



March 2015

# FINANCIAL COMPANY BANKRUPTCIES

## Information on Legislative Proposals and International Coordination

Accessible Version

# GAO Highlights

Highlights of [GAO-15-299](#), a report to congressional committees

## Why GAO Did This Study

The challenges associated with the bankruptcies of large financial companies during the 2007-2009 financial crisis raised questions about the effectiveness of the U.S. Bankruptcy Code and international coordination for resolving complex financial institutions with cross-border activities.

The Dodd-Frank Act mandates that GAO report on an ongoing basis on ways to make the U.S. Bankruptcy Code more effective in resolving certain failed financial companies. GAO has issued three reports on this issue. This fourth report addresses (1) recent changes to the U.S. Bankruptcy Code and (2) efforts to improve cross-border coordination to facilitate the liquidation or reorganization of failed large financial companies under bankruptcy.

GAO reviewed laws, court documents, regulations, prior GAO reports, and academic literature on financial company bankruptcies and regulatory resolution. GAO also reviewed documentation from foreign financial regulators and international bodies such as the Financial Stability Board. GAO interviewed officials from the Administrative Office of the United States Courts, Department of Justice, Department of the Treasury, and financial regulators with a role in bankruptcy proceedings.

GAO makes no recommendations in this report. The Department of the Treasury, Federal Reserve, FDIC, and the Securities and Exchange Commission provided technical comments on a draft of the report that GAO incorporated as appropriate.

View [GAO-15-299](#). For more information, contact Cindy Brown Barnes at (202) 512-8678 or [brownbarnesc@gao.gov](mailto:brownbarnesc@gao.gov).

March 2015

## FINANCIAL COMPANY BANKRUPTCIES

### Information on Legislative Proposals and International Coordination

## What GAO Found

The U.S. Bankruptcy Code (Code) chapters dealing with the liquidation or reorganization of a financial company have not been changed since GAO last reported on financial company bankruptcies in July 2013. However, bills introduced in the previous Congress would, if re-introduced and passed, make broad changes to the Code relevant to financial company bankruptcies. The Financial Institution Bankruptcy Act of 2014 (H.R. 5421) and Taxpayer Protection and Responsible Resolution Act (S. 1861) would have expanded to varying degrees the powers of the Board of Governors of the Federal Reserve System (Federal Reserve) and Federal Deposit Insurance Corporation (FDIC) and would have imposed a temporary stay on financial derivatives (securities whose value is based on one or more underlying assets) that are exempt from the automatic stay under the Code. That stay would prohibit a creditor from seizing or taking other action to collect what the creditor is owed under the financial derivative. The bills also would have added to the Code processes for the resolution of large, complex financial companies similar in some ways to provisions currently in the Orderly Liquidation Authority (OLA) in Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which grants FDIC the authority to resolve failed systemically important financial institutions under its receivership. For example, each bill would have allowed for the creation of a bridge company, in which certain assets and financial contracts of the holding company would be transferred, allowing certain subsidiaries to continue their operations. The 21<sup>st</sup> Century Glass-Steagall Act of 2013—a bill introduced in the House of Representatives (H.R. 3711) and the Senate (S. 1282)—would have repealed safe-harbor provisions that allow most counterparties in a qualifying transaction with the debtor to exercise certain contractual rights even if doing so would otherwise violate the automatic stay. As of March 12, 2015, these legislative proposals had not been re-introduced in Congress.

In the United States, the presumptive mechanism to resolve a failed large financial company with cross-border operations is through the judicial bankruptcy process. Since GAO's 2013 report, no changes have been made to the chapter of the Code that relates to coordination between U.S. and foreign jurisdictions in bankruptcy cases in which the debtor has foreign operations. Some structural challenges remain, such as conflicting regulatory regimes related to the treatment of financial contracts between parties in different countries when a firm enters bankruptcy, but efforts are underway to address them. Regulators have implemented a Dodd-Frank Act provision that requires certain large financial firms to submit a resolution plan to assist with an orderly bankruptcy process, which regulators expect to help address potential problems with international cooperation, among others. However, in 2014, FDIC and the Federal Reserve identified shortcomings with the plans for a number of large financial companies that those firms are to address in their 2015 submissions. Further, international bodies, such as the Financial Stability Board—an international body that monitors and makes recommendations about the global financial system—have focused on having countries adopt a regulatory approach to resolutions. Other recent actions include a January 2015 stay protocol for derivatives contracts developed by the International Swaps and Derivatives Association that is intended to give regulators time to facilitate an orderly resolution of a troubled firm.

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## Abbreviations

AOUSC	Administrative Offices of the United States Courts
CFTC	Commodities Futures Trading Commission
DIP	debtor-in-possession
EU	European Union
FDIC	Federal Deposit Insurance Corporation
FSB	Financial Stability Board
ISDA	International Swaps and Derivatives Association
MFGH	MF Global Holdings Ltd.
OLA	Orderly Liquidation Authority
QFC	qualified financial contract
SEC	Securities and Exchange Commission
SIPA	Securities Investor Protection Act
SIPC	Securities Investor Protection Corporation
SPOE	single-point-of-entry
TARP	Troubled Asset Relief Program
UNCITRAL	United Nations Commission on International Trade Law
WMILT	Washington Mutual Liquidating Trust

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March 19, 2015

### Congressional Committees

There were a number of bankruptcies of complex financial institutions such as Lehman Brothers Holdings, Inc. and Washington Mutual, Inc. during the 2007-2009 financial crisis. Some members of Congress and some legal and financial experts raised questions about the effectiveness of the U.S. Bankruptcy Code (Code) in providing for orderly liquidations or reorganizations of financial institutions that qualify as debtors under the Code.<sup>1</sup> In addition, the Lehman bankruptcy proceedings, which began in September 2008 and included the bankruptcy of Lehman Brothers Holdings, Inc. and a number of its subsidiaries, have highlighted inconsistencies in laws and regulations across countries and limitations on the ability of countries to coordinate effectively during the reorganization or liquidation of a financial institution that operates across national borders.

In 2011, 2012, and 2013 we issued statutorily mandated reports on the effectiveness of the Code for resolving or liquidating complex, internationally active financial institutions.<sup>2</sup> For example, our July 2011 report included a discussion of proposals for revising the Code for large financial companies and examined international coordination efforts. In July 2012, we examined actions taken to implement the Orderly Liquidation Authority (OLA) created by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). OLA authorizes the Secretary of the Treasury to appoint the Federal Deposit Insurance

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<sup>1</sup>Insured depository institutions and insurance companies may not file for debtor protection under the Code, and broker-dealers qualify for liquidation, but not reorganization.

<sup>2</sup>The Dodd-Frank Wall Street Reform and Consumer Protection Act mandates that we study, at first annually and then at specified intervals, issues including the effectiveness of the Code in facilitating the orderly liquidation or reorganization of financial companies and ways to make the orderly liquidation process under the Code for financial companies more effective. Pub. L. No. 111-203, § 202(e), 124 Stat. 1376 (2010). See GAO, *Bankruptcy: Complex Financial Institutions and International Coordination Pose Challenges*, [GAO-11-707](#) (Washington, D.C.: July 19, 2011); *Bankruptcy: Agencies Continue Rulemakings for Clarifying Specific Provisions of Orderly Liquidation Authority*, [GAO-12-735](#) (Washington, D.C.: July 12, 2012); and *Financial Company Bankruptcies: Need to Further Consider Proposals' Impact on Systemic Risk*, [GAO-13-622](#) (Washington, D.C.: July 18, 2013).

Corporation (FDIC) as a receiver when, among other things, the failure of a financial company would have serious adverse effects on U.S. financial stability. Our July 2013 report discussed proposals from experts, government officials, and legislators to change the Code to make bankruptcies of financial companies (especially those that pose systemic risk to the financial system) more orderly and effective.

This report examines (1) recent changes to the U.S. Bankruptcy Code and (2) efforts to improve cross-border coordination to facilitate the liquidation and reorganization of failed large financial companies under bankruptcy.<sup>3</sup> We also continue to monitor developments in the bankruptcy cases of three financial companies (on which we previously reported in reports responding to this mandate) and discuss these cases in appendix I.

