GEORGETOWN LAW

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Analysis of the Taxpayer Protection & Responsible Resolution Act (Chapter 14 Financial Institution Bankruptcy)

The Taxpayer Protection and Responsible Resolution Act (TPRRA) would dangerously increase systemic risk in the U.S. economy. TPRRA creates a new Chapter 14 bankruptcy process for resolving failed megabanks. Chapter 14, however, undermines federal regulators' single most important tool for addressing systemic risk, the Dodd-Frank Act's living will process. If a megabank lacks a credible living will, regulators can impose greater capital and liquidity requirements on it or even break it up in order to avoid another financial crisis. Because the availability of Chapter 14 would satisfy the living will requirement, it would neuter regulators' ability to force megabanks to derisk. And because Chapter 14 promises that all of a megabank's derivative counterparties will be paid in full, it would actually increase systemic risk by encouraging excessive gambling with derivatives. TPRRA would thus increase system risk, even as it would deny regulators their most powerful tool for managing risk.

TPRRA makes it all the more likely that Chapter 14 would be used, but if Chapter 14 were ever invoked, it would be a disaster. Chapter 14 lacks a mechanism for providing the tens of billions of dollars of liquidity that would be needed immediately by a restructured megabank, which all but insures a creditor run once a 48-hour stay is lifted. The result would be the chaos of a second Lehman Brothers, but one in which Main Street investors are forced to bail out Wall Street institutions. For example, TPRRA would ensure that a failed megabank would be paid in full for its gamble with a hedge fund over Toys'R'Us's failure by stiffing the 401(k) investors and pension plans that invested the megabank's bonds. Likewise, TPRRA would ensure that Wells Fargo's CEO would be paid 100 cents on the dollar on a multi-million-dollar contract, while the millions of consumers defrauded by Wells Fargo would recover pennies. TPRRA sticks Main Street with Wall Street's tab.

These and other criticisms of the TPRRA, including its glaring lack of corporate accountability requirements and its creation of a kangaroo court system to rubberstamp the Chapter 14 process, are expanded below.

I. SUMMARY OF TPRRA BILL

TPRRA proposes to add a new Chapter 14 to the federal Bankruptcy Code to allow failed megabanks to be resolved in bankruptcy, rather than through an FDIC receivership. TPRRA is a bankruptcy implementation of the "single-point of entry" (SPOE) resolution strategy the FDIC would likely use under the Dodd-Frank title II Orderly Liquidation Authority (OLA). OLA is an adaptation of the FDIC bank receivership process to bank holding companies. Unlike OLA, Chapter 14 would operate without an FDIC receivership, which means the Chapter 14 process would be run solely by

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the failed firm's management, subject to court approval. It also means that the FDIC's Orderly Liquidation Fund could not be used to finance the failed firm in bankruptcy or to facilitate an acquisition of the failed firm's assets. Also, unlike OLA, in Chapter 14 there is no ability to claw back compensation from the failed firm's officers and directors or prevent golden parachute payments. And, unlike OLA, in Chapter 14 there are no provisions for holding the debtor's officers and directors responsible for their mismanagement or malfeasance.

TPRRA envisions a process commenced by either a voluntary petition by a failing bank holding company or an involuntary petition by the Board of Governors of the Federal Reserve System.[1] The granting of a TPRRA petition triggers an automatic stay of up to 48-hours.[2] TPRRA then anticipates that a newly formed "clean" non-debtor bridge company with no property or debt obligations would purchase select assets of the debtor bank holding company and assume select liabilities in exchange for its equity securities.[3] TPRRA does not require the bridge company to assume any particular assets and liabilities of the debtor, but prohibits the bridge company from assuming the debtor's equity or "capital structure debt", meaning that the bridge company may not assume the failed bank holding company's unsecured financial debt (loans, bonds, and notes) other than QFCs (repos, swaps, and securities and commodities contracts).[4] Through the sale, the equity of bridge company would become property of the bankruptcy estate. The bridge company's equity would be managed by a special trustee, chosen by the debtor. The special trustee would sell off the bridge company's equity and use any proceeds to pay the liabilities that were not assumed.[5] The debtor's subsidiaries would be thus transferred to new ownership without interruption to their operations.

II. PROBLEMS WITH TPRRA

A. TPRRA Undermines the Dodd-Frank Living Wills Process

The single most powerful tool regulators have to police risky megabanks is the ability to impose additional regulatory requirements on megabanks that fail to formulate credible resolution plans ("living wills").[6] The living will process gives regulators substantial leverage to require megabanks to maintain greater capital or liquidity, to insist that megabanks simplify their operations, and ultimately to break up risky megabanks before they break the economy. The living will process properly puts the burden on megabanks to show that they are not a threat to the economy if they fail. Today, living wills are probably the chief constraint on excessive risk taking by megabanks.

