

Can Regulators End Too Big to Fail?

A Discussion of Dodd-Frank Resolution Planning

Financing a Financial Institution's Bankruptcy Proceeding under Dodd-Frank Title I

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The Need for Cash in Bankruptcy

- ***The filing of a voluntary bankruptcy case*** under chapter 11 (reorganization) or chapter 7 (liquidation) ***does not create funding***
- ***Most companies in chapter 11 do not generate sufficient cash*** to fund their operations and restructuring
- Debtor ***must obtain post-bankruptcy “DIP” financing*** from a lender or consortium of lenders willing and able to lend

The Need for Cash in Bankruptcy

The financing required will be substantial:

Largest US Banks by asset value (US\$)

JPMorgan Chase	-	\$2.6T
Bank of America	-	\$2.1T
Citi	-	\$1.8T
Wells Fargo	-	\$1.7T

The largest DIP loan facilities:

Calpine Corporation (2007)	-	\$10.0B
Energy Future Holdings (2014)	-	\$ 9.9B
Lyondell Chemical (2009)	-	\$ 8.5B
Chrysler LLC (2009)	-	\$ 4.9B
ResCap (2012)	-	\$ 1.6B
American Airlines (DIP/exit financing 2013)	-	\$ 1.5B
Lehman (Barclay “loan to own” 2009)	-	\$ 0.45B

Postpetition or “DIP” Financing

- Bankruptcy Court may approve interim DIP financing on an emergency basis on limited notice at the “first day” hearing “to the extent necessary to avoid immediate and irreparable harm to the estate pending a final hearing”

11 USC § 364; Federal Rule of Bankruptcy Procedure (FRBP)
4001(c)(2)

Secured DIP Loans

- DIP loan can be unsecured, though a ***DIP lender almost always will require collateral***
- DIP loan ***cannot “prime”*** (i.e., be given lien priority over an existing prepetition lien in the same collateral) ***unless*** that prepetition lender is given “adequate protection” against any resulting diminution in its collateral position (11 USC § 364(d))

Collateral for DIP Financing – Effect of Prepetition Loans and Liens

- **The BHC's equity (i.e., shares) in its solvent subsidiaries is the most likely collateral for the large DIP financing that will be required for an orderly resolution in bankruptcy**
- **If the BHC granted prepetition liens in that equity then its value as collateral will be that much less, or will be zero if the prepetition secured debt is “undersecured,” i.e., the amount of the prepetition secured debt exceeds the value of the equity**

DIP Financing by the “Undersecured” Prepetition Lender

- **Few new lenders are willing to lend in a subordinate position (behind existing liens) in a bankruptcy**
- **Thus though an existing, prepetition lender cannot be forced to lend postpetition, in non-bank bankruptcies the DIP loan is most often provided by the existing lender because a prepetition lender, especially if “undersecured,” that provides the DIP loan can maximize and preserve the enterprise value of its collateral**

Financial Companies May Be Different

- **It is not clear that either this self-interest or the secured party's ability to act on it will be present in a financial institution's bankruptcy proceeding**
 - **Secured party and collateral may not be subject to automatic stay (e.g., repo lending)**
 - **BHC may have granted liens in the shares to secure its guaranty of subsidiaries' derivatives and other unstayed QFCs, and the secured party may determine that immediate collateral liquidation is preferable to the risk/benefit of a longer-term outcome**
 - **The secured party may be unable to lend new funds during a period of systemic stress**

Dubious Resolution Funding Sources

- A **“fortress” consolidated balance sheet** makes a financial institution more resilient but ***does not*** of itself create funding for a bankruptcy case - unencumbered collateral is still needed
- **Asset sales** under 11 USC § 363 can preserve going concerns – but **proceeds must first be applied to payment of existing, pre-bankruptcy liens**
- **Intercompany payables may takes years to legally characterize** (debt, subordinated debt, equity), and the **debtor that owes the payable may not be able to pay**
 - Lehman Brothers Holdings Inc. Plan Disclosure Statement, Case No. 08-13555 (Bankr. S.D.N.Y.), Docket No. 19629

Do Current Resolution Plans Protect Collateral Available for DIP Financing?

Fed and FDIC, 4/5/14: “plans submitted by the first-wave filers **are not credible and do not facilitate an orderly resolution under the U.S. Bankruptcy Code.**”

Actions required to address some common shortcomings:

- establishing a **rational and less complex legal structure**
- developing a **holding company structure that supports resolvability**
- providing for a **stay of certain early termination rights of external counterparties** triggered by insolvency on an industry-wide and firm-specific basis

<https://www.fdic.gov/news/news/press/2014/pr14067.html>

First-wave filers are: Bank of America, Bank of New York Mellon, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street Corp., UBS.

Feasible Resolution Plans

- What can be done to improve the likelihood of a “rapid and orderly resolution” *under the Bankruptcy Code*, without taxpayer or other governmental assistance, in the event of the company’s “material financial distress or failure?”
- Fostering the creation and maintenance of “clean holding companies” (see e.g., Fed’s 10/30/15 TLAC proposal)

Feasible Resolution Plans

Preserving collateral value available for DIP financing:

- **Minimal or no secured debt against BHC's assets** (e.g., its shares in its subsidiaries)
- **Limits on cross-collateralizations, cross-defaults, and downstream secured guaranties by the BHC**
- **More extensive automatic stay protection to preserve collateral and enterprise value *and* drive parties toward a negotiated resolution** based on the longer-term interests of the parties, similar to that which occurs in a non-bank bankruptcy

Too Big Too File?

- Lehman *did* resolve itself under the Bankruptcy Code (neither rapidly nor orderly), though others including Bear Stearns, AIG, Fannie Mae and Freddie Mac did not
- **5 years after Dodd-Frank, the resolution plans of the largest financial institutions remain inadequate, in the view of their regulators, to provide for their rapid and orderly resolution without governmental assistance under the Bankruptcy Code**

Too Big Too File?

- **Can a large, distressed financial institution** conclude a “rapid and orderly resolution” in a bankruptcy proceeding as required by Dodd-Frank § 165, or is it too big to file?
- **Sufficient DIP financing will be key**, and can be achieved only by the firm’s **protecting and maintaining adequate unencumbered collateral, both in good times and during periods of firm-specific and systemic stress**