To address these objectives, we reviewed proposed legislation in the 113th Congress to change the Code that was relevant to the liquidation or reorganization of financial companies, as well as literature by researchers relevant to such changes. We reviewed documentary evidence from foreign financial regulators and international bodies to describe the status of reform efforts to improve cross-border coordination. We reviewed prior GAO reports, as well as transcripts from expert roundtables on bankruptcy reform that GAO hosted in 2013, and collected and analyzed information from regulatory documents and academic studies. In addition, we interviewed officials from financial regulatory agencies and others with a role in bankruptcy proceedings including the Commodity Futures Trading Commission (CFTC), FDIC, the Board of Governors of the Federal Reserve System (Federal Reserve), and the Securities and Exchange Commission (SEC); the Administrative Office of the United States Courts (AOUSC), the U.S. Department of Justice, and the U.S. Department of the Treasury (Treasury). See appendix II for more information on our scope and methodology.

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<sup>3</sup>The mandate to which this report responds also requires us to study ways to maximize the efficiency and effectiveness of the United States District Court for the District of Columbia, which is responsible for the judicial review provision of the Orderly Liquidation Authority (OLA) of the Dodd-Frank Act. In our 2011 and 2012 reports, we reported on local D.C. District Court rules regarding judicial review in the event of an FDIC receivership under OLA. Since our 2012 report, the D.C. District Court has not changed any rules specifically relevant to financial company bankruptcies or OLA.

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We conducted this performance audit from June 2014 to March 2015, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Background

There are two approaches for reorganizing or terminating a large financial company. Large financial companies may be reorganized or liquidated under a judicial bankruptcy process or resolved under special legal and regulatory resolution regimes that have been created to address insolvent financial entities such as insured depository institutions and insurance companies.

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## Bankruptcy Proceedings

Bankruptcy is a federal court procedure, the goal of which is to help individuals and businesses eliminate or restructure debts they cannot repay and help creditors receive some payment in an equitable manner. Generally the filing of a bankruptcy petition operates as an automatic stay; that is, it stops most lawsuits, foreclosures, and other collection activities against the debtor. Equitable treatment of creditors means all creditors with substantially similar claims are classified similarly and receive the same treatment. For example, a class of secured creditors—those with liens or other secured claims against the debtor’s property—will receive similar treatment as to their secured claims.

Business debtors may seek liquidation, governed primarily by Chapter 7 of the Code, or reorganization, governed by Chapter 11. Proceedings under Chapters 7 and 11 can be voluntary (initiated by the debtor) or involuntary (generally initiated by at least three creditors holding at least a certain minimum amount of claims against the debtor). In an involuntary proceeding, the debtor can defend against the proceeding, including presenting objections. The judge subsequently decides whether to grant the creditors’ request and permit the bankruptcy to proceed, dismiss the request, or enter any other appropriate order.

A Chapter 7 proceeding is a court-supervised procedure by which a trustee takes over the assets of the debtor’s estate subject to limited exemptions, reduces them to cash, and makes distributions to creditors, subject to the rights of secured creditors to the collateral securing their loans to the debtor. A reorganization proceeding under Chapter 11 allows

debtors to continue some or all of their operations subject to court supervision as a way to satisfy creditor claims. The debtor typically remains in control of its assets, and is called a debtor-in-possession (DIP). Under certain circumstances, the court can direct the U.S. Trustee to appoint a Chapter 11 trustee to take over the affairs of the debtor.<sup>4</sup> As shown in figure 1, a firm going through a Chapter 11 bankruptcy generally will pass through several stages. Among these are:

- **First-day motions.** The most common first-day motions relate to the continued operation of the debtor's business and involve matters such as requests to use cash collateral—liquid assets on which secured creditors have a lien or claim—and obtaining financing, if any.
- **Disclosure.** The disclosure statement must include information on the debtor's assets, liabilities, and business affairs sufficient to enable creditors to make informed judgments about how to vote on the debtor's reorganization plan and must be approved by the bankruptcy court.
- **Plan of reorganization.** A debtor has an exclusive right to file a plan of reorganization within the first 120 days of bankruptcy.<sup>5</sup> The plan describes how the debtor intends to reorganize and treat its creditors. The plan divides claims against the debtor into separate classes and

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<sup>4</sup>The United States Trustee Program is a component of the Department of Justice that seeks to promote the efficiency and protect the integrity of the federal bankruptcy system. In all but the six bankruptcy court districts in Alabama and North Carolina, the program is responsible for monitoring the conduct of bankruptcy parties and private estate trustees, overseeing related administrative functions, and acting to ensure compliance with applicable laws and procedures. It also identifies and helps investigate bankruptcy fraud and abuse in coordination with United States Attorneys, the Federal Bureau of Investigation, and other law enforcement agencies. Separate from the U.S. Trustee Program, the remaining six districts have judicial branch bankruptcy administrators (referred to as the Bankruptcy Administrator Program) who perform duties similar to those of the U.S. Trustees.

<sup>5</sup>There are many findings a court must make in order to confirm a plan of reorganization, aside from acceptance or lack of impairment. For example, the court must find that the plan is feasible. To find that the plan is feasible, the judge must find that confirmation of the plan is not likely to be followed by liquidation or the need for further financial reorganization. 11 U.S.C. § 1129(a)(11). Additionally, the 180-day rule allowing third parties to file a plan is tied to voting (i.e., acceptance of the plan by a sufficient number of impaired creditors) on a plan filed by the debtor and not just court approval. See 11 U.S.C. §1121(c)(3).



specifies the treatment each class will receive.<sup>6</sup> The court may confirm the plan if, among other things, each class of allowed creditors has accepted the plan or the class is not impaired by the plan. If not all classes of impaired creditors vote to accept the plan, the court can still confirm the plan if it is shown that it is fair to all impaired creditors.<sup>7</sup>

- **Reorganization.** Possible outcomes, which can be used in combination, include (1) distribution under a plan of the proceeds of a pre-plan sale of the assets of the company (in whole or in part), sometimes called a section 363 sale. Section 363 of the Code permits sales that are free and clear of creditor claims of property of the estate; (2) liquidation of the company's assets with approval of the court, through means other than a 363 sale; and (3) reorganization of the company, in which it emerges from bankruptcy with new contractual rights and obligations that replace or supersede those it had before filing for bankruptcy protection.<sup>8</sup>

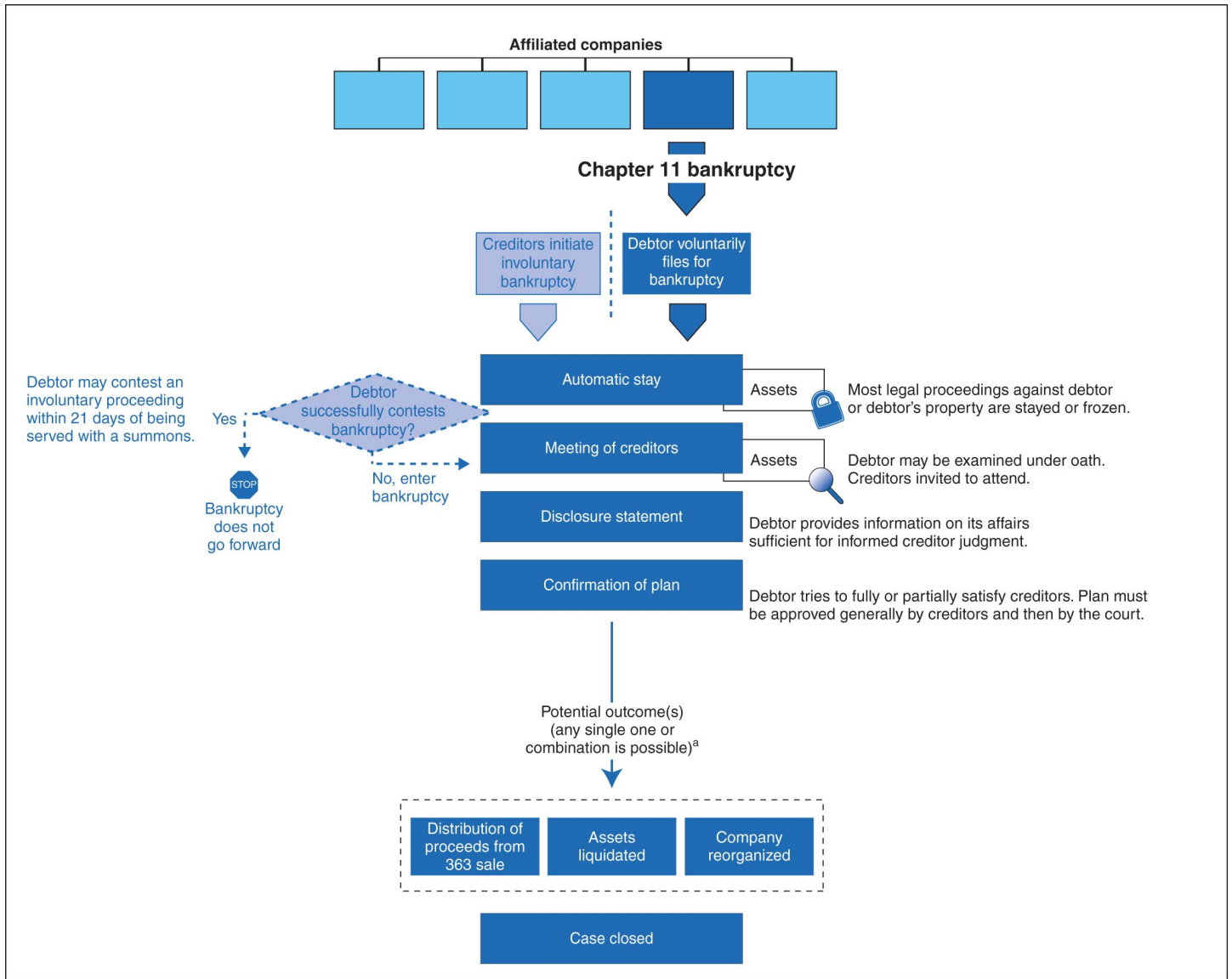
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<sup>6</sup>The plan generally classifies the claim holders as secured creditors, unsecured creditors entitled to priority, general unsecured creditors, and equity security holders.

