on behalf of the National Bankruptcy Conference before the ABI Commission to Study Reform of Chapter 11, May 15, 2013

   [Not available without credentials through worldwide web.]

3. Letter from National Bankruptcy Conference dated March 15, 2010 to Representative Conyers regarding Proposed Amendments to the Bankruptcy Code Concerning Exemptions for Financial Contracts

http://www.nationalbankruptcyconference.org/images/National%20Bankruptcy%20Conference-%20Proposed%20Amendments%20to%20the%20Bankruptcy%20Code%20Concerning%20Exemptions%20for%20Financial%20Contracts_3-15-2010.pdf

Letter from National Bankruptcy Conference dated January 29, 2014 to Senators Cornyn and Toomey regarding R. 1861 – Taxpayer Protection and Responsible Resolution Act

**NATIONAL BANKRUPTCY CONFERENCE**
*A Voluntary Organization Composed of Persons Interested in the Improvement of the Bankruptcy Code and Its Administration*



January 29, 2014

Hon. John Cornyn
United States Senate
Washington, DC 20510

Hon. Pat Toomey
United States Senate
Washington, DC 20510

**Re: S. 1861 – Taxpayer Protection and Responsible Resolution Act**

Dear Senators Cornyn and Toomey:

The National Bankruptcy Conference (NBC) is a voluntary, non-partisan, not-for-profit organization composed of about 60 of the nation's leading bankruptcy judges, professors and practitioners. It has provided advice to Congress on bankruptcy legislation for over 75 years. I enclose a Fact Sheet, which provides further information about the NBC.

The NBC has reviewed S. 1861, the "Taxpayer Protection and Responsible Resolution Act" ("TPRRA"), which you introduced last month. We have considered both the substance of the bill and the technical and drafting issues. Our substantive comments follow immediately below. In addition, consistent with our mission of providing technical assistance to Congress in this very technical area of the law, and without regard to our substantive comments, we have reviewed the legislation for technical and drafting issues that might prevent the bill from achieving its policy objectives. Following the substantive comments is our report on technical and drafting issues and our suggested solutions. We hope this report is helpful in your deliberations.

## Background

TPRRA creates a new chapter 14 of the Bankruptcy Code available only for "covered financial corporations", which are bank holding companies or financial institutions. The chapter 14 debtor is likely to be a parent entity with its operations and regulated activities conducted through subsidiaries or affiliates. The chief departure under TPRRA from general bankruptcy concepts is to permit an expedited transfer of potentially all the assets of the debtor at the beginning of the case, to be administered outside of the confines of the debtor's case and away from the jurisdiction of the court. This is accomplished through the rapid transfer of select assets and liabilities to a new bridge holding company, a "bridgeco," whose equity interests are held in trust for the chapter 14 estate and administered by a special trustee approved by the court. A temporary stay prevents the occurrence of certain destabilizing actions during the transfer process. The expectation is that the chapter 14 debtor in possession will thereafter complete a plan process using the same provisions as under a chapter 11 case, culminating in a plan to distribute any proceeds realized by the

special trustee from the equity of the bridgeco to the creditors of the parent company whose debts have not been assumed by the bridgeco as part of the asset transfer.

The bridgeco mechanism attempts to set the stage for and enable what is now commonly referred to as the Single Point of Entry strategy for resolution of SIFIs. The TPRRA does not contain any special liquidity facility and repeals title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, including the potential credit support guaranty facility and the ability of U.S. regulators to take over the resolution process if necessary to gain the cooperation of foreign regulators. The NBC has not studied the repeal of title II and thus takes no position on the repeal, focusing instead on the portions of TPRRA that contain the proposed chapter 14 provisions.

## General Observations

At the outset we note that the NBC has not previously reviewed the TPRRA or any of the proposals on which it is based, so our comments and questions about the bill are necessarily preliminary and general given the limited time we have had for review. Based on our preliminary review, several members expressed serious reservations about whether the approach under TPRRA would work for SIFIs, raising as it does novel and difficult issues. We have provided a preliminary discussion of some of the most important issues below. We will continue to study the bill after submission of this initial letter and hope to provide more detailed drafting comments in the future.

The NBC generally supports the idea that resolution of covered financial corporations[1] should be done in a manner that (i) maximizes value for stakeholders, (ii) minimizes systemic disruption and moral hazard, yet (iii) protects taxpayers from loss. We accordingly support the growing global consensus that financial firms should be required to maintain a sufficient stack of loss absorbing, contractually or structurally subordinated equity and debt that can be utilized to quickly recapitalize the enterprise, as well as assets (such as intercompany loans) that can be contributed to the capital of distressed operating subsidiaries in connection with any such recapitalization. In contrast to the unitary bank model employed in some other countries, the bank holding company structure in the United States facilitates this approach by separating significant amounts of long-term unsecured debt from deposit and account-holding regulated entities, thereby adding an additional layer of loss absorbency at the holding company level.

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[1] "Covered financial corporation" is the terminology used in the TPRRA, section 3(a), adding a new section 101(9A) to the Bankruptcy Code. The entity does not have to be a SIFI, since any bank holding company can qualify for chapter 14. Some of our concerns here, particularly with respect to the need for liquidity and global coordination, are aimed primarily at SIFIs and G-SIFIs. We recognize that a limited number of smaller bank holding companies holding only US assets have been able to restructure on an expedited basis under chapter 11, and if anything, chapter 14 as proposed would potentially make such restructurings easier.

The proposed chapter 14 takes advantage of the bank holding company structure to recapitalize the covered financial corporation by permitting the rapid transfer of select assets—equity in subsidiaries and other assets held at the parent holding company—to the bridgeco, leaving significant (if not most) liabilities of the parent behind. We believe that to be successful, any such recapitalization needs to be announced and accomplished with remarkable speed to stabilize the recapitalized firm and minimize any liquidity "run" or asset fire-sales. The TPRRA addresses this by including expedited procedures to create the bridgeco. (Our detailed comments below suggest ways in which the procedures can be further expedited.) We also believe the temporary stay prohibiting the exercise of rights by counterparties to qualified financial contracts ("QFCs") has the potential to substantially reduce the short-term liquidity and collateral needs of the covered financial corporation and avoid wholesale termination of QFCs on terms disadvantageous to the covered financial corporation, aiding in its near-term stability and ability to recapitalize. Given the interconnectivity of exposure between covered financial corporations which are SIFIs through QFCs, the temporary stay may also significantly reduce the risk of contagion.

Stabilizing and permanently restructuring any financial institution, though, will require some form of immediate liquidity source and/or credit support which the TPRRA does not provide. Despite the speed of the recapitalization proposed under TPRRA, we believe, even under the best of circumstances, it will take a period of time for the market to assimilate information about the financial restructuring of the covered financial corporation before the institution's full access to market liquidity returns.[2] Without some degree of certainty that the bridgeco has sufficient liquidity on its own taking into account the specific assets and liabilities assumed and discarded, that funding will be available at the time of filing, or failing both, without advance planning, communication and coordination among the debtor, the Federal Reserve Board, and regulators worldwide, the commencement of a chapter 14 case may cause ring-fencing by regulators worldwide, flight of short-term capital and value erosion. In severe cases, these events could cause the very sort of run on the regulated subsidiary entities that the Single Point of Entry strategy seeks to avoid.

The TPRRA needs to provide for an additional source of backstop interim liquidity for those covered financial corporations which will file without sufficient liquidity to prevent flight of short-term capital and stabilize the institution, particularly if there is a risk of contagion. The backstop can be limited to fully secured commitments or advances similar to the discount window currently available to banks. At a minimum, consideration should be given to incorporating provisions similar to section 364 to

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[2] The regulated banks held by the bridgeco will have access to the discount window and their deposits will be supported by deposit insurance, both of which should prevent and/or fund any run on its liquidity resources. However, covered financial corporations that are diversified financial firms will have broker dealers, insurers, and other operating subsidiaries which lack access to any credit support other than through the public markets.

permit priming liens in the bridgeco's assets and first-out provisions for any new credit support provided to bridgeco, although we question whether even this will be sufficient to entice the public markets in the early stages of the recapitalization. In any event, all of the NBC's comments below must be understood in the context of our overriding concern that a successful recapitalization which achieves all of the goals stated at the outset of this memorandum cannot be achieved in all cases without some provision for potentially significant credit and collateral support.

