Testimony of
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The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform, Part II

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Chairman Johnson, Ranking Member Coble, other Members of the Subcommittee, thank you for inviting me to testify before you today. My name is Michael Rosenthal and I am the Co-Chair of the Business Restructuring and Reorganization Practice Group at the law firm of Gibson, Dunn & Crutcher LLP.

I have been in practice for over 30 years and have spent my entire career in the distressed restructuring field representing debtors, creditors, and distressed asset sellers and acquirers in a wide variety of different industries. During this recent financial and credit crisis, my colleagues and I have been active in representing and providing advice to entities regarding their rights and exposure related to difficulties in the financial services sector, including issues related to loan restructurings, spin-offs, derivative products, securitizations, and customer account issues. Among others, I am presently representing PricewaterhouseCoopers AG, Zurich, in its capacity as bankruptcy liquidator for Lehman Brothers Finance, SA, and various other large, public companies in the chapter 11 and related cases involving Lehman Brothers and its affiliates, as well as certain directors of DaimlerChrysler in connection with the Chrysler bankruptcy. I want to note that the views I express today are my own and that they do not necessarily reflect the views of my firm or the firm's clients.

I want to applaud the subcommittee for addressing this critically important - and highly technical - issue today. While many other issues associated with financial regulatory reform have received more attention, no issue is of greater importance to the stability of our financial markets.

I appreciate the opportunity to be heard on this crucial issue, and believe that there are two over-arching goals of the proposal. The first relates to flexibility: we need to give the government the ability to act quickly to construct solutions, and to ensure that no institution is too big to fail. The second relates to predictability: market stability requires predictable results, particularly when times are bad, and particularly when the results relate to financial actors that do business across broad bands of our economy.

We all recognize that creating a system to manage the failure of our largest financial participants, if done right, is extremely complicated. The incredible diversity of transactions in which systemically-significant institutions engage in today's marketplace demands a highly nuanced and transaction-specific approach to resolve the rights of creditors, debtors, and taxpayers, and at the same time, preserve systemic stability.

But there are also first principles that set the foundation on which reform is built. And we need to get these right or the structure will not stand the test of time, and future financial crises. Let me talk about one key principle on which a new resolution authority regime can be built, and then discuss other, more specific points as time permits.

The key principle is this: market stability. Absent compelling public policy reasons to the contrary, we should base a new system, as much as possible, on what the market knows and understands. As Congress considers how to construct a system for resolving systemically-significant institutions, it has two existing regimes to choose from -- the Federal Deposit Insurance Act, which is used to resolve banks, and the Bankruptcy Code, which is used to resolve virtually all other businesses that fail.

I believe that, while both regimes are appropriate in certain circumstances, the proposed legislation could benefit from the adoption of more features of the Bankruptcy Code. In part, this is the case because the Bankruptcy Code has features, including those that govern the judicial review of creditor claims, that work better in the face of a system-shaking failure, and in part because businesses and other creditors throughout the economy are familiar with the Bankruptcy Code, and see it as more stable and predictable.

While the FDIA and the Bankruptcy Code have many similarities in treatment of claims, the credit markets would not - and indeed, could not - assume that creditor claims would receive identical treatment under the FDIA. As a result, under current proposals, credit would be needlessly displaced for at least several years while the law and rules of the new regime were worked out through practice.

Bankruptcy courts adjudicate claims disputes as part of their day to day responsibilities. Bankruptcy courts determine these disputes in a transparent, predictable and expedited fashion, pursuant to established procedures and governed by an already well developed body of case law. Market participants understand, and have structured and priced their transactions on their expectations about these procedures and precedents. These expectations regarding how their claims will be dealt with under the Bankruptcy Code are essential to their ability to manage systemic , industry and counterparty risk so that they are not forced to deal with the double impact of the financial crisis along with the destabilization of their own unexpected losses and uncertainty. This ability to foresee, plan and reserve for known risks is crucial to overall market stability. Absent being able to rely on those expectations, markets are likely to contract in the face of uncertainty, as we saw after the bankruptcy of Lehman Brothers, and market stability will take longer to restore, in part because market participants will have to plan for a more uncertain regime, even where the likelihood of being under it is extremely low, in terms of determining pricing and other terms for new transactions. Therefore, the dispute resolution process under the

new regime should follow the Bankruptcy Code's established procedures and precedent to the greatest extent possible.