<sup>7</sup>Impaired means the plan alters the rights of a class of creditors compared to the contractual rights prior to bankruptcy. Unimpaired creditors' rights aren't changed by the plan.

<sup>8</sup>Potential outcomes also include dismissal of the case or conversion to a Chapter 7 liquidation.

Figure 1: Chapter 11 Process



Source: GAO analysis of U.S. Court information. | GAO-15-299

<sup>a</sup>Potential outcomes also include dismissal of the case or conversion to a Chapter 7 liquidation. A 363 sale refers to that section of the Code which permits sales that are free and clear of creditor claims.

The debtor, creditors, trustee, or other interested parties may initiate adversary proceedings—in effect, a lawsuit within the bankruptcy case to preserve or recover money or property, to subordinate a claim of another creditor to their own claims, or for similar reasons. Furthermore, the

Chapter 11 trustee or others may bring a preference action (a type of avoidance action) challenging certain transfers made by a debtor to a creditor generally within 90 days prior to the bankruptcy filing or a fraudulent transfer action on transfers made within 2 years before a bankruptcy if payments were determined to be made with actual intent to hinder, delay, or defraud or were made for less than reasonably equivalent value under certain circumstances.<sup>9</sup> If successful, such transfers may be returned to the debtor's estate.

The U.S. bankruptcy system involves multiple federal entities. Bankruptcy courts are located in 90 federal judicial districts; however, as we reported in 2011, the Southern District of New York and the District of Delaware adjudicate a majority of larger corporate or business bankruptcy cases.<sup>10</sup> The Judicial Conference of the United States serves as the judiciary's principal policymaking body and recommends national policies on all aspects of federal judicial administration.<sup>11</sup> In addition, AOUSC serves as the central administrative support entity for the Judicial Conference and the federal courts, including bankruptcy courts. The Federal Judicial Center is the education and research agency for the federal courts and assists bankruptcy courts with reports and assessments relating to the administration and management of bankruptcy cases. Finally, the Department of Justice's U.S. Trustee Program and the judiciary's Bankruptcy Administrator Program oversee bankruptcy trustees and promote integrity and efficiency in the bankruptcy system by overseeing the administration of bankruptcy estates.<sup>12</sup>

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<sup>9</sup>A preference action can be asserted for payments made to an insider within a year prior to the bankruptcy filing.

<sup>10</sup>In Arkansas, the bankruptcy judges serve both the Eastern and Western Districts, so there are 90 bankruptcy courts that serve 91 districts.

<sup>11</sup>See <http://www.uscourts.gov/FederalCourts/JudicialConference.aspx>.

<sup>12</sup>See [http://www.justice.gov/ust/eo/ust\\_org/](http://www.justice.gov/ust/eo/ust_org/). The program covers 84 of the 90 bankruptcy courts and consists of the Executive Office for U.S. Trustees, which provides general policy and legal guidance, oversees operations, and handles administrative functions; the program includes 95 field offices and 21 U.S. Trustees—federal officials charged with supervising the administration of federal bankruptcy cases. Bankruptcy Administrators, who are employees of the federal judiciary, perform the functions of the U.S. Trustees in the remaining six bankruptcy courts, located in Alabama and North Carolina.

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## Financial Companies and the Bankruptcy Code

Large, complex financial companies that are eligible to file for bankruptcy generally file under Chapter 11 of the Code. Such companies operating in the United States engage in a range of financial services activities. Many are organized under both U.S. and foreign laws. The U.S. legal structure is frequently premised on a parent holding company owning regulated subsidiaries (such as depository institutions, insurance companies, broker-dealers, and commodity brokers) and nonregulated subsidiaries that engage in financial activities.

Certain financial institutions may not file as debtors under the Code and other entities face special restrictions in using the Code:

- **Insured depository institutions.** Under the Federal Deposit Insurance Act, FDIC serves as the conservator or receiver for insured depository institutions placed into conservatorship or receivership under applicable law.<sup>13</sup>
- **Insurance companies.** Insurers generally are subject to oversight by state insurance commissioners, who have the authority to place them into conservatorship, rehabilitation, or receivership.
- **Broker-dealers.** Broker-dealers can be liquidated under the Securities Investor Protection Act (SIPA) or under a special subchapter of Chapter 7 of the Code. However, broker-dealers may not file for reorganization under Chapter 11.<sup>14</sup>
- **Commodity brokers.** Commodity brokers, which include futures commission merchants, foreign futures commission merchants, clearing organizations, and certain other entities in the derivatives

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<sup>13</sup>12 U.S.C. § 1821(c).

<sup>14</sup>Chapter 7 of the Code contains special provisions for the liquidation of stockbrokers. 11 U.S.C. §§ 741-753. Under SIPA, the Securities Investor Protection Corporation (SIPC) initiates a liquidation proceeding, the primary purpose of which is to protect customers against financial losses arising from the insolvency of their brokers. Once a protective decree has been applied for, any other pending bankruptcy proceeding involving the debtor stockbroker is stayed, and the court where the application is filed has exclusive jurisdiction over that stockbroker. SIPC participation can displace a Chapter 7 liquidation pending the SIPA liquidation, but provisions of the Code apply in a SIPA liquidation to the extent they are consistent with SIPA. See 15 U.S.C. §§ 78eee(b)(2)(B), 78fff(b). Because the stockbrokers discussed in this report are also dealers registered with SEC as broker-dealers, we generally use broker-dealer rather than stockbroker in this report.

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industry, can only use a special subchapter of Chapter 7 for bankruptcy relief.<sup>15</sup>

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## Current Role of Financial Regulators in Bankruptcy Proceedings

Regulators often play a role in financial company bankruptcies. With the exception of CFTC and SEC, the Code does not explicitly name federal financial regulators as a party of interest with a right to be heard before the court. In practice, regulators frequently appear before the court in financial company bankruptcies. For example, as receiver of failed insured depository institutions, FDIC's role in bankruptcies of bank holding companies is typically limited to that of creditor. CFTC has the express right to be heard and raise any issues in a case under Chapter 7. SEC has the same rights in a case under Chapter 11. SEC may become involved in a bankruptcy particularly if there are issues related to disclosure or the issuance of new securities. SEC and CFTC are, in particular, involved in Chapter 7 bankruptcies of broker-dealers and commodity brokers. In the event of a broker-dealer liquidation, pursuant to SIPA the bankruptcy court retains jurisdiction over the case and a trustee, selected by the Securities Investor Protection Corporation (SIPC), typically administers the case. SEC may participate in any SIPA proceeding as a party.