TPRRA undermines the living will process because it enables megabanks to satisfy the resolution plan requirement by simply stating that they will resolve themselves in Chapter 14. It does not matter that Chapter 14 is not workable for the reasons described below in part II.E because the federal regulators will be required to assume that Chapter 14 will work.[7] Chapter 14 thus frees megabanks from having to formulate meaningful living wills and thereby takes away regulators' ability to use the living will process to ensure that megabanks do not prevent a systemic threat to the U.S. economy. In this regard, Chapter 14 would undermine a core pillar of the Dodd-Frank Act and add substantially to systemic risk in the U.S. financial system.

TPRRA anticipates Chapter 14 co-existing with Dodd-Frank's title II Orderly Liquidation Authority (OLA). Indeed, the TPRRA expressly preserves regulators' ability to pull a firm out of Chapter 14 and put it into OLA.[8] This raises the question of why federal regulators would ever allow a resolution in Chapter 14. It is hard to imagine regulators preferring Chapter 14 to OLA because Chapter 14 has fewer tools for ensuring a smooth landing than OLA, grants regulators much less control over the substance and fairness of the process than OLA, and is virtually guaranteed to create

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a political backlash because it favors Wall Street creditors over Main Street consumers and does not allow for the removal of officers and directors that engaged in malfeasance. Chapter 14 is a superfluous tool at best, but the fact that it would not likely be used points to its most important function: undermining regulators' ability to derisk megabanks through the Dodd-Frank living will process.

B. TPRRA Increases Systemic Risk by Encouraging Excessive Gambling with Derivatives

Not only does TPRRA deprive regulators of their most important tool for managing systemic risk, it actually increases systemic risk. TPRRA does so by codifying too-big-to-fail in regarding to derivatives contracts. TPRRA anticipates that in Chapter 14, the bridge institution will assume all qualified financial contracts (QFCs), including all derivatives contracts. That means that the debtor's QFC counterparties—hedge funds, private equity funds, and other megabanks—would get paid 100 cents on the dollar.

Because TPRRA promises to eliminate counterparty risk on QFCs, it will also encourage these megabanks to rely even more on QFCs as a source of funding. TPRRA thus encourages excessive gambling with derivative products, part of the very behavior that lead to the 2008 crisis. TPRRA's treatment of QFCs makes it more likely that megabanks will fail. And by undermining the living wills requirement, TPRRA removes the most critical check on systemic risk.

What's more, because TPRRA eliminates all credit risk for QFCs, it will give the very largest banks—those eight G-SIBs that can be forced into Chapter 14[9]—a cost-of-funding advantage over smaller banks. QFCs, particularly repos, are a major source of funding for large financial institutions. TPRRA's treatment of QFCs will enable megabanks to borrow more cheaply than community banks that rely on deposit funding. TPRRA will only ensure that the largest banks get larger, making them even more concentrated nodes of financial risk.

C. TPRRA Sticks Main Street with Wall Street's Tab

If Chapter 14 were ever in fact to be used, it would, like any bankruptcy process, pick winners and losers. This is inevitable when there are not enough assets to satisfy all claims. TPRRA, however, has an incredibly regressive system for allocating the cost of the failure of a megabank. TPRRA protects Wall Street institutions at the expense of Main Street creditors, such as 401(k) investors and pension plan beneficiaries.

TPRRA's creates three categories of winners and three categories of losers. The winners under TPRRA are: (1) secured creditors, (2) the debtor's QFC counterparties (hedge funds, private equity funds, and other megabanks), and (3) other entities whose obligations the bridge company decides to assume. Because these three types of parties' obligations are assumed by a solvent bridge company, they will get paid in full. While the first and second categories are almost exclusively Wall Street institutions, the third category includes employment contracts with the debtor's officers and directors.

The losers under TPRRA are: (1) the debtor's equity holders, (2) the debtor's bondholders, and (3) other entities whose obligations the bridge company decides *not* to assume. The bridge company is likely to assume only obligations that it finds useful—valuable leases, outstanding contracts with major vendors, and most employment contracts (including those of top executives). It is unlikely that the bridge company will assume obligations to tax authorities, to public enforcement authorities (*e.g.*, fines owed to state attorneys general or the CFPB or SEC), to small business vendors, to retirees, and restitution to tort victims (*e.g.*, defrauded consumers). These creditors will be paid little, if anything.