## Section-by-Section Comments

**TPRRA Sec. 3(c)**. *Who May be a debtor:* The court should have the power to authorize the conversion of a case under chapter 14 to a case under chapter 7 once the transfer of assets to the bridgeco has occurred pursuant to section 1406. Section 1112 should be modified to permit conversion from chapter 14 to chapter 7. Chapter 7 will be necessary in those instances when a chapter 14 debtor is not able to satisfy the requirements for confirmation of a plan, for example, when the administrative expenses cannot be paid in full in cash.

**TPRRA Sec. 3(b)**. *Applicability of chapters*: Rather than create a full plan process in chapter 14 or create the bridgeco mechanism within existing chapter 11, TPRRA adds a new section 103(m), which incorporates the chapter 11 plan process into chapter 14. Given this approach, section 1401 should be expanded in a manner similar to section 901 after a thorough review of provisions in the other chapters of the Bankruptcy Code to be sure their omission or inclusion is intentional.

**Bankruptcy Code Sec. 1401**. *Inapplicability of other sections*: See above.

**Bankruptcy Code Sec. 1402**. *Definition of "capital structure debt"*: The definition creates a category of liabilities that are not permitted to be transferred over to the bridgeco. It is critical to the success of a chapter 14 recapitalization that many liabilities presumptively do not get assumed by the bridgeco. But great care should be taken with this definition. Liabilities transferred over to bridgeco will presumably receive much better recoveries than those left behind. The potential preferential treatment of certain obligations and liabilities violates the fundamental bankruptcy policy of equality of distribution and should occur only in furtherance of the chapter 14 goals. We considered whether to approach the exercise by restricting the types of debts that bridgeco could assume rather than defining the liabilities that must remain with the chapter 14 debtor, but determined that the Bankruptcy Code should give the Federal Reserve Board and the special trustee flexibility in creating the optimum bridgeco. In any event, the NBC is concerned that debt can be too easily structured to avoid characterization as capital structure debt if the definition is based on the original maturity date and suggests that the following concept would not be as easily manipulated: all unsecured debt for borrowed money for which the debtor is the primary obligator.

**Bankruptcy Code Sec. 1403**. *Commencement of case*: The successful recapitalization under chapter 14 requires speed and certainty. After the fact challenges

to either the appropriateness of the filing or the creation of the trust will undermine the very maintenance or restoration of market confidence and prompt access to sources of liquidity the bridgeco mechanism is designed to achieve. It is critical that the statute be unambiguous, standards clear and opportunity to undo non-existent. Similarly, we anticipate that before the chapter 14 petition is filed, most if not all of the planning for the creation of the bridgeco will have occurred by the Federal Reserve Board and the debtor in coordination with other relevant regulators, sources of funding and, in some cases, potential buyers. A meaningful judicial review process of even one day could jeopardize the process, and the NBC is concerned that the proposed one-day judicial process would not be meaningful in any event given the import of the findings the court is required to make.

We therefore propose here and in other places that certain actions would require Federal Reserve Board approval in lieu of a notice and hearing before a court. We would remove the requirement of a court determination in section 1403(a)(2)(B) and require that for any petition to be accepted, the Federal Reserve Board must make the finding and certification described in section 1403(a)(2)(A). Removing the judicial approval construct would also mean removing the appeal process. To the extent it is considered either necessary or desirable to limit the type of filing that is not subject to judicial review further, we would still recommend removing the judicial approval construct under section 1403(a)(2)(B) so long as the covered financial company has not objected to the Board's action within some very limited period of time. We also recommend that in the event the debtor has either filed the petition or consented to the petition at the time it is filed, the members of the board of directors and management involved in that decision should be able to make it free from any threat of recrimination or penalty from the constituents at the chapter 14 entity. The filing triggers an immediate transfer of potentially all the assets of the chapter 14 entity for a recapitalization process that will be largely without judicial review and will not be undertaken solely for the benefit of the chapter 14 constituents. It is easy to imagine that the constituents' representatives will challenge the decision-making process that results in the extraordinary transfer of assets without legally required approvals under constituent documents, exchange rules and state laws requiring shareholder approval and the like. We would therefore recommend that the statute include some form of safe harbor or exculpation protecting members of the debtor's board of directors and management for participating in the decision-making process, albeit a narrowly crafted one.

**Bankruptcy Code Sec. 1404.** *Regulator*: None.

**Bankruptcy Code Sec. 1405.** *Special trustee and bridge company*. As a preliminary observation, we believe the TPRRA anticipates that either the chapter 14 debtor will have created an intermediary entity which can act as the bridgeco shortly before the filing or one will be created simultaneously with the filing. In either event, the section should more clearly distinguish between (1) the new holding company to which the assets and certain liabilities of the chapter 14 debtor are transferred, (2) the trust, which holds the equity of the new holding company, and (3) the equity of the subsidiaries held, after the transfer, by the new holding company. Section 1405(a)(1) appropriately

requires that the entity should not be a preexisting company which has liabilities and assets prior to the filing, For additional clarification, some consideration should be given to insulating this new bridgeco from preexisting liabilities that attach by operation of law on a joint and/or several basis (for example, certain tax liabilities). Ideally, the provision should also contemplate the transfer of lower-tiered equity interests in a multi-tiered enterprise, while skipping the assets and liabilities of intermediate funding entities, so that bridgeco can recapitalize not only by the conversion of the parent debt to equity but also by similar recapitalization of mezzanine type financing, for example, trust preferred securities, although this additional type of selection requires more detailed analysis.

Management of bridgeco and guardianship of the bridgeco interests will be significant factors in the effort to restore or maintain market confidence. In addition, similar to our comment with respect to section 1403, the designation of the special trustee and management of bridgeco must be rapid and certain. To the extent the Federal Reserve Board has appointed a person (or entity) to act as special trustee at the time the request to create the trust is filed, that appointment should be final, absent subsequent gross negligence, fraud, or similar misconduct. Likewise, the Federal Reserve Board's consent to the designation of senior management at bridgeco should be required, again with the expectation that these individuals will have been selected prior to the actual filing. Once the trust has been established and the selected assets and liabilities transferred, the powers of the special trustee would include the power to replace and appoint new senior management without further court approval. At the chapter 14 case level, we believe that once the bridgeco order has been entered, the mandatory appointment of a trustee rather than the continued control of prior management as a debtor in possession under section 1107 is appropriate. (This should not preclude any party in interest from seeking the appointment of a trustee sooner, and some consideration should be given to an expedited request process if the Federal Reserve Board wants a trustee at the chapter 14 debtor immediately upon filing.) The chapter 14 debtor is not an operating entity after the transfer, and there is no particular expertise existing management has for the negotiation of the allocation of value among the chapter 14 constituents or administration of the claims allowance process. Removal of existing management from the chapter 14 process should add to the perception of fairness in the overall process.

Section 1405(b)(3) requires the special trustee to provide notice to the parties in interest in the chapter 14 of certain corporate actions, including significant actions affecting the assets and liabilities of the bridgeco. Nothing further is provided for, leaving open the possibility that creditors and even equity interest holders in the parent can object in court but equally leaving open the possibility that there is no recourse beyond the ability to voice an objection. The special trustee will require extraordinary skills in executing its fiduciary duties under extreme stress and time constraints. It may seem beyond dispute that there is little a special trustee could do which would harm the chapter 14 constituents beyond the filing itself, but experience has taught us that it is a rare bankruptcy case in which valuation and strategy disputes do not exist. We would

recommend that rather than such an open-ended process creating uncertainty both as to the finality of actions taken by the special trustee and the special trustee's potential legal exposure for taking those actions, the statute permit (but not require) the special trustee to specify any actions it intends to take in furtherance of the recapitalization of bridgeco and its subsidiaries and, so long as the Federal Reserve Board does not object to any of those actions, to allow the bridgeco order to reference such actions and immunize the special trustee and the bridgeco's directors and officers from any liability to the chapter 14 parties-in-interest for taking those actions.