The Code does not restrict the federal government from providing DIP financing to a firm in bankruptcy, and in certain cases it has provided such funding—for example, financing under the Troubled Asset Relief Program<sup>16</sup> (TARP) in the bankruptcies of General Motors and Chrysler.<sup>17</sup> The authority to make new financial commitments under TARP terminated on October 3, 2010. In July 2010, the Dodd-Frank Act amended section 13(3) of the Federal Reserve Act to prohibit the establishment of an emergency lending program or facility for the purpose of assisting a single and specific company to avoid bankruptcy. Nevertheless, the Federal Reserve may design emergency lending

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<sup>15</sup> Chapter 7 of the Code contains special provisions for commodity broker liquidation (11 U.S.C. §§ 753, 761-767), and CFTC's rules relating to bankruptcy are set forth at 17 C.F.R. § 190.01 et seq.

<sup>16</sup> Pub. L. No. 110-343, 122 Stat. 3765 (2008).

<sup>17</sup> In a bankruptcy proceeding, creditors often provide financing for the debtor to have immediate cash as well as ongoing working capital during a reorganization process. This financing is called DIP financing.

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programs or facilities for the purpose of providing liquidity to the financial system.<sup>18</sup>

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### Current Safe-Harbor Treatment for Financial Contracts under the Code

Although the automatic stay generally preserves assets and prevents creditors from taking company assets in payment of debts before a case is resolved and assets are systematically distributed, the stay is subject to exceptions, one of which can be particularly important in a financial institution bankruptcy. These exceptions—commonly referred to as the “safe harbor provisions”—pertain to certain financial and derivative<sup>19</sup> contracts, often referred to as qualified financial contracts (QFC).<sup>20</sup> The types of contracts eligible for the safe harbors are defined in the Code. They include derivative financial products, such as forward contracts and swap agreements that financial companies (and certain individuals and nonfinancial companies) use to hedge against losses from other transactions or speculate on the likelihood of future economic developments.<sup>21</sup> Repurchase agreements, which are collateralized instruments that provide short-term financing for financial companies and others, also generally receive safe-harbor treatment.

Under the safe-harbor provisions, most counterparties that entered into a qualifying transaction with the debtor may exercise certain contractual rights even if doing so otherwise would violate the automatic stay.<sup>22</sup> In the event of insolvency or the commencement of bankruptcy proceedings, the nondefaulting party in a QFC may liquidate, terminate, or accelerate the contract, and may offset (net) any termination value, payment amount, or

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<sup>18</sup>Dodd-Frank Act, Pub. L. No. 111-203, § 1101(a). FDIC can create widely available programs to guarantee obligations of solvent insured depository institutions or holding companies during times of severe economic distress.

<sup>19</sup>Financial derivatives are financial instruments whose value is based on one or more underlying reference items such as a security or assets.

<sup>20</sup>The term “qualified financial contract” is not used in the Code.

<sup>21</sup>A futures contract is a contract that is standardized and traded on an organized futures exchange, while a forward contract is privately negotiated between the buyer and seller. A swap is a type of derivative that involves an ongoing exchange of one or more assets, liabilities, or payments for a specified period. Financial and nonfinancial firms use swaps and other over-the-counter derivatives to hedge risk, or speculate, or for other purposes.

<sup>22</sup>A contractual right includes a right set forth in the rules or bylaws of, among others, a derivatives clearing organization, a multilateral clearing organization, a national securities exchange or association, or a securities clearing agency.

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other transfer obligation arising under the contract when the debtor files for bankruptcy. That is, generally nondefaulting counterparties subtract what they owe the bankrupt counterparty from what that counterparty owes them (netting), often across multiple contracts. If the result is positive, the nondefaulting counterparties can sell any collateral they are holding to offset what the bankrupt entity owes them. If that does not fully settle what they are owed, the nondefaulting counterparties are treated as unsecured creditors in any final liquidation or reorganization.

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## Orderly Liquidation Authority

OLA gives FDIC the authority, subject to certain constraints, to resolve large financial companies, including a bank holding company or a nonbank financial company designated for supervision by the Federal Reserve, outside of the bankruptcy process.<sup>23</sup> This regulatory resolution authority allows for FDIC to be appointed receiver for a financial company if the Secretary of the Treasury, in consultation with the President, determines, upon the recommendation of two-thirds of the Board of Governors of the Federal Reserve and (depending on the nature of the financial firm) FDIC, SEC, or the Director of the Federal Insurance Office, among other things, that the firm's failure and its resolution under applicable law, including bankruptcy, would have serious adverse effects on U.S. financial stability and no viable private-sector alternative is available to prevent the default.<sup>24</sup> In December 2013, FDIC released for public comment a notice detailing a proposed single-point-of-entry

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<sup>23</sup>Pub. L. No. 111-203, § 204, 124 Stat. at 1454-1456.

<sup>24</sup>The factors to be considered by the Secretary of the Treasury are set forth in Section 203(b) of the Dodd-Frank Act. Pub. L. No. 111-203, § 203(b), 124 Stat. at 1451 (codified at 12 U.S.C. § 5383(b)). Before the Secretary of the Treasury, in consultation with the President, makes a decision to seek the appointment of FDIC as receiver of a financial company, at least two-thirds of those serving on the Board of Governors of the Federal Reserve System and at least two-thirds of those serving on the Board of Directors of FDIC must vote to make a written recommendation to the Secretary of the Treasury to appoint FDIC as receiver. Pub. L. No. 111-203, § 203(a)(1)(A), 124 Stat. at 1450 (codified at 12 U.S.C. § 5383(a)(1)(A)). In the case of a broker-dealer, the recommendation must come from at least two-thirds of those serving as members of the Federal Reserve Board and at least two-thirds of those serving as members of the Securities and Exchange Commission, in consultation with FDIC, and in the case of an insurance company, from at least two-thirds of those serving as members of the Federal Reserve Board and the Director of the Federal Insurance Office, in consultation with FDIC. Pub. L. No. 111-203, § 203(a)(1)(B)-(C), 124 Stat. at 1450 (codified at 12 U.S.C. § 5383(a)(1)(B)-(C)).

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(SPOE) approach to resolving a systemically important financial institution under OLA.<sup>25</sup>

Under the SPOE approach, as outlined, FDIC would be appointed receiver of the top-tier U.S. parent holding company of a covered financial company determined to be in default or in danger of default pursuant to the appointment process set forth in the Dodd-Frank Act. Immediately after placing the parent holding company into receivership, FDIC would transfer assets (primarily the equity and investments in subsidiaries) from the receivership estate to a bridge financial company. By allowing FDIC to take control of the firm at the parent holding company level, this approach could allow subsidiaries (domestic and foreign) carrying out critical services to remain open and operating. In a SPOE resolution, at the parent holding company level, shareholders would be wiped out, and unsecured debt holders would have their claims written down to reflect any losses that shareholders cannot cover.

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## Challenges of Resolving Failing Cross Border Financial Companies

The resolution of globally active large financial firms is often associated with complex international, legal, and operational challenges. The resolution of failed financial companies is subject to different national frameworks. During the recent financial crisis, these structural challenges led to government rescues or disorderly liquidations of systemic firms.

- Insolvency laws vary widely across countries. The legal authorities of some countries are not designed to resolve problems in financial groups operating through multiple legal entities that span borders. Some resolution authorities may not encourage cooperative solutions with foreign resolution authorities.
- Regulatory and legal regimes may conflict. Depositor preference, wholesale funding arrangements, derivatives, and repurchase agreements are often treated differently among countries when a firm enters bankruptcy.
- Some resolution authorities may lack the legal tools or authority to share information with relevant foreign authorities about the financial group as a whole or subsidiaries or branches.

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<sup>25</sup>Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614, Dec. 18, 2013.



- Country resolution authorities may have as their first responsibility the protection of domestic financial stability and minimization of any risk to public funds. For instance, if foreign authorities did not have full confidence that national and local interests would be protected, the assets of affiliates or branches of a U.S.-based financial institution chartered in other countries could be ring fenced or isolated and wound down separately under the insolvency laws of other countries thus complicating home-country resolution efforts.<sup>26</sup>

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## Chapter 15 of the Bankruptcy Code Governs Judicial Cross-Border Coordination in Limited Circumstances

In 2005, the United States adopted Chapter 15 of the U.S. Bankruptcy Code.<sup>27</sup> Chapter 15 is based on the Model Law on Cross-Border Insolvency of the United Nations Commission on International Trade Law (UNCITRAL). The model law is intended to promote coordination between courts in different countries during insolvencies and has been adopted in 21 jurisdictions.<sup>28</sup> More than 450 Chapter 15 cases have been filed since its adoption, with more than half filed in the Southern District of New York and the District of Delaware.