In the starkest terms, under TPRRA:

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- Wells Fargo's CEO will get paid 100 cents on the dollar on a multi-million-dollar contract, while the millions of consumers defrauded by Wells Fargo might get nothing.
- A hedge fund that entered into a credit default swap with the debtor to gamble on the likelihood of Sears filing for bankruptcy will get paid 100 cents on the dollar, but the firm that provides janitorial services for the debtor might get nothing.

In Chapter 14, those who play it straight will get stuck with the bill for others' risky gambling. Chapter 14 hard codes even more unfair giveaways to Wall Street creditors on the backs of Main Street creditors and investors. This is not taxpayer protection or responsible resolution at all.

D. TPRRA Shields Corporate Executives from Accountability for Mismanagement and Malfeasance

Chapter 14 also shields corporate executives that engaged in wrong-doing and protects golden parachutes and other extravagant executive compensation. TPRRA contains a fairly broad exculpation of the debtor's officers and directors, not just for authorizing the bankruptcy filing, but for a range of acts undertaken in connection with the filing.[10]

In contrast, OLA, limits exculpation solely to the acquiescence to a receiver.[11] More notably, OLA requires the removal of corporate directors who were responsible for the megabank failing.[12] No equivalent provision exists in TPRRA. Similarly, OLA gives regulators authority to seek officer/director bans against the officers and directors that engaged in a range of malfeasance.[13] No such authority exists in TPRRA for holding corporate executives accountable.

E. TPRRA Protects Golden Parachutes and Other Executive Compensation

TPRRA's lack of corporate accountability extends to its treatment of executive compensation. TPRRA allows the bridge company to assume liability for golden parachute payments owed to officers and directors. The assumption of these payments is at the discretion of the very same corporate officers who presided over the megabank's failure and would be the beneficiaries of the payments. Moreover, TPRRA lacks the tools for clawing back such payments, and the regular Bankruptcy Code avoidance powers (*e.g.* fraudulent transfers, voidable preferences) are of little application to most pre-bankruptcy executive compensation or to preventing the bridge company from performing the compensation contracts it assumes.

Under Chapter 14, the officers and directors who drove the megabank into bankruptcy would get paid in full by the bridge bank and would get to keep most or all of their compensation from the time before bankruptcy, as well as their corporate indemnification. Chapter 14 incentivizes excessive risk-taking by megabanks' officers and directors by giving them a heads-I-win-tails-you-lose gamble. Meanwhile, tax authorities would likely be stiffed in Chapter 14, leaving the public with the bill.

In contrast, OLA contains express statutory authority for clawing back any compensation (broadly defined and including profits from stock sales) received in the two years before a receivership by any current or former officers and directors who were responsible for the firm's failure.[14] Again, despite TPRRA's name, this contrast with OLA in the treatment of executive compensation suggests that the bill runs counter to taxpayer protection.

F. Chapter 14's Use Will Result in Lehman Brothers 2.0

Chapter 14 would undermine the key Dodd-Frank tool for preventing systemic risk even as it increases systemic risk. But that is not even the worst of it. Having disarmed regulators and primed

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the financial system for a crisis, Chapter 14 would be disastrous as a resolution mechanism, setting up a repeat of the chaos that followed the Lehman Brothers bankruptcy in 2008.

Chapter 14 does not work as a resolution mechanism because it cannot prevent a run on the bridge company. Chapter 14's 48-hour stay protects only the debtor, not the bridge company. TPRRA deems inoperable all "*ipso facto* clauses"—event-of-default clauses triggered by the financial condition of the debtor or by the transfer to the bridge company.[15] But TPRRA does not prevent QFC counterparties (or any other creditors) from terminating their contracts post-transfer based on the *subsequent* financial condition of the bridge company.

In order to prevent creditors from running on the bridge company after the transfer, the bridge company will have to have sufficient capital and liquidity such that creditors are confident that it can perform its obligations. Indeed, TPRRA requires this.[16] The problem is that there is no way for this condition to be fulfilled. The bridge company would need to have tremendous liquidity—cash and cash-like assets—in order to address counterparty concerns about its ability to pay its obligations as they come due. Specifically, the bridge company would need the same level of liquidity as a healthy bank holding company or counterparties will run.

To give a sense of the scale of liquidity required, JPMorgan had at the end of 2017 some $560 billion in high quality liquid assets.[17] A firm in Chapter 14 would, by definition, have an impaired liquidity position; liquid firms do not generally file for bankruptcy. Because the stay does not cover the bridge company, the bridge company would have to come up with tens or hundreds of billions of dollars of liquidity within 48 hours in order to prevent counterparties from running.[18] It cannot be done.