The disclosure statement is a crucial element of the plan proposal process; informed consent is essential. There are known difficulties in gathering and understanding information when a debtor loses access to its books and records. Here, a significant portion of the debtor's books and records may be transferred to the bridgeco and no longer in the control of the chapter 14 entity. The standard for the chapter 14 trustee's access to that information in the current proposal seems unnecessarily high. We recommend that in lieu of "necessary" in section 1405(b)(2)(B), the special trustee should make the information available if "necessary or advisable".

**Bankruptcy Code Section 1406**: *Special transfer of property of the estate*. This section, authorizing transfers of assets into the trust, should make clear that once assets have been transferred into the trust, they are no longer part of the chapter 14 estate by adding a new sentence following the first sentence of section 1406(a): "Property ceases to be property of the estate once the court has ordered the transfer and the transfer has occurred." (Conforming clarifications may also be required to sections 1407 and 1408.) Section 1406(c)(3) should be deleted: the bridgeco will not be a deposit holding entity under any circumstances. To the extent that this provision refers to deposits which the chapter 14 entity itself holds as depositor at any of its subsidiaries, there should be no absolute requirement that all such deposits go over to the bridgeco. Once the bridgeco has been created and assets have gone over, the chapter 14 estate will have no access to cash flow. Conceivably, it might be able to get new (probably expensive) financing, but to the extent it has sufficient cash to fund its chapter 14 administrative expenses and fees, it should be allowed to retain at least some cash for that purpose.

Section 1406(c)(4) requires the court to find by a preponderance of the evidence that the Federal Reserve Board has certified as to adequate assurance of future performance of contacts, leases and liabilities assumed by the bridgeco. We are not certain that this requirement adds anything beyond the certification by the Federal Reserve Board itself, and in any event, believe that the Federal Reserve Board certification should be sufficient. We would therefore recommend substituting a requirement that the Federal Reserve Board provide the certification in a filing with the court for the current section 1406(c)(4). Further, as with our earlier comments on sections 1403 and 1405, we believe that the Federal Reserve Board's consent should also be required. While there is no time period prescribed for the judicial review in this section, the temporary stays in section 1407 and 1408 create a practical 48-hour limit for the review process. We believe it will be far more valuable for the statute to encourage an active dialogue between the Federal Reserve Board and the prospective debtor (whether

as a continuation of the living will dialogue or otherwise) and to that end, the specifics of bridgeco should be in hand and approved by the Federal Reserve Board by the time the filing is made with the court.

We believe that the TPRRA should specifically address the treatment of liens in assets which are transferred to the bridgeco. Section 363(k) provides for credit bidding, but we do not expect that the transfer to bridgeco will occur in any sort of auction process. One possibility would be for the liens to transfer with the assets on a nonrecourse basis; there could also be a mechanism for bridgeco essentially to purchase the collateral by giving the secured creditor cash equal to the value of the lien (although this would have to be accomplished in a manner that did not interfere with the expedited transfer at the beginning of the case). As a practical matter, there may not be much of any secured debt at the chapter 14 entity, but to the extent there is, the transfer process currently leaves the treatment of liens uncertain.

**Bankruptcy Code Section 1407**. *Automatic stay; assumed debt*: See below.

**Bankruptcy Code Section 1408**. *Treatment of qualified financial contracts and affiliate contracts*: Both this section and section 1407 create special stay provisions and are addressed together here. These special stay provisions go beyond established bankruptcy concepts by staying actions against nondebtors and their assets which would otherwise occur because of the condition of the chapter 14 debtor and the transfer to the bridgeco. They also significantly curtail actions by counterparties under QFCs, which normally are protected by a variety of safe harbor provisions under the Bankruptcy Code, safe harbors which include, importantly, special carveouts from the automatic stay under section 362. Both of these new special stay provisions are in our view appropriately limited in duration and scope; they are necessary to give the Single Point of Entry approach to recapitalization a brief moment in time to freeze the effect of the chapter 14 filing until the bridgeco is up and running and has assumed the liabilities, contracts and leases it wants in order to recapitalize.

The transfer provisions are similar to, but not identical to, section 365. Significantly, the bridgeco has the power to assume notwithstanding any state or contractual restrictions, but not the power to assign in a subsequent transaction. We considered whether these special provisions should extend to a subsequent transfer, and concluded that on balance, because of the indeterminate duration of the bridgeco and the myriad of potential transactions it may engage in during that time, it was better not to give special treatment to subsequent transfers.[3]

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[3] Sections 1407 and 1408 identify assumptions, assumptions and assignments, and assignment in various places. We believe the intent in each case is in connection with the transfer to bridgeco and not a subsequent transfer. It is possible that a more consistent use of the different terminology is required. As time permits, we recommend a thorough review of this terminology to avoid confusion later.

We note that in a number of places, these special provisions preclude the termination or modification of rights or obligations during the period in which the special stay provisions are in effect. We believe particularly in light of the fact that debt instruments are included in these special provisions, that the sections should specifically reference acceleration (that is, eliminate or stay any acceleration) and any other modification that occurs automatically upon the occurrence of one the specified events. For example, most debt instruments provide for automatic acceleration of debt upon the debtor's (and sometimes, any of its significant affiliate's) bankruptcy filing. There is no need for this automatic acceleration for debt that is assumed by the bridgeco within the prescribed time limits, and unwinding it may be more than a matter of simply reinstating the debt. Likewise, some securitizations have "flip" or "extinction" clauses which purport to change contractual entitlements to waterfalls upon a bankruptcy filing. These should also not be triggered automatically upon the filing. In other words, the concepts termination and modification should clearly include any alteration in the contractual or legal status quo that occurs because of the events specified, and for the periods specified, in the applicable subsections of sections 1407 and 1408.

The NBC does not have substantive comments on any of the sections following section 1408.

**Technical and Drafting Comments**

As a general comment, the NBC believes it would be preferable to include the provisions on covered financial corporations in a new subchapter V of chapter 11, instead of adding a new chapter 14. Most of the provisions of chapter 11 are applicable to such cases, fewer Bankruptcy Code sections would have to be amended, and it would cause less confusion if the new provisions on covered financial corporations were placed in a new subchapter of chapter 11.

Other comments relate to specific provisions. References are to the new provisions of titles 11 and 28, rather than the bill sections.

**§ 103(*l*) –** As proposed ("Chapter 14 of this title applies only in a case under this title concerning a covered financial corporation"), this subsection suggests that chapter 14 would apply if a covered financial institution files a chapter 7 or chapter 11 petition (even though section 109 would not make it eligible for such a filing). To make it clearer, we suggest: "Chapter 14 of this title applies only in a case under such chapter." That also conforms to the style of section 103 (see 103(i) and (j)).

**§ 103(m) –** The new section 103(m) is fine, but if it is added to the Code it will conflict with section 103(g). Therefore, section 103(g) should be amended as follows: "Except as provided in <u>sections 103(m) and</u> ~~section~~ 901 of this title,…"

**§ 109(i) –** To conform to the style used in other subsections of section 109 (see section 109(d), (e) and (f)), change section 109(i) to: "Only a covered financial corporation may be a debtor in a case under chapter 14 of this title."

**§ 1401 –** Change to read: "Sections 321(c) and 322(b) of this title do not apply in a case under this title."

**§ 1402(2) –** Change to read "…. under section 1405(a) of this title."

**§ 1402(4) –** First, the list of sections referenced in this provision should include section 561. Also, the referenced sections do not define "contractual right." Therefore, change section 1402(4) to the following: "The term 'qualified financial contract' means any contract ~~as defined~~ of the kind described in section 555, 556, 559, ~~or~~ 560, or 561 of this title."

**§ 1402(5) –** Change to "The term 'qualified financial contract' means any contract of a kind ~~specified~~ defined in paragraph (25) …" Note that the sections cited do contain definitions. Also, add "of this title" after "section 761).