Among the stated objectives of Chapter 15 are promoting cooperation between U.S. and foreign parties involved in a cross-border insolvency case, providing for a fair process that protects all creditors, and facilitating the rescue of a distressed firm.<sup>29</sup> In pursuit of these goals, Chapter 15 authorizes several types of coordination, including

- U.S. case trustees or other authorized entities operating in foreign countries on behalf of a U.S. bankruptcy estate;

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<sup>26</sup>Ring fencing refers to the practice by which local authorities set aside or shield assets of a local subsidiary from the failed institution and insist that local creditors get paid first, prior to any funds being transferred to satisfy claims made against the failed parent.

<sup>27</sup>Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 801, 119 Stat. 23, 134 (2005).

<sup>28</sup>See, H.R. Rep. No. 109-31, pt. 1 at 105-07 (2005). As of March 2015, legislation based upon the UNCITRAL Model Law had been enacted in Australia (2008); the British Virgin Islands (2003); Canada (2009); Chile (2013); Colombia (2006); Eritrea (1998); Greece (2010); Japan (2000); Mauritius (2009); Mexico (2000); Montenegro (2002); New Zealand (2006); Poland (2003); the Republic of Korea (2006); Romania (2003); Serbia (2004); Slovenia (2008); South Africa (2000); Uganda (2011); UK (2006); and the United States (2005).

<sup>29</sup>11 U.S.C. § 1501(a).

- foreign representatives having direct access to U.S. courts, including the right to commence a proceeding or seek recognition of a foreign proceeding; and
- U.S. courts communicating information they deem important, coordinating the oversight of debtors' activities, and coordinating proceedings.

Chapter 15 excludes the same financial institutions that are generally not eligible to file as debtors under the Code (such as insured depository institutions and U.S. insurance companies), with the exception of foreign insurance companies. It also excludes broker-dealers that can be liquidated under SIPA or a special provision of Chapter 7 of the Code and commodity brokers that can be liquidated under a different special provision of Chapter 7. Based on the UNCITRAL model law, Chapter 15 contains a public policy exception that allows a U.S. court to refuse cooperation and coordination if doing so would be “manifestly contrary to the public policy of the United States.”<sup>30</sup>

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## No Changes Have Been Made to the Bankruptcy Code but Proposals Were Introduced in the Previous Congress

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<sup>30</sup>11 U.S.C. § 1506.

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## Two Proposals Would Have Made Broad Changes Relating to Complex Financial Institutions

Since we last reported on financial company bankruptcies in July 2013, no changes have been made to Chapters 7, 11, or 15 of the Bankruptcy Code relating to large financial companies, although two bills were introduced in the 113th Congress that would have attempted to address challenges associated with the reorganization of large financial firms as governed by Chapter 11 of the Code. Neither bill was signed into law nor re-introduced in the current Congress, as of March 12, 2015.<sup>31</sup>

The Taxpayer Protection and Responsible Resolution Act (S. 1861) was introduced in the Senate on December 19, 2013. The bill would have added a new chapter to the Code—"Chapter 14: Liquidation, Reorganization, or Recapitalization of a Covered Financial Corporation"—that would have generally applied to bank holding companies or corporations predominantly engaged in activities that the Federal Reserve Board has determined are financial in nature. Its provisions would have made changes to the role of regulators, changed the treatment of QFCs, and specifically designated judges to hear Chapter 14 cases, as the following examples illustrate.

- The proposal would have repealed the regulatory resolution regime in Title II of the Dodd-Frank Act—revoking FDIC’s role as a receiver of a failed or failing financial company under OLA—and returned all laws changed by Title II to their pre-Title II state.
- The proposal would have allowed the Federal Reserve Board to commence an involuntary bankruptcy and granted the Federal Reserve Board the right to be heard before the court.<sup>32</sup> The proposal would have allowed the court to transfer assets of the estate to a bridge company (on request of the Federal Reserve Board or the trustee and after notice and hearing and not less than 24 hours after the start of the case). The court would have been able to order transfer of assets to a bridge company only under certain conditions

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<sup>31</sup>Because the legislative session of the 113<sup>th</sup> Congress ended on January 3, 2015, all introduced legislative proposals not signed into law during the 113<sup>th</sup> Congress are no longer active unless re-introduced during the current or future Congress.

<sup>32</sup>At an expert roundtable on bankruptcy reform, none of the experts who responded to written questions indicated that granting regulators a right to be heard in bankruptcy court would greatly change the existing bankruptcy process. Experts who addressed this issue during the roundtable noted that regulators often appear before the court in bankruptcy proceedings.

(including that a preponderance of evidence indicated the transfer was necessary to prevent imminent substantial harm to U.S. financial stability). FDIC also would have been granted the right to be heard before the court on matters related to the transfer of property to the bridge company. However, this proposal would have explicitly prohibited the Federal Reserve Board from providing DIP financing to a company in bankruptcy or to a bridge company and provided no specific alternative non-market source of funding.

The Taxpayer Protection and Responsible Resolution Act (S. 1861) also would have changed the treatment of QFCs in bankruptcy. The rights to liquidate, terminate, offset, or net QFCs would have been stayed for up to 48 hours after bankruptcy filing (or the approval of the petition from the Federal Reserve Board). During the stay, the trustee would have been able to perform all payment and delivery obligations under the QFC that became due after the case commenced. The stay would have been terminated if the trustee failed to perform any payment or delivery obligation. Furthermore, QFCs would not have been able to be transferred to the bridge company unless the bridge assumed all contracts with a counterparty. If transferred to the bridge company, the QFCs could not have been terminated or modified for certain reasons, including the fact that a bankruptcy filing occurred. Aside from the limited exceptions, QFC counterparties would have been free to exercise all of their pre-existing contractual rights, including termination.

Finally, the Taxpayer Protection and Responsible Resolution Act (S. 1861) would have required the Chief Justice to designate no fewer than 10 bankruptcy judges with expertise in cases under Title 11 in which a financial institution is a debtor to be available to hear a Chapter 14 case. Additionally, the Chief Justice would have been required to designate at least one district judge from each circuit to hear bankruptcy appeals under Title 11 concerning a covered financial corporation.

A second bankruptcy reform proposal, the Financial Institution Bankruptcy Act of 2014 (H.R. 5421), was passed by voice vote by the House of Representatives on December 1, 2014, and would have added a new Subchapter V under Chapter 11. Generally, the proposed subchapter would have applied to bank holding companies or corporations with \$50 billion or greater in total assets and whose activities, along with its subsidiaries, are primarily financial in nature.

The Financial Institution Bankruptcy Act (H.R. 5421) contained provisions similar or identical to those in the Taxpayer Protection and Responsible

Resolution Act (S. 1861) that would have affected the role of regulators, treatment of QFCs, and designation of judges. For example, this proposal would have allowed an involuntary bankruptcy to be commenced by the Federal Reserve Board and allowed for the creation of a bridge company to which assets of the debtor holding company could be transferred. This proposal also would have granted the Federal Reserve Board and FDIC the right to be heard before the court, as well as the Office of the Comptroller of the Currency and SEC (which are not granted this right under the Taxpayer Protection and Responsible Resolution Act).<sup>33</sup> The changes to the treatment of QFCs under this proposal were substantively similar to those under the Taxpayer Protection and Responsible Resolution Act (S. 1861). In addition, the Financial Institution Bankruptcy Act (H.R. 5421) would have required that the Chief Justice would designate no fewer than 10 bankruptcy judges to be available to hear a Subchapter V case. The Chief Justice also would have been required to designate not fewer than three judges of the court of appeals in not fewer than four circuits to serve on an appellate panel.

Although the two bills have similarities, there are significant differences. For example, the Financial Institution Bankruptcy Act (H.R. 5421) would not have repealed Title II of the Dodd-Frank Act. Instead, Title II would have remained an alternative to resolving a firm under the Bankruptcy Code. Also, the Financial Institution Bankruptcy Act (H.R. 5421) would not have restricted the Federal Reserve Board from providing DIP financing to a financial firm under the proposed subchapter.<sup>34</sup> Furthermore, the Financial Institution Bankruptcy Act (H.R. 5421) would have given the court broad power in the confirmation of the bankruptcy plan to consider the serious adverse effect that any decision in connection with Subchapter V might have on financial stability in the United States. By contrast, the Taxpayer Protection and Responsible Resolution Act (S. 1861) mentioned financial stability as a consideration in specific circumstances, such as whether the Federal Reserve Board could initiate an involuntary bankruptcy under Chapter 14, or whether the court could order a transfer of the debtor's property to the bridge company.