Our proposed revisions, taken together, would create a hybrid between the FDIA and the Bankruptcy Code, by incorporating some of the basic creditor protections provided by the Bankruptcy Code, including judicial oversight, predictability and transparency, which are crucial to maintaining market stability, while still empowering the federal agency with the flexibility to address the failure of systemically significant financial companies quickly to minimize adverse systemic repercussions. While you might ultimately embrace a resolution system that is more administrative in nature than what we have recommended, I encourage you, even then, to incorporate into that system as many of these recommendations as possible and, particularly, those that implement best what market participants already know, understand and expect, such as access to ready and effective judicial review with established precedent and rules, especially with respect to claim determinations, transparency, adequate protection, contract rejection and avoidance rules similar to those in the Bankruptcy Code.

In view of the scope and complexity of the issues you are addressing, my colleagues and I have prepared a set of materials, which are appended hereto, which we ask that you include in the record of this hearing. These materials are (a) an Overview Memorandum and (b) a side-by-side chart comparing the Bankruptcy Code, Federal Deposit Insurance Act, and the Senate Banking Committee's recently proposed legislation addressing Enhanced Resolution Authority as part of the Restoring American Financial Stability Act of 2009 (the "Bill"). We hope these background materials will be of use to you as you consider the best ways to restore market stability in times of systemic financial crisis. We see these materials as works in progress and will continue to revise them, and to that end we welcome any and all thoughts you may have.

Key Determinations

We have identified two main sets of issues that we believe should be addressed by policymakers as the proposed legislation moves forward. The first set of issues relate to flexibility, by giving the FDIC or other federal agency the authority it needs to act quickly to avert a financial crisis, and the extent to which it will be empowered to take such actions (the crisis powers) without oversight by a court.

The second set of issues relate to maintaining market stability, by providing predictable rules and processes by which the covered financial company will ultimately be liquidated after the FDIC or other federal agency has transferred or sold such company's assets or taken other actions to avert a financial crisis. This second set of issues highlights the rights of creditors and other counterparties, how disputes will be resolved and who will administer the covered financial company and/or bridge company after the crisis has been averted.

In our recommendations, we have focused on a hybrid approach, which gives the FDIC or other federal agency flexibility and discretion to act as it determines is necessary for the first thirty days of the resolution process without intervention by any supervising court. After the initial "crisis" period, the liquidation and claims process would continue to be managed by the FDIC or other federal agency, but under the oversight of a supervising court, which we believe should be the bankruptcy court applying procedures and precedent of the Bankruptcy Code, which market participants already know, understand and expect.

Summary of Proposed Changes

Let me walk us through some of the specific changes that we recommend to the proposed legislation. These are all designed to provide the FDIC or other federal agency with the flexibility required to ensure systemic stability, and at the same time protect as much as possible market predictability and legitimate creditor expectations:

1. **The Exclusive Period**: The Bill empowers the Treasury to appoint the FDIC or other federal agency with exclusive authority, broad discretion and power to address systemic risk and to resolve the business of a covered financial company. In order to give the FDIC, or other federal agency, both flexibility and discretion to act at the commencement of a case involving a covered financial company, we have suggested amending the Bill to include an initial thirty (30) day exclusive period during which the FDIC or other federal agency can make decisions and take actions for the covered financial company that are outside the ordinary course of business, with Treasury approval, but without approval from the supervising court (the "Exclusive Period"). Treasury can extend the Exclusive Period for up to 3 additional fifteen (15) day periods upon a request from the FDIC or other relevant federal agency.

Based on the disclosure required in Section 3 (below), and as described in Section 2 (below), for a limited period of time after the Exclusive Period, decisions made and actions taken by the FDIC or other federal agency during the Exclusive Period can be reviewed by the supervising court and creditors injured by those decisions and actions can seek redress. However, a sale or transfer to a third party purchaser or transferee acting in good faith cannot be reversed.

2. **Judicial Review**: In order to give creditors of Covered Financial Companies quicker and more direct access to judicial review of claims determinations by the FDIC or other federal agency, we have suggested revisions to allow direct review of decisions by such resolution authority by a supervising court. The United States Bankruptcy Court for the judicial district in which the chief executive office, assets or center of main interests of such covered financial company are located, or where it is incorporated, would be likely candidates to be the supervising court. After the Exclusive Period, the actions of the FDIC or other federal agency for the covered financial company that are not in the ordinary course of business must be approved by the supervising court after notice and a hearing, and such court would have sole jurisdiction over all matters with respect to the covered financial company. Any actions would be on adequate notice to creditors, so that they will have an opportunity to be heard.

3. **Transparency and Disclosure**: We have suggested requiring the covered financial company, through the FDIC or other federal agency, to file schedules of assets and liabilities, and a statement of financial affairs, in essentially the same form as would be required in a case under the Bankruptcy Code. The schedules and statement of financial affairs would be required to be filed within thirty (30) days after the termination of the Exclusive Period in sufficient detail to enable the judicial review described in paragraph 2 (above). In addition, the covered financial company, through the resolution authority will be required to file a report detailing any assets or liabilities transferred to a Bridge Company, within five (5) days of such

transfer. All of these documents, together with other information typically required in a bankruptcy case, would be publicly available.