**§ 1402 –** The use of the word "trustee" used in sections 1405, 1406 and elsewhere is confusing. Chapter 11 uses that term to mean a person appointed or elected under section 1104. Although section 1107 generally gives the debtor in possession the rights and powers of a trustee, it is unclear whether "trustee" in chapter 14 is meant to include a DIP when a trustee has not been appointed. For example, see section 1405(a), which says "On request of the trustee or the Board, the court may order the trustee to appoint …" Is it intended that a DIP can make that request if there is no trustee? Does the court order the DIP to appoint the special trustee? To make it clear, we suggest that a definition of "trustee" be included in section 1402. If it is intended that "trustee" mean a DIP if there is no trustee, section 1402 can define "trustee" to mean "a person that has been appointed or elected under section 1104 of this title, and that has been qualified under section 322 of this title, to serve as trustee in the case or, in the absence of such person, the debtor in possession."

**§ 1403(a)(2) –** The way the proposed provision is organized, a Board petition certifying circumstance (IV) requires a duplicate certification of imminent financial harm to financial stability in the US (see 1403(a)(2)(A)(i)(IV) and (a)(2)(ii), which are both required). We suggest that (IV) be changed by ending it after "sufficiently soon", thereby deleting "such that the immediate commencement of a case …. financial stability in the United States." An alternative fix would be to move the provision that is now 1403(a)(2)(A)(ii) to follow (a)(2)(A)(i)(III) and then have what is now (a)(2)(A)(IV) as an alternative basis for a Board petition.

**§ 1403(a)(2)(B) –** This refers to the "bankruptcy court" making a determination that the requirements for commencing the case have been satisfied. Is it intended that 28 USC § 157 does not apply? Does the bankruptcy court's authority to make this determination depend on a reference under section 157(a)? Can a district judge withdraw the reference under section 157(d)? If not, perhaps section 1403(a)(2)(B) should start with "Notwithstanding section 157 of title 28." If it is not intended that section 157 be displaced, it may be better to say "court," instead of "bankruptcy court." This also applies in other places where "bankruptcy court" is used. Similarly, section 1403(c)(1)

and (2) refer to the "district court" hearing an appeal. If a district judge withdraws the reference and there is an appeal, it should go to the court of appeals.

**§ 1403(b)(1) –** As proposed, the hearing must be within 12 hours after a certification under section (a)(2)(A), but there is nothing that prevents the certification from being made (signed) before the petition is filed. To avoid the 12-hour period from expiring prepetition, change "makes a certification under subsection (a)(2)(A)" to "files a petition under subsection (a)(2)." The certification must be in the petition. In addition, on lines 19-20, will the wording "with notice only to" create a potential problem if someone else (other than the listed entities) gets actual notice? Would the court proceeding then not be a "hearing described in this subsection"? It may help to insert "given by the Board" between "notice" and "only". This also seems like an indirect way to prohibit notice to other parties (which is apparently the intent). Perhaps change section 1403(b)(2) to directly prohibit such notice ("Only the Board and the entities listed in paragraph (1) may receive notice, attend, or participate in a hearing…").

**§ 1403(b)(2) –** Change the last sentence as follows: "Transcripts of such hearings shall be sealed until the ~~end of~~ the case is closed." The "end of the case" is ambiguous and not consistent with Code style.

**§ 1403(c) –** First, the provision is silent about further appeals to the court of appeals. If the intent is to limit appeals to the district court level, an exception should be provided to make the relevant provisions of title 28 (§§158, 1291, 1292) inapplicable. If an appeal to the court of appeals is contemplated, providing for an expedited appeal should be considered. Second, (c)(1) says that a covered financial corporation may file an appeal, but it is silent on whether the Board may file an appeal if the bankruptcy judge dismisses the case because it finds that the Board has failed to meet its burden to prove that the requirements for the filing have been satisfied? The negative inference is that the Board does not have the right to appeal, but it is not clear? Are they to be treated as the SEC is under section 1109(a)? This should be clarified. It could be clarified by amending proposed section 1404(a). Third, section 1403(c)(2) is missing language specifying within 12 hours of *what* shall the district court review the determination. Should it be "within 12 hours of such determination?

**§ 1403(d)(2) –** Though this may be a substantive comment, it has been suggested that "bankruptcy court shall immediately order" should be changed to "bankruptcy court shall promptly order" to give the court some leeway if it is impractical to issue the order exactly when the time to appeal has expired or when the district court affirms.

**§ 1403(d)(2)(B)(i) –** Change it to read "the period for appeal … has ~~passed~~ expired without an appeal."

**§ 1404 –** The provisions regarding the Board's and the FDIC's standing are unclear. Does "case or proceeding under this title" mean only a proceeding that arises under title 11, or does it have a broader meaning (any proceeding arising under title 11, or arising in or related to a case under title 11)? The "in connection with" phrase is also

unclear in section 1404(b). Also, the authority should be limited to chapter 14 cases (similar to the limitation in section 1109 to "a case under this chapter"). We believe it would be clearer if changed to: "The Federal Deposit Insurance Corporation may raise and may appear and be heard on any issue ~~in any case or proceeding under this title in connection with~~ involving a transfer under section 1406 in a case under this chapter or in any proceeding within such a case." Similar changes should be considered for section 1404(a).

**§ 1405(a)(2) –** It is unclear as to which "estate" this paragraph is referencing. It probably should be changed to "… are property of the estate of a debtor under this chapter" or something similar. We make the same comments with respect to sections 1405(b)(1), 1406, 1408(f)(1), 1408(f)(3), and 1409(a).

**§ 1405(b)(1) –** The special trustee is supposed to be paid "from the assets of the trust and not from property of the estate," but under (a) the assets of the trust are the equity securities of the bridge company and those equity securities are property of the estate (and to be held by the special trustee for the sole benefit of the estate, so the estate continues to hold the beneficial interest of the equity securities). Which assets of the trust would not be property of the estate and, therefore, could be used to pay the special trustee? Consider clarifying this paragraph.

**§ 1406(b)(8) –** Change to "the United States trustee or bankruptcy administrator."

**§ 1406(c)(3) –** The proposed transfer must provide for "the transfer of any accounts of depositors of the debtor…" Since the debtor is the bank holding company, not the bank, how can the debtor transfer deposit accounts (which are not property of the estate in the holding company's bankruptcy case)?

**§ 1406(c)(4) –** Change "leased" to "lease" on lime 14 (typo).

**§ 1407(a)(1) –** Change as follows: "… any debt, contract, lease, or agreement of the kind described in paragraph (2) …." This conforms to the phrasing in section 1407(c)(1) and in (c)(2) on page 20, lines 11-12, and page 21, lines 9-10.

**§ 1407(a)(1)(B)(iv)(III) –** on page 18, lines 1-2, delete "of the bridge company" because the phrase repeats in (a)(a) on line 3.

**§ 1408(a) –** The list of sections referenced at the beginning of section 1408(a) probably should include section 362(o). Consider changing the subsection as follows: "Notwithstanding sections 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 362(o), 555, …."

**§ 1408(c)(1)—**We believe the intent is to nullify certain provisions in a debt, contract, lease, or agreement once it has been assumed by bridgeco, and we recommend that this clarification be made. (This would be similar to the language in section 1408(d) which does specify that the relevant agreement must have been assumed and assigned to the bridgeco.)

**§ 1408(e)** – We question whether the reference to section 1407(b) was intended to be a reference to section 1407(a)(1).

**28 U.S.C. § 298(b)(1)** – The phrase "bankruptcy judges who are experts in cases under title 11 in which a financial institution is a debtor" may be either too high a standard or too unclear? Does taking a course on such cases (perhaps one to be offered by the Federal Judicial Center) make a judge an expert? Does one become an "expert" only by presiding over at least one such case? Assuming it does, are there as many as 10 bankruptcy judges sitting at the same time that have presided over such cases? Should the standard be made clearer and also lowered a bit so that judges who have never presided over a financial institution case, but have completed an FJC course of study or another reputable course of study designed for such cases, and/or have backgrounds in private practice involving financial institutions, be eligible (which would result in a greater pool and in more geographic diversity among the judges)?