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<sup>33</sup>Currently, SEC has the right to raise and be heard before the court on any issue in a case under Chapter 11.

<sup>34</sup>The Dodd-Frank Act also restricts the Federal Reserve from providing emergency lending to individual firms, allowing it only to make funds available through programs with broad-based eligibility.

Certain provisions in these bills resembled those in OLA and may have facilitated a resolution strategy similar to FDIC's SPOE strategy under OLA. For example, each of the bankruptcy reform bills and FDIC's SPOE strategy under OLA would have allowed for the creation of a bridge company, in which assets, financial contracts, and some legal entities of the holding company would have been transferred, allowing certain subsidiaries to have maintained operations. In addition, OLA, like the bills, included a temporary stay for QFCs.<sup>35</sup>

OLA uses a regulatory approach to resolution, while the bankruptcy reform bills in the 113th Congress would have maintained a judicial approach to resolution. Some experts have expressed concern that a regulatory resolution may not adequately ensure the creditors' rights to due process. For example, experts attending GAO's 2013 bankruptcy reform roundtables noted that if preferences were given to some counterparties or creditors during a temporary stay, other counterparties or creditors would have the right to take action to recover value later in the process, as opposed to having a judge consider the views of all of the parties prior to making any decisions. However, as we reported in July 2013, other experts have stated that the judicial process of bankruptcy does not contemplate systemic risk, or have some of the tools available for minimizing the systemic risk associated with the failure of a systemically important financial institution.<sup>36</sup> For example, to act quickly in cases involving large and complex financial companies, courts might need to shorten notice periods and limit parties' right to be heard, which could compromise due process and creditor rights. In the United States, the judicial process under bankruptcy remains the presumptive method for resolving financial institutions, even those designated as systemically important.

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### Another Proposal Would Have Removed Safe Harbor Treatment of QFCs in Bankruptcy

A third proposal would have more narrowly amended the Code. The 21st Century Glass-Steagall Act of 2013 (S. 1282 in the Senate and H.R. 3711 in the House) contained a provision that would have repealed all safe-harbor provisions for QFCs. This legislative proposal was neither signed into law nor re-introduced in the current Congress, as of March 12, 2015.

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<sup>35</sup>Under OLA, QFCs would be subject to an automatic stay of 1 business day.

<sup>36</sup>See [GAO-13-622](#).

Some experts have identified the safe-harbor treatment of QFCs under the Code as a challenge to an orderly resolution in bankruptcy. For example, safe-harbor treatment can create significant losses to the debtor's estate, particularly for financial institution debtors that often are principal users of these financial products. As we previously reported in July 2011, some experts we interviewed suggested that modifying the safe harbor provisions might help to avoid or mitigate the precipitous decline of the asset values typical in financial institution bankruptcies.<sup>37</sup> For example, these experts suggested that the treatment of QFCs in the Lehman bankruptcy contributed to a significant and rapid loss of asset values to the estate. Other experts we spoke with in 2011 suggested that safe-harbor treatment might lessen market discipline. Because counterparties entered into QFCs may close out their contracts even if doing so would otherwise violate the automatic stay, the incentive to monitor the risk of each other could be reduced. Additionally, as we reported in July 2013, attendees of our roundtable discussions on bankruptcy reform noted that the safe harbors lead to a larger derivatives market and greater reliance on short-term funding because QFCs would not be subject to a stay, which could increase systemic risk in the financial system.<sup>38</sup>

However, others argue that a repeal of the safe-harbor provisions could have adverse effects. As we previously reported in July 2011, these experts assert that subjecting any QFCs to the automatic stay in bankruptcy would freeze many assets of the counterparties of the failed financial institution, causing a chain reaction and a subsequent systemic financial crisis.<sup>39</sup> In January 2011, regulatory officials we spoke with also told us that the safe harbor provisions uphold market discipline through margin, capital, and collateral requirements. They said that the requirement for posting collateral limits the amount of risk counterparties are willing to undertake. In addition, during the 2013 expert roundtable on financial company bankruptcies, one expert noted that one of the goals of safe harbors is to limit market turmoil during a bankruptcy—that is, they are to prevent the insolvency of one firm from spreading to other firms.

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<sup>37</sup>See [GAO-11-707](#).

<sup>38</sup>See [GAO-13-622](#).

<sup>39</sup>See [GAO-11-707](#).

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## Recent Efforts to Enhance International Coordination to Resolve Failing Financial Companies under Bankruptcy

In the United States the presumptive mechanism to resolve a failed cross-border large financial company continues to be through the judicial bankruptcy process, though no statutory changes have been made to Chapter 15 of the Code or the U.S. judicial bankruptcy process to address impediments to an orderly resolution of a large, multinational financial institution. However, while some structural challenges discussed earlier remain, others, such as conflicting regulatory regimes and the treatment of cross-border derivatives, are being addressed through various efforts. For example, the Federal Reserve and FDIC have taken certain regulatory actions mandated by the Dodd-Frank Act authorities toward facilitating orderly resolution, including efforts that could contribute to cross-border coordination.<sup>40</sup> Specifically, certain large financial companies must provide the Federal Reserve and FDIC with periodic reports of their plans for rapid and orderly resolution in the event of material financial distress or failure under the Code.<sup>41</sup> The resolution plans or living wills are to demonstrate how a company could be resolved in a rapid manner under the Code. FDIC and the Federal Reserve have said that the plans were expected to address potential obstacles to global cooperation, among others. In 2014, FDIC and the Federal Reserve sent letters to a number of large financial companies identifying specific shortcomings with the resolution plans that those firms will need to address in their 2015 submissions, due on or before July 1, 2015, for the first group of filers.<sup>42</sup>

International bodies have also focused on strengthening their regulatory structures to enable the orderly resolution of a failing large financial firm and have taken additional actions to facilitate cross-border resolutions. In October 2011, the Financial Stability Board (FSB)—an international body that monitors and makes recommendations about the global financial

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<sup>40</sup>Pub. L. No. 111-203, § 165(d), 124 Stat. 1376, 1426 (2010).

<sup>41</sup>Bank holding companies with \$50 billion or more in total consolidated assets and nonbank financial companies designated for Federal Reserve supervision are to submit resolution plans on an annual basis.

<sup>42</sup>The 11 firms in the first group of filers include Bank of America, Bank of New York Mellon, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street Corp., and UBS. On February 18, 2005, the Federal Reserve Board and FDIC announced that they would extend the resolution plan submission deadline for American International Group, Inc., General Electric Capital Corporation, Inc., and Prudential Financial, Inc. The three organizations will be required to submit their second annual plans by Dec. 31, 2015, instead of July 1, 2015.



system—issued a set of principles to guide the development of resolution regimes for financial firms active in multiple countries. For example, each jurisdiction should have the authority to exercise resolution powers over firms, jurisdictions should have policies in place so that authorities are not reliant on public bailout funds, and statutory mandates should encourage a cooperative solution with foreign authorities. In addition, in December 2013 the European Parliament and European Council reached agreement on the European Union’s (EU) Bank Recovery and Resolution Directive, which establishes requirements for national resolution frameworks for all EU member states and provides for resolution powers and tools. For example, member states are to appoint a resolution authority, institutions must prepare and maintain recovery plans, resolution authorities are to assess the extent to which firms are resolvable without the assumption of extraordinary financial support, and authorities are to cooperate effectively when dealing with the failure of cross-border banks. Unlike the United States, EU and FSB do not direct resolution authorities to use the bankruptcy process developed for corporate insolvency situations.

In a letter to the International Swaps and Derivatives Association (ISDA) in 2013, FDIC, the Bank of England, BaFin in Germany, and the Swiss Financial Market Supervisory Authority called for changes in the exercise of termination rights and other remedies in derivatives contracts following commencement of an insolvency or resolution action.<sup>43</sup> In October 2014, 18 major global financial firms agreed to sign a new ISDA Resolution Stay Protocol to facilitate the cross-border resolution of a large, complex institution. This protocol was published and these 18 financial firms agreed to it on November 12, 2014, and certain provisions of which became effective in January 2015. Generally, parties adhering to this protocol have agreed to be bound by certain limitations on their termination rights and other remedies in the event one of them becomes subject to certain resolution proceedings, including OLA. These stays are intended to give resolution authorities and insolvency administrators time to facilitate an orderly resolution of a troubled financial firm. The Protocol also incorporates certain restrictions on creditor contractual rights that would apply when a U.S. financial holding company becomes subject to U.S. bankruptcy proceedings, including a stay on cross-default rights that would restrict the counterparty of a non-bankrupt affiliate of an insolvent

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<sup>43</sup>BaFin refers to the German financial regulator, *Bundesanstalt für Finanzdienstleistungsaufsicht*, meaning “Federal Financial Supervisory Authority.”