4. **Treatment of Creditors and Claims**: The Bill provides that the maximum liability that the FDIC or other federal agency would have as receiver to any person having a claim against it will be what such claimant would have received in a liquidation under the Bankruptcy Code. We have suggested revisions to the Bill to more closely provide to creditors the same rights that they would have if the covered financial company were liquidated under chapter 7 of the Bankruptcy Code. These rights include rights with respect to claims procedures, avoidance actions, priority of distribution, and the right to be heard by the supervising court regarding claims disputes.

5. **Treatment of Secured Claims and Security Entitlements**: We have revised the Bill to include a methodology to ensure protection of secured claims. The proposed adequate protection provisions in the Bill require that secured creditors receive at least what they would have received if the covered financial company had been liquidated under chapter 7 of the Bankruptcy Code (i.e., the value of their collateral). We have included language to ensure that this determination would generally be made pursuant to the same principles used to satisfy the best interest test under section 1129(a)(7)(A)(ii) of the Bankruptcy Code, and would be subject to review by the supervising court if the secured creditor disagrees with the determination by the FDIC or other federal agency.

6. **Valuation**: As described above, the Bill caps the FDIC or other federal agency's liability to any creditor at the liquidation value of the creditor's claim, taking into consideration the value of any collateral that secures such claim. The Bill does not clearly identify the methodology used to value the collateral. We have revised the Bill to provide that collateral is valued by the methodologies used in cases under the Bankruptcy Code. A creditor may dispute the valuation of its secured claim, and such dispute will be determined by the supervising court using methods applicable in cases under the Bankruptcy Code.

7. **Disputed Claims**: The Bill provides that the FDIC or other federal agency will determine claim amounts, but is not clear as to whether there would be any judicial review of such determination. We have revised the proposed language to clarify that the FDIC or other federal agency will make the initial determinations regarding the amount and validity of creditors' claims, and to provide that any creditor that disagrees with this determination is entitled to an expedited judicial determination of its claim by the supervising court.

8. **Preferences and Fraudulent Transfers**: The Bill provides that the FDIC or other federal agency may avoid transfers made in contemplation of insolvency or where there is an intent to hinder, delay or defraud the covered financial company or its receiver (whether the FDIC or other federal agency), however, these standards are not defined. As such, we have suggested that the fraudulent conveyance provisions of the Bankruptcy Code be adopted in the Bill to take advantage of the extensive body of case law governing fraudulent transfers. The Bill does not provide for reversal of transactions that would be preferences under the Bankruptcy Code. We suggest that the Bankruptcy Code preference provisions also be incorporated in the Bill.

9. **Automatic Stay and QFCs**: Given the complexity and the number of QFCs to which a covered financial company will likely be a party, this is one area where we believe the current treatment under the Bankruptcy Code should be carefully considered. We agree that the automatic stay on the exercise of contractual termination, liquidation and netting rights, based on the appointment of the FDIC or other federal agency as receiver or the insolvency or financial condition of the covered financial company, should apply for three (3) days, while the FDIC or other federal agency determines whether to terminate or transfer the QFCs of the covered financial company. We suggest giving the FDIC or other federal agency the ability to guarantee obligations under a QFC so that contracts that are valuable to the estate can be maintained. In the event the FDIC or other federal agency either guarantees or transfers a QFC, the counterparty would no longer be entitled to terminate, liquidate, or net such contract solely by reason of the appointment of the FDIC or other federal agency as receiver, or the insolvency or financial condition of the covered financial company.

10. **Contract Assumption/Rejection**: We suggest that the Bill incorporate the Bankruptcy Code's provisions regarding assumption, assignment and rejection of executory contracts and unexpired leases, including the treatment of rejection damage claims and the limitations on the types of contracts and leases that can be assigned.

11. **Precedent and Rulemaking**: The Bill authorizes, but does not require, that the FDIC or other federal agency prescribe comprehensive rules and regulations to implement the Bill. To provide greater certainty to creditors, we recommend that comprehensive rules and regulations be required to be promulgated. We would encourage you to require the FDIC or other federal agency to use notice and comment rule making for any rules that it promulgates. In addition, we suggest that relevant precedent under the Bankruptcy Code and Bankruptcy Rules be used to govern a proceeding involving a covered financial company.

Mr. Chairman, distinguished Members of the Subcommittee, you have an important task at hand. I commend you for taking the time to see that it is accomplished thoughtfully, and with the goal of promoting market stability in good times as well as bad.

Once again, I want to express my appreciation for the opportunity extended by the Subcommittee to testify at this Hearing, and I welcome any questions that you have, either at this time or later in the process.