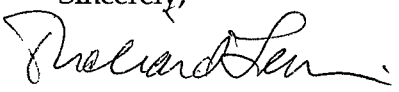
**28 U.S.C. § 298(f)(1)** – The reference to "bridge company formed under section 1405" (page 30, lines 18-19) should be changed because the bridge company is not "formed" under section 1405. We assume it is formed under state law (such as a Delaware corporation). The phrase "formed under section 1405" should be deleted. Since "bridge company" is defined in section 1402, the sentence in section 298(f)(1) should work well without that phrase.

**Conclusion**

We hope these comments are useful in your deliberations. We conclude by noting that this is important legislation, one that is deserving of far more attention and study than we have been able to give it in the time allotted. To the extent the legislative time table permits, the NBC would welcome the opportunity to continue its analysis and submit further recommendations.

With best regards.

Sincerely,



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Statement of Jane Lee Vris on behalf of the National Bankruptcy Conference before the ABI Commission to Study Reform of Chapter 11, May 15, 2013

# Statement Before American Bankruptcy Institute Commission to Study the Reform of Chapter 11
## May 15, 2013

My name is Jane Vris, and I am here today in my capacity as a conferee in the National Bankruptcy Conference and chair of the Conference's Committee on Capital Markets and the Uniform Commercial Code. Our topic today is the treatment of certain financial contracts under the Bankruptcy Code, call them "Qualified Financial Contracts" or QFCs, and I have been invited to share with you the recommendations and conclusions reached by the NBC's Capital Markets Committee after reviewing QFCs under the Bankruptcy Code.

As a preliminary matter, I note that the Capital Markets Committee did not undertake the comprehensive review of QFCs that you are now engaged in, and I salute you for committing to this brave project. The Committee has recognized over the years the extraordinary breadth, as well as importance, of the exemptions and safe harbors afforded QFCs and has addressed certain aspects of those exemptions and safe harbors with specific legislative recommendations. As I sit here today and share these recommendations, I do so with the understanding that on topics as complex and significant as these, the chapter 11 process will be well-served by as much collaboration among bankruptcy professionals – judges, practitioners and professors alike – as possible, and it is therefore a pleasure to be here today with you, a varied and accomplished group of professions, to share the Capital Markets Committee's work.

The Committee has recognized the reasons for the special treatment of QFCs and over the years has consistently affirmed the need for some level of protection for QFCs. It has appreciated that any proposed changes to the safe harbors should neither create uncertainty in the market about the availability of the safe harbor, nor remove the protection from transactions that implicate systemic risk.

However, it has also continuously expressed concern that the safe harbor provisions in their various forms over the years have sheltered transactions which do not pose the type of systemic risk that warrants special treatment. In particular, it has focused on three areas of concern and proposed legislation for each: (1) limiting the protection for securities settlement payments once they have gone to the beneficial holders; (2) protecting the estate's operating assets from the safe harbors exemptions to the automatic stay to avoid frustrating the ability to reorganize; and (3) not protecting forward and commodity contracts entered into purely for commercial supply rather than financial purposes. In addressing each of these, the Committee kept its recommendations as specific and targeted as possible.

**Settlement payments under 546**

Ten years ago, the Committee studied the origins and use of the safe harbor under section 546(e) and concluded then that the section went further than necessary to achieve its original purpose. Congress created the safe harbor in reaction to a ruling in the Ira Haupt case.

A slight digression by way of an interesting history note, one that is useful to remember as you review the safe harbor provisions – the Haupt opinion.[1] Ira Haupt & Co. was a commodities broker which had the misfortune of having as its customer a company run by "a master swindler", in the word of the court. The customer had gone long on salad oil, too long, and collapsed from the effort of meeting variation margin calls as the prices for salad oil dropped. (At one point, it was the buyer for 90% of the salad oil futures contract market.) It filed under old chapter XI. As Ira Haupt made calls on its customer, the clearing association for the New York Produce Exchange in turn required Haupt to post more collateral. Although Haupt had collected collateral from its customer and could have survived (with help from the exchange, which shut down trading in oil futures to avoid further declines), it too

[1] *Seligson v. New York Produce Exchange (In re Ira Haupt & Co., L.P.)*, 394 F. Supp. 125 (S.D.N.Y. 1975).

collapsed with the discovery that the collateral posted by its client consisted of forged warehouse receipts.

The trustee (for the historians here, Charlie Seligson) sued the New York Produce Exchange, its clearing association, directors and officers, and some of the members (big names in commodities: Bunge and Continental Grain). The suit alleged, among other things, that the transfers Haupt made to the clearing association for variation margin payments were fraudulent transfers, payments made by Haupt without receiving fair consideration in return at a time when it was insolvent. The clearing association moved for summary judgment, and the court denied it.

Congress enacted the first safe harbor, former Section 764(c), to overrule the Haupt case. The provision prohibited avoidance of margins or deposits to a commodity broker or forward contract merchant and settlement payments by a clearing organization. The same protection moved to section 546 (then as section 546(d), and since renumbered as section 546(e)) in 1982, when Congress expanded it to the securities exchanges and brokers. By protecting parties participating in the commodities clearance and settlement system (and by subsequent amendment, the securities system as well), Congress wanted to avoid the failure of one participant in the system from spreading to other participants, threatening the entire market – a systemic risk.

After studying the various types of payments protected by the safe harbor in the years since it was first enacted, the Capital Markets Committee found that payments received by beneficial holders of securities, in other words, payments going beyond those made to market system participants, were being sheltered under section 546(e). The Committee concluded that avoidance recoveries from the ultimate recipients of certain transfers on securities, the beneficial owners, would not create the systemic risk the safe harbor was intended to avoid. As an unwarranted limitation on the trustee's power to recovery assets for all creditors, the Committee recommended that actions against beneficial

holders for recovery of redemption payments, principal payments, dividend payments, interest payments or other distributions on or in respect of securities be taken out of the safe harbor provision of section 546(e).

The Committee has periodically revisited section 546(e) (and now its analogues in sections 546 (f) and (g)) and the continuing developments in the case law. Over the years, more, not fewer, types of payments have benefitted from the safe harbor. The Committee has maintained its recommendation, adopted by the Conference, that payments of any kind on securities once received by (or for) ultimate beneficial holders should not be exempt from avoidance actions. It has also expanded its recommendation, more in the nature of a technical amendment, to exclude from the safe harbor actual fraudulent conveyance actions under state law to mirror the exclusion under the federal cause of action in the Bankruptcy Code.

**Protecting operating assets**

Following the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[2] (the "2005 Amendments"), the Committee recognized the growing potential that ordinary loans could be structured, and in fact were being structured, as repurchase or reverse repurchase agreements. The Committee noted that the home mortgage industry relied increasingly on repurchase and reverse repurchase agreements to finance the securitization pipeline, replacing the former warehouse lines for whole loans. The 2005 Amendments explicitly included agreements for the repurchase of mortgage loans, interests in mortgage loans, and mortgage-related securities in the definition of "repurchase agreement" (as well as securities and obligations of Fannie Mae and Freddie Mac). What had previously been ordinary commercial loans known as warehouse lines became protected QFCs. The 2005 Amendments also added security agreements for these repurchase

[2] Pub. L. No. 109-8, 119 Stat. 23 (April 20, 2005).

obligations. As a result, lenders could structure ordinary financings as repurchase agreements secured by a security interest in substantially all of the assets of the borrower, and foreclose on the collateral during the bankruptcy without relief from the automatic stay. This risk is not limited to repurchase agreements; the 2005 Amendments significantly expanded the definition of swaps, the protection for which includes the ability to enforce security agreements, and added a new category of protected transactions, master netting agreements, also with security agreements. (Just to complete the picture, commodity, forward and security contracts also include security agreements, enabling certain counterparties to foreclose, set off or take other enforcement actions notwithstanding the automatic stay.)