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U.S. financial holding company from immediately terminating its derivatives contracts with that affiliate.

Finally, a United Nations working group (tasked with furthering adoption of the UNCITRAL Model Law) included the insolvency of large and complex financial institutions as part of its focus on cross-border insolvency.<sup>44</sup> In 2010, Switzerland proposed that the working group study the feasibility of developing an international instrument for the cross-border resolution of large and complex financial institutions. The working group has acknowledged and has been monitoring the work undertaken by FSB, Basel Committee on Banking Supervision, the International Monetary Fund, and EU.<sup>45</sup>

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## Agency Comments

We provided a draft of this report to AOUSC, CFTC, Departments of Justice and the Treasury, FDIC, Federal Reserve, and SEC for review and comment. The agencies did not provide written comments. We received technical comments from the Department of the Treasury, FDIC, Federal Reserve, and SEC, which we incorporated as appropriate.

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We are sending copies of this report to the appropriate congressional committees, Director of the Administrative Office of the U.S. Courts, the Chairman of the Commodity Futures Trading Commission, Attorney General, the Secretary of the Treasury, the Chairman of the Federal Deposit Insurance Corporation, the Director of the Federal Judicial Center, the Chair of the Board of Governors of the Federal Reserve System, the Chair of the Securities and Exchange Commission, and other

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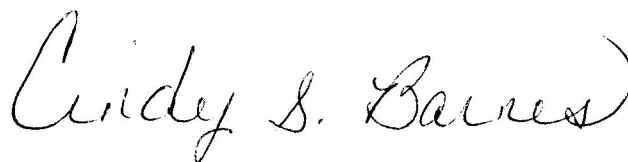
<sup>44</sup>When we last reported on this issue in 2011, 19 jurisdictions—some of considerable commercial importance—had adopted legislation based on the Model Law. Since July 2011, Uganda and Chile have also adopted legislation based on the UNCITRAL Model Law. Some large economies with large banks such as France and Germany have not adopted the Model Law.

<sup>45</sup>See Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Basel, Switzerland: Oct. 15, 2014); Basel Committee on Banking Supervision, *Report and Recommendations of the Cross-border Bank Resolution Group* (Basel, Switzerland: March 2010); International Monetary Fund, *Cross-Border Bank Resolution: Recent Developments* (Washington, D.C.: June 2014); and European Parliament and Council of the European Union, *Bank Recovery and Resolution Directive*, Directive 2014/59/EU.

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interested parties. The report also is available at no charge on the GAO web site at <http://www.gao.gov>.

If you or your staff members have any questions about this report, please contact Cindy Brown Barnes at (202) 512-8678 or [brownbarnesc@gao.gov](mailto:brownbarnesc@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Major contributors to this report are listed in appendix III.

A handwritten signature in black ink that reads "Cindy S. Barnes". The signature is written in a cursive style with a large initial 'C' and 'B'.

Cindy Brown Barnes  
Director  
Education, Workforce, and Income Security

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*List of Committees*

The Honorable Richard Shelby  
Chairman  
The Honorable Sherrod Brown  
Ranking Member  
Committee on Banking, Housing, and Urban Affairs  
United States Senate

The Honorable Charles E. Grassley  
Chairman  
The Honorable Patrick J. Leahy  
Ranking Member  
Committee on the Judiciary  
United States Senate

The Honorable Jeb Hensarling  
Chairman  
The Honorable Maxine Waters  
Ranking Member  
Committee on Financial Services  
House of Representatives

The Honorable Robert W. Goodlatte  
Chairman  
The Honorable John Conyers, Jr.  
Ranking Member  
Committee on the Judiciary  
House of Representatives

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# Appendix I: Updates on the Bankruptcy Proceedings for Lehman Brothers Holdings, Inc., MF Global, and Washington Mutual

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In our July 2011 and July 2012 reports on the bankruptcy of financial companies, we reported on the status of the bankruptcy proceedings of, among other financial companies, Lehman Brothers Holdings Inc., MF Global, and Washington Mutual. In the 2011 report, we found that comprehensive data on the number of financial companies in bankruptcies were not readily available. We collected information to update the status of the bankruptcy proceedings for Lehman Brothers Holdings Inc., MF Global, and Washington Mutual. Since we last reported in July 2012, in each case, additional payments to creditors have been distributed and litigation with various parties is ongoing.

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## Update on the Lehman Bankruptcy

Lehman Brothers Holdings Inc. (Lehman) was an investment banking institution that offered equity, fixed-income, trading, asset management, and other financial services. In 2008, Lehman was the fourth largest U.S. investment bank and had been in operation since 1850. It had 209 registered subsidiaries in 21 countries. On September 15, 2008, Lehman filed Chapter 11 cases in the U.S. Bankruptcy Court. Its affiliates filed for bankruptcy over subsequent months. Some of Lehman's affiliates also filed bankruptcy or insolvency proceedings in foreign jurisdictions. There are three different legal proceedings involving (1) the holding company or LBHI, (2) the U.S. broker dealer or LBI, and (3) the U.K. broker dealer or LBIE. On September 19, 2008, Lehman's broker-dealer was placed into liquidation under the Securities Investor Protection Act (SIPA). The bankruptcy court approved the sale of LBI's assets to Barclays PLC on September 20, 2008—5 days after the filing of the LBHI Chapter 11 case.

In March 2010, LBHI debtors filed their proposed Chapter 11 plan. In December 2010, a group of senior creditors filed an alternative plan. Since then, various plan amendments and counter plans were filed. In December 2011, the U.S. Bankruptcy Court for the Southern District of New York confirmed a reorganization plan for LBHI and the plan took effect in March 2012.

## Payments to Creditors Continue

LBHI had more than 100,000 creditors. As of October 2, 2014, some \$8.6 billion had been distributed to LBHI creditors in the nonpriority unsecured claims class. The Trustee of LBI has distributed more than \$106 billion to 111,000 customers. As of September 2014, £34 billion has been distributed by the LBIE Administrator to counterparties in the House Estate (general unsecured estate) and the Trust Estate (Client Assets, Client Money and Omnibus Trust). In February 2015, the bankruptcy court approved a second interim distribution of \$2.2 billion to general unsecured creditors with allowed claims. This would bring the total

distributions to allowed general unsecured creditors to approximately 27 percent.

## Litigation Continues

There is ongoing litigation involving a breach of a swap with Giants Stadium, the payment of creditor committee members' legal fees, and transactions with foreign entities, according to an official of the U.S. Trustees Program. Litigation concerning issues surrounding the sale of LBI assets to Barclays PLC also continues. On December 15, 2014, the SIPA Trustee filed a petition for a writ of certiorari with the U.S. Supreme Court seeking review of the lower court rulings that awarded \$4 billion of margin cash assets to Barclay's.

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## Update on the MF Global Bankruptcy

MF Global Holdings Ltd. (MFGH) was one of the world's leading brokers in markets for commodities and listed derivatives. The firm was based in the United States and had operations in Australia, Canada, Hong Kong, India, Japan, Singapore, and the U.K. On October 31, 2011, MFGH and one of its affiliates filed Chapter 11 cases in the U.S. Bankruptcy Court for the Southern District of New York. In the months following four other affiliates filed for relief in Bankruptcy Court. Also, on October 31, 2011, the Securities Investor Protection Corporation (SIPC) commenced a SIPA case against MF Global's broker-dealer subsidiary (MFGI). The SIPA trustee has been liquidating the firm's assets and distributing payments to its customers on a rolling basis pursuant to a claims resolution procedure approved by the bankruptcy court overseeing the case. MFGI was required to pay \$1.2 billion in restitution to its customers as well as a \$100 million penalty. In December 2014, CFTC obtained a federal court consent order against MFGH requiring it to pay \$1.2 billion or the amount necessary in restitution to ensure the claims of MFGI are paid in full.