A liquidity facility of that size would require a syndicate made up of multiple lenders; no single lender is capable of or willing to loan tens of billions of dollars to a single borrower, much less on the 48-hour timetable and in troubled financial markets. A lending syndicate would take weeks to assemble because of the need for substantial diligence and negotiation. There is no time after the bankruptcy filing for meaningful diligence and negotiation. Nor is diligence and negotiation possible in advance of a bankruptcy because if word leaks out, it will trigger a run on the financial institution. Assembling a lending syndicate would also be difficult in troubled financial markets, such as after a large financial institution's Chapter 14 filing. To provide some perspective on the impossibility of financing for the bridge company, the largest syndicated loan in history was a $75 billion loan to AB InBev in 2015. That loan, made to a solvent company, took weeks to organize.[19] The bridge company will not be able to assemble adequate liquidity to prevent a run within 48 hours.

In theory, the liquidity problem could be addressed if the bridge company were purchased by another financial institution, but that purchase would have to happen as soon as the 48-hour stay elapsed in order to prevent a run. Such a timely purchase is unlikely. There are few potential buyers for the assets of a failed megabank, and fewer still during a financial crisis. Most potential buyers are other megabanks, which raises serious antitrust concerns and even greater systemic risk concerns.[20] Moreover, a transaction within the 48 hours would preclude serious diligence and negotiation, while pre-filing negotiations would risk triggering a run.

The standard way of dealing with the need for speed in FDIC receiverships is for the FDIC to enter into a loss-sharing agreement with a purchaser, which reduces the need for diligence, but there's no authority for the FDIC to do loss-sharing in Chapter 14, unlike under the Dodd-Frank Act's title II Orderly Liquidation Authority (OLA). Indeed, the liquidity problem does not exist in FDIC receiverships under OLA because OLA includes a provision that creates an orderly liquidation fund,

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funded from assessments on megabanks, to finance OLA receiverships.[21] The orderly liquidation fund ensures the availability of financing for a receivership irrespective of market conditions.

The absence of an analogous source of financing to the OLA orderly liquidation fund dooms Chapter 14 resolution to being a train wreck if used, with the bridge company having to file for bankruptcy just days after the failed megabank's bankruptcy. Chapter 14 guaranties financial market chaos. TPRRA is a recipe for Lehman Brothers 2.0.

G. TPRRA's Kangaroo Court Denies Main Street Creditors Even Getting Notice in Order to Defend Their Interests

Finally, TPRRA creates a kangaroo court that will deny mom-and-pop investors and Main Street creditors the basic due process rights needed to defend their interests.

First, TPRRA imposes a set of exceedingly fast and arbitrary deadlines on court action that preclude careful judicial review. If Chapter 14 is invoked as an involuntary process, the trial court is required to have a hearing within 16 hours and to issue an order with 18 hours.[22] This means that there might be only two hours permitted for a court hearing and ruling. Similarly, appeals must be taken within one hour, with a hearing within 12 hours and a ruling within 14 hours of the filing of the appeal, leaving potentially only two hours for an appellate hearing and ruling on an immensely significant matter.[23]

Second, if the Chapter 14 petition is granted, TPRRA does not require notice to go to all creditors and equity holders. Instead, it requires notice only to the twenty largest secured and twenty largest unsecured creditors, as well as to all QFC counterparties.[24] No notice whatsoever is required for other creditors—Main Street creditors—even though their rights may be affected by the Chapter 14.

Specifically, creditors whose obligations are not assumed by the bridge company are unlikely to be paid in full, yet under Chapter 14 they will not have an opportunity to be heard and object to the non-assumption of their liabilities. What creditors might this include? It includes all equity holders and smaller bondholders, such as 401(k) investors and pension plan beneficiaries. It could include consumer tort creditors (*e.g.*, defrauded Wells Fargo customers), as well as taxing authorities, and public enforcement agencies that are owed fines. It could also include "dispensable" creditors, such retirees and small business vendors. Yet the very largest creditors and all QFC counterparties are given notice under TPRRA. TPRRA creates first class seats for Wall Street institutions and prevents Main Street creditors from even learning of the flight until the plane's in the air.

Third, the bankruptcy court order approving the assumption may well contain critical provisions affecting creditors' rights. It is standard practice in Chapter 11 bankruptcies to use sale orders to affect creditors' rights, such as by cutting off successor liability claims against the purchaser. Nothing in TPRRA prevents this, and given Chapter 11 practice, it is likely that the Chapter 14 transfer order will be used to the detriment of unsophisticated parties that are not even given notice of the bankruptcy.