The Committee explored different ways of addressing its concern and ultimately proposed that the exemptions from the automatic stay should be limited to "financial collateral", such as cash, U.S. Treasuries and money-market instruments and should not include assets typically used in the operations of a debtor that is not a financial services company In this way, the Committee concluded that the operating assets of a typical non-financial services company business debtor necessary for reorganization - e.g., inventory, trade receivables and equipment and other fixed assets - would remain in the estate without creating any systemic risk of failure in the financial markets.

**Supply contracts with end-users**

The final area of concern which the Committee addressed was the protection given to ordinary course supply contracts to end-users. The Committee followed developments in the case law, which does not currently appear to distinguish the "end-user", that is, a counterparty that contracts for the future delivery of a commodity either expecting to take physical delivery at the end of the contract or hedging for physical delivery it will need, from the market participant. Stated differently, the Committee was of the view that the failure of a debtor to pay for commodities used in its business was

not likely to create the type of systemic risk the safe harbors were designed to prevent, at least so long as that end-user was not itself a financial participant.

The Committee treaded very carefully. It sought some way of distinguishing transactions which threatened the commodity contract system from those that did not. Yet, it also recognized that even if commodity contracts did not pose a systemic risk and were treated like other executory contracts under section 365, the value of a commodity contract can swing widely (and wildly) in a short period of time, creating challenges not usually faced by debtors and creditors (as well as bankruptcy courts) when considering the merits of assuming or rejecting executory contracts.

Ultimately, the approach that garnered the support of the Conference did not rely solely on excluding contracts with end-users. Rather, it excluded certain contracts from the safe harbors, "excluded commodity contracts", but limited the debtor's/trustee's ability to assume or reject to avoid the potential for extraordinary prejudice to the counterparty. First, the debtor/trustee's decision to assume or reject must be made within a limited period of time; second, no cherry-picking with a counterparty would be allowed; third, the debtor would have to perform until it either assumed or rejected; and finally, the counterparty would be entitled to an administrative expense claim for postpetition loss and security for that claim at 105% of the claim amount. Failing assumption by the debtor/trustee, the counterparty would have a limited time to exercise any termination rights it may have. The debtor/trustee could also file a list of financial contracts that would <u>not</u> be treated as excluded commodity contracts within the first 48 hours of filing. In this way, the debtor/trustee could avoid having to perform under the agreement and the counterparty would have all the exemptions and safe harbors commodity contracts generally have under the Bankruptcy Code. Transfers to counterparties to excluded commodity contracts would not be exempt from avoidance actions under section 546.

Even as the Conference reached a consensus on this final, most detailed and elaborate of the Committee's recommendations, the conferees continued a spirited debate on the merits of the 2005 Amendments to the safe harbor provisions generally. This debate is likely to continue, as is the Capital Market's study and consideration of further modifications as the case law develops. There is also some sense in the Conference that the other initiatives and statutory regimes for containing the insolvencies of systemically important financial institutions may affect the need for the safe harbors under the Bankruptcy Code to some extent. Not surprisingly, SIFI initiatives are also a topic of Capital Market attention.

As a postscript to this story, the National Bankruptcy Conference presented all three recommendations to the then Chair of the House Committee on the Judiciary for his consideration. As far as I am aware, there has been no legislative action on these recommendations.

Thank you. I look forward to your report, as, I am sure, do all members of our Capital Markets Committee.

Letter from National Bankruptcy Conference dated March 15, 2010 to Representative Conyers regarding Proposed Amendments to the Bankruptcy Code Concerning Exemptions for Financial Contracts

# NATIONAL BANKRUPTCY CONFERENCE

*A Voluntary Organization Composed of Persons Interested in the Improvement of the Bankruptcy Code and Its Administration*



March 15, 2010

The Honorable John Conyers, Jr.
Committee on the Judiciary
United States House of Representatives
Washington, DC 20515

Re: Proposed Amendments to the Bankruptcy Code
Concerning Exemptions for Financial Contracts

Dear Mr. Chairman:

The National Bankruptcy Conference (the "Conference")[1] is writing to you to propose amendments to the Bankruptcy Code concerning the current exemptions in the Bankruptcy Code for financial contracts. As you may know, following amendments made to the Bankruptcy Code in 2005 and 2006, there has been a significant concern raised by bankruptcy professionals, academicians and others as to whether the current exemptions for financial contracts contained in the Bankruptcy Code are unnecessarily broad. The proposals made by the Conference in this letter would narrow the exemptions for the reasons explained below.

Some background may be helpful. By financial contracts we mean swap agreements, repurchase agreements, securities contracts, commodity contracts and futures contracts, all as defined in the Bankruptcy Code. Financial contracts are currently exempt from many of the provisions of the Bankruptcy Code that would govern ordinary commercial transactions. For example, a non-debtor would normally be barred by the automatic stay in a bankruptcy case from terminating a contract with the debtor based on the commencement of the debtor's bankruptcy case. A non-debtor party to a financial contract is not so barred. Usually a creditor in possession or control of collateral would be barred by the automatic stay in a bankruptcy case from enforcing its rights against the collateral to obtain payment of amounts owed to by it the debtor. A non-debtor party to a financial contract is not so barred. Typically also a creditor who receives a payment or collateral from the debtor on the eve of the commencement of the debtor's bankruptcy case would be vulnerable to the payment or collateral being returned to the debtor's bankruptcy estate as a preference. A non-debtor party to a financial contract is exempt from any preference risk.

[1] The Conference is a voluntary, non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. For approximately 70 years, its primary purpose has been and is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws. A fact sheet describing the Conference and a list of its current members is enclosed.


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The justification for these exemptions is based on a concern about systemic risk. Financial contracts are so much a part of the capital markets that the bankruptcy of a participant may, absent exemptions from the Bankruptcy Code, "freeze" contracts with the debtor from unwinding and produce a "daisy chain" effect of multiple defaults among market participants. The Conference does not question this justification. However, the Conference does question whether the exemptions are currently drafted so broadly that they would exempt from the Bankruptcy Code various non-financial-contract commercial transactions for which the normal rules of bankruptcy should govern, and thereby undermine the goals of the Bankruptcy Code aimed at a collective proceeding involving all creditors and equal treatment of all creditors similarly situated. Indeed, the Conference is concerned that the breadth of the current exemptions affords parties the opportunity voluntarily to structure ordinary commercial transactions, such as loans or supply agreements, as financial contracts in order to fall within the exemptions and avoid the normal rules of bankruptcy, even though the transactions pose no or little systemic risk.

The Conference in this letter is making three proposals. The first proposal is to confine collateral securing performance under financial contracts and benefiting from the exemptions to so-called "financial collateral". The second proposal is to limit the defense relating to a settlement payment on a security so that the defense is not available to the beneficial holder of the security. The third proposal is to provide a separate scheme for forward and commodity contracts where the underlying commodity is actually used or sold in the ordinary course of the debtor's business. Each of these proposals is discussed below.

I. Financial Collateral

The current exemptions contain no limitation on the types of collateral against which a non-debtor counterparty may exercise contractual rights with the benefit of the exemptions. Therefore, a non-debtor counterparty to a financial contract, such as a swap agreement, may exercise its secured party rights against the collateral posted for such agreement free from any bankruptcy stay, regardless of whether the collateral is cash or securities (as would be common for a swap agreement) or the debtor's plants, equipment and other operating assets (which would be quite uncommon for a legitimate swap agreement). Indeed, the use of uncommon collateral in what is otherwise facially a protected financial contract may be a strong indicator that the transaction is, in fact, a secured loan or commercial arrangement that has been documented to appear to be a financial contract entitled to the exemptions.

The unfettered exercise of secured party rights against operating assets could end the debtor's prospects for reorganization, and thus likely lead to the termination of its employees and the loss of going concern values to other creditors and stakeholders. Where collateral is cash, securities or other fungible financial assets, affording a non-debtor counterparty the right to realize on such collateral free from the automatic stay should not deprive the debtor of its reorganization prospects. In contrast, where the collateral is operating assets – which can often be unique or practically irreplaceable – not only does the type of collateral raise serious issues as to the bona fides of the transaction as a protected contract, but the loss of the automatic stay can be fatal to the debtor's reorganization prospects. The Conference's proposal limits the special protections related to the exercise of contractual rights against collateral to financial assets of types that are usual for legitimate protected financial contracts and do not present as high a level of risk to reorganization prospects.

