SULLIVAN & CROMWELL LLP

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GAO Report on Financial Company Bankruptcies

GAO Releases Fifth Report Under Dodd-Frank Act Examining the Bankruptcy and Orderly Liquidation Process for Financial Companies Under the Bankruptcy Code

SUMMARY

On July 21, 2020, the Government Accountability Office issued a report to the Senate Committee on Banking, Housing, and Urban Affairs, the Senate Committee on the Judiciary, the House Financial Services Committee and the House Judiciary Committee relating to the effectiveness of the U.S. Bankruptcy Code in facilitating the orderly liquidation or reorganization of financial companies, and ways to make the orderly liquidation of such companies under the U.S. Bankruptcy Code more effective. The report is the fifth report issued by the GAO pursuant to Section 202(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and focuses on proposed or enacted changes to the U.S. Bankruptcy Code related to financial companies and the Orderly Liquidation Authority[1] since 2015 and regulatory actions related to resolution planning and the Orderly Liquidation Authority.[2] The Report notes that there have not been any amendments to the Bankruptcy Code or the Orderly Liquidation Authority since 2015. However, the regulators have adopted several rules to facilitate an effective "single point of entry" resolution of a globally significant financial institution, as well as amendments to the resolution planning rules, and additional rule changes are pending.

REPORT FINDINGS

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") requires the Government Accountability Office (the "GAO") to study, at specified intervals, the effectiveness of the U.S. Bankruptcy Code (the "Code") in facilitating orderly liquidation or reorganization of financial companies and ways to make orderly liquidation under the Code more effective.[3] Since the enactment of Dodd-

Frank, the GAO has issued four reports to the Senate Committee on Banking, Housing, and Urban Affairs, the Senate Committee on the Judiciary, the House Financial Services Committee and the House Judiciary Committee.[4] In the Report, the GAO makes the following findings:

A. BOTH CONGRESS AND THE U.S. DEPARTMENT OF THE TREASURY HAVE PROPOSED CHANGES TO THE CODE AND THE ORDERLY LIQUIDATION AUTHORITY, BUT THESE CHANGES HAVE NOT BEEN ENACTED

Although the Code and the Orderly Liquidation Authority have not been amended since 2015, both Congress and the U.S. Department of the Treasury have proposed changes in recent years. Congressional proposals include:

- amendments to the Code describing the conditions under which the bankruptcy court may order the transfer of assets, qualified financial contracts ("QFCs"),[5] and other contracts to a bridge company under the Code;[6]
- amendments to the Code that include provisions to place a stay on the termination, acceleration, or modification of any QFC at the commencement of a bankruptcy to mitigate the risk of QFC counterparties exercising their default rights if the court approved first-day motions;[7] and
- elimination or amendment of the Orderly Liquidation Authority.[8]

Proposals by the U.S. Department of the Treasury include:

- adding a new chapter to the Code (Chapter 14) for resolving distressed financial companies;[9] and
- changes to the OLA including eliminating the FDIC's authority to treat similarly situated creditors differently on an ad hoc basis in certain circumstances and eliminating the tax-exempt status of a bridge holding company.[10]

The Report notes that experts had "mixed views on the potential effectiveness of the proposed amendments to the Code relevant to financial companies."[11] For example, most experts said that an amendment to clarify that certain large bank holding companies may transfer their intermediate holding companies and other subsidiaries to a bridge holding company would mitigate potential challenges to the transfer, but experts were split as to whether a Code amendment to shield such a bank holding company's board of directors from liability for a good faith bankruptcy filing would further mitigate the risk that the board of directors would not file for bankruptcy in a timely manner.[12]

B. FEDERAL RESERVE AND FDIC FINALIZED AMENDMENTS TO THE RESOLUTION PLANNING RULE

The Report notes that the Federal Reserve and FDIC have finalized amendments to the resolution planning rule, in part to address statutory changes made by the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 and to better match resolution planning requirements to the risks posed by the different types of companies covered by the resolution planning rule.[13] These changes are described in our October 24, 2019 Memorandum to Clients.

The Report notes that the "groups [GAO] interviewed had mixed views on the overall impact of the rule."[14] For example, the Report states that Federal Reserve and FDIC officials said that "revisions to the rule incorporate knowledge gained by regulators in reviewing resolution plan submissions under the original 2011 rule" and that the "new rule balances the regulatory burden placed on covered companies with the risk those companies pose to U.S. financial stability."[15] Similarly, industry associations interviewed by the GAO were largely supportive of the new rule.[16] However, a consumer group interviewed by GAO opposed the 2019 rule because "it exempts more companies from resolution planning than EGRRCPA requires."[17] Additionally, this consumer group, along with an academic and a former regulatory official, stated that "the increased time between resolution plan submissions increases the risk of a company's plan becoming obsolete, and therefore ineffective, if the company faces material distress or failure" and that "the cumulative effect of the rule's changes increases the likelihood of a company's disorderly failure and the need for public assistance."[18]

C. REGULATORS HAVE FINALIZED A NUMBER OF RULES RELATED TO THE ORDERLY LIQUIDATION AUTHORITY AND RESOLUTION PLANNING

The Report notes that, since 2015, regulators have finalized a number of rules related to the Orderly Liquidation Authority and resolution planning. These rules include:

- ***QFC Recordkeeping Requirements***. In October 2016, the Secretary of the Treasury adopted final rules, in consultation with FDIC, that require recordkeeping for positions, counterparties, legal documentation and collateral to assist the FDIC as receiver under the Orderly Liquidation Authority.[19]
- ***Final QFC Stay Rules***. In 2017, the Federal Reserve, FDIC, and Office of the Comptroller of the Currency issued final rules requiring U.S. G-SIBs and their subsidiaries, and the U.S. operations of foreign G-SIBs, to include provisions in their QFCs that prevent counterparties from exercising certain default rights based on the entry of the G-SIB or one of its subsidiaries into a bankruptcy or resolution proceeding.[20]
- ***Total Loss-Absorbing Capacity***. In January 2017, the Federal Reserve finalized a rulemaking that sets the minimum amount of total loss-absorbing capacity that U.S. G-SIBS and the top-tier intermediate holding companies of certain foreign G-SIBs must hold to recapitalize key subsidiaries.[21]

D. REGULATORS HAVE PROPOSED TWO RULES RELATED TO RESOLUTION PLANNING THAT HAVE NOT BEEN FINALIZED

The Report also notes that, since 2015, regulators have proposed two rules related to resolution planning that have not been finalized. These rules include:

- A March 2016 notice of proposed rulemaking, issued by the Securities and Exchange Commission and the FDIC, to implement provisions applicable to the orderly liquidation of covered brokers and dealers under Title II of Dodd-Frank. The notice of proposed rulemaking is "intended to clarify the distribution of responsibilities between the SEC and the FDIC and the Securities Investor Protection Corporation in the event of a broker-dealer's failure" and "would allow FDIC the option of establishing a bridge broker-dealer to maintain customers' access and prevent a distressed sale of the assets." FDIC officials told the GAO that the notice of proposed

rulemaking is still relevant, despite no published updates, and that the FDIC hopes to move forward with the rule in the near future.[22]

- An April 2019 advance notice of proposed rulemaking, issued by the FDIC, concerning the resolution plan requirements for larger insured depository institutions (the "IDI Rule"). The advance notice of proposed rulemaking "presents the idea that rules could revise the frequency and content of plan submissions based on the insured depository institution's size and risk profile" and "proposes improvements to the process for periodic engagement between FDIC and insured depository institutions regarding resolution plans." FDIC officials told the GAO that they continue to work on the notice of proposed rulemaking for the IDI Rule and plan to release the proposal in 2020.[23]

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ENDNOTES

1 Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2011 established the Orderly Liquidation Authority, which gives FDIC the authority, subject to certain constraints, to resolve certain financial companies, including a bank holding company or a nonbank financial company designated for supervision by the Federal Reserve, outside of the bankruptcy process. *See* 12 U.S.C. § 5384.

2 Government Accountability Office, *Financial Company Bankruptcies: Congress and Regulators have Updated Resolution Planning Requirements*, GAO-20-608R (Washington, D.C.: July 21, 2020), *available at* https://www.gao.gov/products/GAO-20-608R?source=ra (the "Report").

3 *See* 12 U.S.C. § 5382(e).

4 *See* GAO, *Financial Company Bankruptcies: Information on Legislative Proposals and International Coordination*, GAO-15-299 (Washington, D.C.: Mar. 19, 2015); *Financial Company Bankruptcies: Need to Further Consider Proposals' Impact on Systemic Risk*, GAO-13-622 (Washington, D.C.: July 18, 2013); *Bankruptcy: Agencies Continue Rulemakings for Clarifying Specific Provisions of Orderly Liquidation Authority*, GAO-12-735 (Washington, D.C.: July 12, 2012); *Bankruptcy: Complex Financial Institutions and International Coordination Pose Challenges*, GAO-11-707 (Washington, D.C.: July 19, 2011).

5 The term "qualified financial contract" is not used in the Code, but types of contracts eligible for certain safe harbors described in the Code are defined in the Code and include swap agreements, repurchase agreements, reverse repurchase agreements, commodity contracts, forward contracts, securities contracts, and master netting agreements. *See* 11 U.S.C. § 362(b)(6), (7), (17) and (27); 11 U.S.C. § 101(25), (38A), (47), (53B); 11 U.S.C. § 741(7); 11 U.S.C. § 761(4).

6 Report at 4.

7 *Id.* at 5.

8 *Id.*

9 *Id.*

10 *Id.*

11 *Id.*

12 *See id.*

13 *Id.* at 6.

14 *Id.*

15 *Id.*

16 *See, e.g.*, *id.* at 8 ("[I]ndustry associations that we interviewed said the rule's changes reduce regulatory burden and give covered companies the time they need to effectively consider and incorporate agencies' firm-specific feedback and general guidance into the next iteration of their resolution plans.").

17 *Id.* at 7.

18 *Id.*

19 *Id.* at 9. *See also* Qualified Financial Contracts Recordkeeping Related to Orderly Liquidation Authority, 81 Fed. Reg. 75624 (Oct. 31, 2016).

20 Report at 9. *See also* Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations, 82 Fed. Reg. 42882 (Sept. 12, 2017); Restrictions on Qualified Financial

Contracts of Certain FDIC-Supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreements and Related Definitions, 82 Fed. Reg. 50228 (Oct. 30, 2017); and Mandatory Contractual Stay Requirements for Qualified Financial Contracts, 82 Fed. Reg. 56630 (Nov. 29, 2017).

21 Report at 9. *See also* Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations, 82 Fed. Reg. 8266 (Jan. 24, 2017).

22 Report at 10. *See also* Covered Broker-Dealer Provisions Under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 81 Fed. Reg. 10798 (Mar. 2, 2016).

23 Report at 10. *See also* Resolution Plans Required for Insured Depository Institutions With $50 Billion or More in Total Assets, 84 Fed. Reg. 16620 (Apr. 22, 2019).

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