Fourth, the 48-hour limit on the stay makes the bankruptcy court a mere rubber stamp. If the sale order is not approved within the 48-hour window, creditors will run, and the megabank will find itself in a disorderly, piecemeal liquidation. While the bankruptcy court is formally required to approve the sale order and make various findings before doing so, the 48-hour deadline makes the entire process wholly perfunctory. Contrast this with the Federal Rules of Bankruptcy Procedure, which generally require 21-days' notice before an asset sale and generally prohibit asset sales within the first 21 days after the bankruptcy filing.[25] Faced with a 48-hour deadline, an absence of objecting creditors (because of lack of notice), and a debtor claiming that the U.S. economy will collapse unless the

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proposed sale order is approved in its entirety, it is unlikely that a judge would refuse to authorize the sale.

A supposed attraction of using bankruptcy law rather than OLA is that bankruptcy appears to be a neutral, judicial process in which there can be no regulatory favoritism and no federal funds are put at jeopardy. Yet because of the need for speed and secrecy, Chapter 14 turns bankruptcy into a faux judicial process, with courts told to hurry up and rubberstamp a set of transactions without any meaningful due process for parties whose rights are affected.

CONCLUSION

TPRRA is a flawed bill that forces Main Street to pay for Wall Street's gambling. TPRRA will substantially exacerbate systemic risk, while simultaneously depriving regulators of their most powerful tool for controlling the riskiness of megabanks and then sticking them with a resolution process that is doomed to fail. While TPRRA purports to create a safer, fairer approach to the failure of a large financial firm, it would only increase the risks of too-big-to-fail and give Wall Street insiders an even larger advantage than they enjoy today. TPRRA should be rejected.

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[1] TPRRA § 1403.

[2] TPRRA §§ 1407(a)(3); 1408(a)(1).

[3] TPRRA §§ 1405(c)(1)(G), (d)(2).

[4] TPRRA § 1405(c)(1)(B), (E).

[5] *See* TPRRA §§ 1405(d)(2); 1406(a)(1); 1406(b)(3)-(4).

[6] 12 U.S.C. § 5365(d).

[7] TPRRA does not currently amend the living wills process, but if enacted, it seems likely that subsequent legislation would seek to do exactly that.

[8] TPRRA § 6.

[9] TPRRA § 1403(a)(2)(A)(ii). The eight G-SIBs are JPMorgan Chase, Bank of America, Citigroup, Goldman Sachs, Wells Fargo, Bank of New York Mellon, Morgan Stanley, and State Street.

[10] TPRRA § 1403(d).

[11] 12 U.S.C. § 5387.

[12] 12 U.S.C. § 5386(5).

[13] 12 U.S.C. § 5393.

[14] 12 U.S.C. § 5390(s).

[15] TPRRA § 1407(1)(B).

[16] TPRRA § 1405(c)(1)(F).

[17] JPMORGAN CHASE & CO., LIQUIDITY COVERAGE RATIO DISCLOSURE: FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2017, at 1, http://perma.cc/P9A7-GE8H.

[18] The bridge company cannot use the Bankruptcy Code's debtor-in-possession financing provision because it is not a debtor.

[19] Alasdair Reilly & Tessa Walsh, *AB InBev Backs SABMiller Buy with Record $75 Billion Loan*, REUTERS (Nov. 11, 2015), http://perma.cc/8BZW-CJGE.

[20] Such an acquisition would also require regulatory approval, something that might not happen within 48-hours; the whole point of Chapter 14 is to not involve regulators. TPRRA requires only a consultation with regulators before the sale of the equity by the special trustee. TPRRA § 1406(b)(4).

[21] 12 U.S.C. § 5390(n)-(o). The orderly liquidation fund is funded through assessments on megabanks. The assessments are made post-crisis, with the FDIC fronting the funds, but the FDIC is forbidden from incurring any losses in an OLA receivership. 12 U.S.C. § 5394(c). The Federal Reserve's emergency lender of last resort powers are, post-Dodd-Frank, reserved for programs with broad-based eligibility, not for assisting single firms. 12 U.S.C. § 343(3)(A).

[22] TPRRA §§ 1403(b)(1)(A), (c)(2)(A).

[23] TPRRA § 1403(c)(2)(B)(ii).

[24] TPRRA § 1405(b).

[25] FED. R. BANKR. PROC. 2002(a)(2), 6003(b). These rules have exceptions for exigent circumstances, but the exigency in the case of TPRRA would be created by the legislation itself, through the limitation of the stay to 48 hours.

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