Attached as Exhibit A is a draft of the suggested amendments to the Bankruptcy Code to confine recourse to collateral under the financial contracts exemption provisions solely to collateral that is "financial collateral" as defined in the draft. The draft is designed to exclude from the exemptions recourse to collateral consisting of a debtor's operating assets on the theory that the transactions are likely abusive ones, i.e., transactions that in economic effect are ordinary commercial transactions, but are structured as derivative transactions merely to benefit from the exemptions. In the Conference's view, these abusive transactions do not implicate systemic risk and should not benefit from the exemptions.

II. Settlement Payments

Bankruptcy Code § 546(e) was designed to protect prepetition transfers under securities contracts from avoidance as preferential transfers or fraudulent transfers. For example, a mark-to-market margin payment under a securities purchase agreement, securities loan, margin loan, clearing advance or other securities contract might be subject to avoidance as a preferential transfer absent § 546(e) protection. Similarly, § 546(e) protects intermediaries in the national securities clearance and payment process from avoidance exposure with respect to the transfers for which they act as intermediaries.

There has been disagreement among the courts as to the scope of the § 546(e) protection with respect to payments to shareholders in connection with leveraged buyouts and similar transactions. Absent § 546(e), shareholders who received payouts for their stock in connection with a leveraged buyout that rendered the target company insolvent may be vulnerable to recovery of their payouts as constructive fraudulent transfers by the target company's bankruptcy estate. The recovered amounts would be available to repay the target company's unpaid creditors. Most (but not all) courts have interpreted § 546(e) sufficiently broadly as to immunize shareholders from such recoveries if they received their payouts through the national securities clearance or payment system or even merely from a bank, even though no securities contract was implicated and they are not themselves securities or payment intermediaries. The Conference believes that this result is unfair and unnecessary to protect the securities markets.

Attached hereto as Exhibit B is a draft of the suggested amendments to §§ 546 and 550 of the Bankruptcy Code to permit recourse to the beneficial holder of a security on which a settlement payment is made if the settlement payment otherwise constitutes a constructive fraudulent transfer. The proposed amendments would not affect the exemptions under those sections currently available to banks, brokers and other intermediaries who are not the beneficial holder of the security.

III. Forward and Commodity Contracts

The current Bankruptcy Code financial contract exemptions apply to forward and commodity contracts because forward and commodity contracts are regularly traded, much in the same way as securities are traded, and pose many of the same systemic risk issues. However, the exemptions for forward and commodity contracts are so broadly drafted that they could include ordinary commodity supply contracts by which the debtor in ordinary course of its business sells a commodity to an end-user or buys a commodity from a supplier for use in the debtor's business.

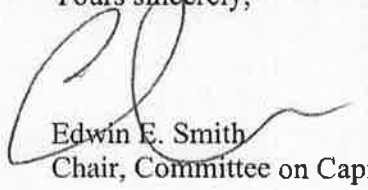
The Conference is of the view that commodity supply contracts in which in the ordinary course of its business the commodity is sold by the debtor to an end-user or is used by the debtor should not pose systemic risk issues and therefore should not be exempt from the ordinary bankruptcy rules. However, the Conference has been unable to formulate a "bright line" rule that would distinguish a forward or commodity contract that is regularly traded and that poses a systemic risk concern from an ordinary supply contract that does not pose a systemic risk concern. The difficulty in devising a "bright line" rule lies in part in the fact that many debtors enter into forward and commodity contracts not only to sell or use the underlying commodity but also to hedge market volatility risk. Accordingly, a supplier or end-user will often preserve the option to trade a forward or commodity contract even though it would otherwise sell or use the underlying commodity.

Given that the efforts of the Conference to distinguish a forward or commodity contract that is regularly traded from an ordinary supply contract have not been successful, the Conference instead proposes a different scheme for forward and commodity contracts. Under this scheme, a debtor in possession would have a very short opportunity to elect that all forward and commodity contracts between the debtor and a single counterparty not have the benefit of the exemptions otherwise applicable to the contracts. If the election is made, the forward and commodity contracts with the single counterparty would be governed by a set of rules under which, if the debtor in possession wishes to preserve the value of the forward and commodity contracts for the benefit of the debtor's bankruptcy estate, the debtor in possession is required to post cash collateral in favor of the counterparty to cover postpetition volatility risk. In this way, the debtor in possession may retain the value of the forward and commodity contracts by "putting its money where its mouth is," while at the same time the non-debtor counterparty is protected by the cash collateral posted.

Attached hereto as Exhibit C is a more detailed outline as to how these provisions would work. If there is sufficient interest in exploring this proposal, we would be happy to work with you to develop statutory language.

We encourage you to consider the Conference's proposals, and look forward to discussing them with you. If you would like any further information, please contact me by telephone at (617) 951-8615 or by email at Edwin.smith@bingham.com.

Yours sincerely,



Edwin E. Smith
Chair, Committee on Capital Markets

Attachments and Enclosure

**Amend section 362(b)(6), (7), (17) and (27) as follows:**

(b) The filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay –

* * *

(6) under subsection (a) of this section, of the exercise by a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency of any contractual right (as defined in section 555 or 556) <u>to foreclose on, dispose of, draw against, demand and receive payment under, or otherwise realize on any financial collateral</u> under any security agreement or arrangement or other credit enhancement forming a part of or related to any commodity contract, forward contract or securities contract, or of any contractual right (as defined in section 555 or 556) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such contracts, including any master agreements for such contracts;

(7) under subsection (a) of this section, of the exercise by a repo participant or financial participant of any contractual right (as defined in section 559) <u>to foreclose on, dispose of, draw against, demand and receive payment under, or otherwise realize on any financial collateral</u> under any security agreement or arrangement or other credit enhancement forming a part of or related to any repurchase agreement, or of any contractual right (as defined in section 559) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreements for such agreements;

* * *

(17) under subsection (a) of this section, of the exercise by a swap participant or financial participant of any contractual right (as defined in section 560) <u>to foreclose on, dispose of, draw against, demand and receive payment under, or otherwise realize on any financial collateral</u> under any security agreement or arrangement or other credit enhancement forming a part of or related to any swap agreement, or of any contractual right (as defined in section 560) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreements for such agreements;

* * *

(27) under subsection (a) of this section, under subsection (a) of this section, of the exercise by a master netting agreement participant of any contractual

right (as defined in section 555, 556, 559, or 560) to foreclose on, dispose of, draw against, demand and receive payment under, or otherwise realize on any financial collateral under any security agreement or arrangement or other credit enhancement forming a part of or related to any master netting agreement, or of any contractual right (as defined in section 555, 556, 559, or 560) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such master netting agreements to the extent that such participant is eligible to exercise such rights under paragraph (6), (7), or (17) for each individual contract covered by the master netting agreement in issue; and

* * *

**Amend section 101 to insert the following after paragraph (21B):**

(21C) The term "financial collateral"

(A) means, with respect to one or more contracts of the kind described in paragraphs (1) through (5) of section 561(a), --

(i) any property sold or to be sold in the performance of such contracts, cash, cash equivalent, security, instrument, certificate of deposit, mortgage loan, or interest in a contract of the kind described in paragraphs (1) through (5) of section 561(a) (except in each case any security or instrument issued or executed by the debtor or a person under common control with the debtor), in each case which also secures obligations under such contracts;

(ii) any other property not used in the operation of any business owned or conducted by the debtor or a person under common control with the debtor, in each case which secures obligations under such contracts; or

(iii) any letter of credit, guarantee, reimbursement agreement or other credit enhancement issued or provided by a person other than the debtor for the obligations under such contracts (regardless of any recourse that such person may have to the debtor), in each case which provides credit enhancement for obligations under such contracts; and

(B) notwithstanding subparagraph (A), does not include --

(i) any receivable ~~(as defined in section 547(a)(3))~~ arising in the ordinary course of business of the debtor or a person under common control with the debtor relating to the sale or lease of goods, the provision of services or the licensing of information; and

(ii) any property that was not of a kind described in subparagraph (A) at the time of the filing of the petition, and the proceeds of such property.

**Note: The Section 362(b) portion of the foregoing is identical to the Drafting Committee report of July 23, 2008. The Section 101(21C) portion of the foregoing contains changes from such report in clauses (A)(i) and B(ii).**

EXHIBIT B

**Amend Section 546(e) as follows:**

(e) Notwithstanding sections 544, 545, 547, 548(a)(l)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except

(1) a transfer that is otherwise avoidable under section 548(a)(l)(A) of this title; or

(2) a transfer that is otherwise avoidable under section 544, 545, 547, 548(a)(1)(B) or 548(b) of this title, but only to the extent such transfer is a redemption payment, principal payment, dividend payment, interest payment or other distribution on or in respect of a security, made for the benefit of the beneficial holder of the security, by or on behalf of the issuer of the security or another entity obligated with respect to the security.

**Add a new Subsection (g) to Section 550 as follows:**

(g) The trustee may not recover any transfer of a kind described in section 546(e)(2), except from the entity that is the beneficial holder of the security on or in respect of which such transfer is made.

**Note: The Section 546(e) portion of the foregoing is identical to the Drafting Committee report of July 23, 2008. The Section 550(g) portion has been changed.**

# Excluded Commodity Contracts
## Outline of Key Provisions

New definition of "excluded commodity contract".

An "excluded commodity contract" would be any "forward contract" or "commodity contract" (or similar term, such as "forward agreement") for the purchase or sale of a commodity actually used or sold by the debtor in the ordinary course of its business, including a hedging contract for actual business operations, if the debtor is not a "financial participant".

Replacement protections applicable to excluded commodity contracts.

Except as to all excluded commodity contracts with a single counterparty listed by the debtor or trustee in a statement filed with the court within 48 hours after the order for relief, the Bankruptcy Code's exemptions for financial contracts would not apply to an excluded commodity contract. The exemptions that would not apply would include exemptions from avoidance relating to the excluded commodity contract itself or any guaranty of, security interest securing, or other credit enhancement of the excluded financial contract.

Instead, the following protections would apply:

*Interim post-petition performance.* Pending assumption or rejection of each excluded commodity contract, the trustee would be required to perform all terms of the contract (other than provisions described in section 365(b)(2)) that are required to be performed by the debtor post-petition. During this period the trustee would not be required to pay any unpaid amounts on an excluded commodity contract that were required to have been paid by the debtor pre-petition.

*No cherry picking.* The trustee would not be permitted to cherry pick among excluded commodity contracts with a single counterparty. All such contracts with the counterparty would have to be either assumed or rejected.

*Administrative expense claim for "in the money" claims including post-petition changes in value.* If, on the date on which excluded commodity contracts with a particular counterparty are assumed or rejected, the net market value to the counterparty of the excluded commodity contracts (measured across all such contracts) is positive, then the counterparty would have an administrative expense claim for any amount by which the net market value to the counterparty on that date is greater than the net market value (by the same measure) of all those contracts on the earlier of the date of the order for relief and the post-petition date on which the net market value (by the same measure) to the counterparty is first positive.

*Cash collateral to be posted to secure the administrative expense claim.* The trustee would be required to post cash collateral, starting no later than X (~5) days after

the date of the order for relief, to secure payment of the administrative expense claim (determined, as to each counterparty, as if all of such excluded commodity contracts were being assumed or rejected as of the date of determination) in an amount equal to 105% of the allowable administrative expense claim, and the counterparty would be required to return any excess cash collateral. Cash collateral would be posted or returned each business day based on the closing price at the end of the prior business day. The amount of cash collateral to be posted under this provision would not be subject to modification by any agreement between the debtor and the counterparty, except a post-petition agreement approved by the court.

*Period in which to assume or reject.* The trustee would have up to Y (~30) days after the order for relief to move for court approval to assume or reject the contract. Cash collateral would continue to be posted or returned as required pending court approval. If the contract is not assumed within that time period, it is considered rejected.

*Effect of rejection.* If a counterparty's excluded commodity contracts are rejected, the counterparty's netting rights would be preserved, and the contracts would no longer be "excluded", i.e., all financial contract exemptions would apply (including with respect to collateral posted post-petition for any administrative expense claim). The counterparty would then have a period of up to 30 days following the rejection date to exercise the counterparty's right under the financial contract exemptions to terminate the contracts and exercise liquidation and netting rights without leave from the bankruptcy court. In addition, on rejection, the counterparty's damage claim under section 365(g) would be measured as of the rejection date (subject to sections 562(b) and (c)), rather than as of the petition date.

*Stay relief.* If the trustee fails to post cash collateral, otherwise perform the excluded commodity contract or timely assume the excluded commodity contract, then stay relief would be automatic for the counterparty, all excluded commodity contracts of that counterparty would cease to be excluded commodity contracts, and the general financial contract exemptions would be available to the counterparty.

*Transition provisions*

The foregoing treatment of excluded commodity contracts would apply to a contract entered into on or after the date of enactment. If a confirmation is entered into on or after the date of enactment under a master agreement entered before the date of enactment, the foregoing treatment would apply to the confirmation.

The foregoing treatment would not otherwise apply to a contract, or to a confirmation under a master agreement, entered into before the date of enactment unless the contract or confirmation were amended on or after the date of enactment to add a commodity or to increase the amount of a commodity, the price for a commodity or margin or collateral or to provide a guaranty or other credit enhancement of the debtor's performance.

# National Bankruptcy Conference

*A non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws.*

**History.** The National Bankruptcy Conference (NBC) was formed from a nucleus of the nation's leading bankruptcy scholars and practitioners, who gathered informally in the 1930's at the request of Congress to assist in the drafting of major Depression-era bankruptcy law amendments, ultimately resulting in the Chandler Act of 1938. The NBC was formalized in the 1940's and has been a resource to Congress on every significant piece of bankruptcy legislation since that time. Members of the NBC formed the core of the Commission on the Bankruptcy Laws of the United States, which in 1973 proposed the overhaul of our bankruptcy laws that led to enactment of the Bankruptcy Code in 1978, and were heavily involved in the work of the National Bankruptcy Review Commission (NBRC), whose 1997 report initiated the process that led to significant amendments to the Bankruptcy Code in 2005.

**Current Members.** Membership in the NBC is by invitation only. Among the NBC's 60 active members are leading bankruptcy scholars at major law schools, as well as current and former judges from eleven different judicial districts and practitioners from leading law firms throughout the country who have been involved in most of the major corporate reorganization cases of the last three decades. The NBC includes leading consumer bankruptcy experts and experts on commercial, employment, pension, mass tort and tax related bankruptcy issues. It also includes former members of the congressional staff who participated in drafting the Bankruptcy Code as originally passed in 1978 and former members and staff of the NBRC. The current members of the NBC and their affiliations are set forth on the second page of this fact sheet.

**Policy Positions.** The Conference regularly takes substantive positions on issues implicating bankruptcy law and policy. It does not, however, take positions on behalf of any organization or interest group. Instead, the NBC seeks to reach a consensus of its members - who represent a broad spectrum of political and economic perspectives - based on their knowledge and experience as practitioners, judges and scholars. The Conference's positions are considered in light of the stated goals of our bankruptcy system: debtor rehabilitation, equal treatment of similarly situated creditors, preservation of jobs, prevention of fraud and abuse, and economical insolvency administration. Conferees are always mindful of their mutual pledge to "leave their clients at the door" when they participate in the deliberations of the Conference.

**Technical and Advisory Services to Congress.** To facilitate the work of Congress, the NBC offers members of Congress, Congressional Committees and their staffs the services of its Conferees as non-partisan technical advisors. These services are offered without regard to any substantive positions the NBC may take on matters of bankruptcy law and policy.

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