The bankruptcy court confirmed a liquidation plan for MFGH on April 22, 2013, which became effective in June 2013. As of the end of 2013, the SIPA trustee reported the probability of a 100 percent recovery of allowed net equity claims for all commodities and securities customers of MFGI.

## Payments to Creditors Continue

As of mid-December 2014, 100 percent of the distributions through the SIPA trustee have been completed to substantially all categories of commodities and securities customers and 39 percent of the first interim distribution on allowed unsecured claims. The trustee started to make \$551 million in distributions to general creditors on October 30, 2014. An interim payment of \$518.7 million went to unsecured general claimants and covered 39 percent of their allowed claims. A reserve fund of \$289.8 million was to be held for unresolved unsecured claims and a reserve

fund of \$9.9 million will be held for unresolved priority claims. In April 2014, the SIPA trustee began final distributions to all public customers. With this distribution a total of \$6.7 billion was to have been returned to over 26,000 securities and commodities futures customers. General creditor claims totaling more than \$23 billion in asserted amounts, as substantial unliquidated claims, were filed in this proceeding as of the end of June 2014. As of December 2014, the SIPA trustee reports that of 7,687 general creditor claims asserted or reclassified from customer status, only 23 claims remain unresolved.

## Litigation Continues

Current litigation surrounds a malpractice complaint against PricewaterhouseCoopers (the company's former auditor) and an investigation of the officers, according to an official of the U.S. Trustees Program.

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## Update on Washington Mutual Bankruptcy

Washington Mutual Inc. was a thrift holding company that had 133 subsidiaries. Its subsidiary Washington Mutual Bank was the largest savings and loan association in the United State prior to its failure. In the 9 days prior to receivership by the Federal Deposit Insurance Corporation (FDIC), there were more than \$16.7 billion in depositor withdrawals. At the time of its filing, Washington Mutual had about \$32.9 billion in total assets and total debt of about \$8.1 billion. Its failure was the largest bank failure in U.S. history. On September 25, 2008, the Office of Thrift Supervision found Washington Mutual Bank to be unsafe and unsound, closed the bank, and appointed FDIC as the receiver.<sup>1</sup> FDIC as receiver then took possession of the bank's assets and liabilities and transferred substantially all the assets and liabilities to JPMorgan Chase for \$1.9 billion. On September 26, 2008, Washington Mutual and its subsidiary WMI Investment Corporation filed Chapter 11 cases in U.S. Bankruptcy Court for the District of Delaware. On March 12, 2010, Washington Mutual, FDIC, and JPMorgan Chase announced that they had reached a settlement on disputed property and claims. This was called the global settlement. On July 28, 2010, the bankruptcy court approved the appointment of an examiner, selected by the U.S. Trustee's office, to investigate the claims of various parties addressed by the global

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<sup>1</sup>The Dodd-Frank Act mandated that on July 21, 2011, unless authorized otherwise, the Office of Thrift Supervision transfer its authority over thrift holding companies to the Federal Reserve and authority over federal thrifts to the Office of the Comptroller of the Currency.

settlement. The seventh amended plan was confirmed by the court on February 24, 2012. The plan established a liquidating trust—the Washington Mutual Liquidating Trust (WMILT)—to make subsequent distributions to creditors on account of their allowed claims. Upon the effective date of the plan, Washington Mutual became a newly reorganized company, WMI Holdings Corp. consisting primarily of its subsidiary WMI Mortgage Reinsurance Company, Inc.

### Payments to Creditors Continue

In 2012, there was an initial distribution of \$6.5 billion. Since that initial distribution, an additional \$660 million has been distributed to creditors, according to officials at the U.S. Trustee Program, including a distribution of \$78.4 million paid on August 1, 2014.

### Litigation Continues

In August 2013, WMILT, pursuant to an order by the U.S. Bankruptcy Court for the District of Delaware, filed a declaratory judgment in the U.S. District Court for the Western District of Washington against FDIC, the Board of Governors of the Federal Reserve System (Federal Reserve), and 90 former employees who were also claimants in the bankruptcy proceeding. Certain employee claimants have asserted cross-claims against FDIC and the Federal Reserve, contending that the banking agencies are without authority to assert limits on payment from troubled institutions that are contingent on termination of a person's employment over WMILT, because WMILT is a liquidating trust. After the case was transferred to the U.S. Bankruptcy Court for the District of Delaware in July 2014 and all pending motions terminated, most of the parties stipulated to withdraw the reference to the bankruptcy court. FDIC moved to dismiss the complaint on September 5, 2014. The proposed order to withdraw the reference and the briefing on the motion to dismiss remains pending.



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# Appendix II: Objectives, Scope, and Methodology

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Section 202(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act) mandated that we report on the orderliness and efficiency of financial company bankruptcies every year for 3 years after passage of the act, in the fifth year, and every 5 years thereafter.<sup>1</sup> This report, the fourth in the series, examines (1) recent changes to the U.S. Bankruptcy Code (Code) and (2) efforts to improve cross-border coordination to facilitate the liquidation and reorganization of failed large financial companies under bankruptcy.

For each of our objectives, we reviewed relevant regulations and laws, including the Code and the Dodd-Frank Act as well as GAO reports that addressed bankruptcy issues and financial institution failures. We specifically reviewed the reports we issued during the first 3 years of the mandate as well as reports written under the same or similar mandates by the Administrative Office of the United States Courts (AOUSC) and the Board of Governors of the Federal Reserve System (Federal Reserve).<sup>2</sup> We interviewed officials from the following federal agencies due to their role in financial regulation and bankruptcy proceedings: AOUSC; the Commodity Futures Trading Commission (CFTC); Federal Deposit Insurance Corporation (FDIC); Department of Justice; Department of the Treasury (Treasury), including officials who support the Financial Stability Oversight Council (FSOC); Federal Reserve; and Securities and Exchange Commission (SEC). We also updated our review of published economic and legal research on the financial company bankruptcies that we had originally completed during the first year of the mandate (see

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<sup>1</sup>Pub. L. No. 111-203, § 202(e). The Administrative Office of the U.S. Courts (AOUSC) is also required to address Pub. L. No. 111-203, § 202(e) on the same time frame. The Board of Governors of the Federal Reserve System (Federal Reserve) was required to address a similar mandate—Pub. L. No. 111-203, § 216—in July 2011.

<sup>2</sup>GAO, *Bankruptcy: Complex Financial Institutions and International Coordination Pose Challenges*, [GAO-11-707](#) (Washington, D.C.: July 19, 2011), *Bankruptcy: Agencies Continue Rulemakings for Clarifying Specific Provisions of Orderly Liquidation Authority*, [GAO-12-735](#) (Washington, D.C.: July 12, 2012); and *Financial Company Bankruptcies: Need to Further Consider Proposals' Impact on Systemic Risk*, [GAO-13-622](#) (Washington, D.C.: July 18, 2013). See also Administrative Office of the United States Courts, *Report Pursuant to Section 202(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, (Washington, D.C.: July 2011); *Second Report Pursuant to Section 202(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* (Washington, D.C.: July 2012); *Third Report Pursuant to Section 202(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, (Washington, D.C.: July 2013); and Board of Governors of the Federal Reserve System, *Study on the Resolution of Financial Companies under the Bankruptcy Code* (Washington, D.C.: July 2011).

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appendix I). For the original search, we relied on Internet search databases (including EconLit and Proquest) to identify studies published or issued after 2000 through 2010.

To address our first objective, we reviewed Chapters 7, 11, or 15 of the Bankruptcy Code for any changes. In addition, we reviewed legislation proposed in the 113th Congress that would change the Code for financial company bankruptcies. We also reviewed academic literature on financial company bankruptcies and regulatory resolution, transcripts of congressional hearings on bankruptcy reform, and transcripts from expert roundtables on bankruptcy reform that were hosted by GAO in 2013.

To address our second objective, we reviewed Chapter 15 of the Bankruptcy Code, which relates to coordination between U.S. and foreign jurisdictions in bankruptcy cases in which the debtor is a company with foreign operations, for any changes. In addition, we sought information on U.S. and international efforts to improve coordination of cross-border resolutions from the federal agencies we interviewed. We also reviewed and analyzed documentary information from the Bank of England, Basel Committee on Banking Supervision, European Union, the Financial Stability Board, BaFin in Germany, International Monetary Fund, Swiss Financial Market Supervisory Authority, and the United Nations.<sup>3</sup>

To update the three bankruptcy cases of Lehman Brothers Holdings, Inc.; MF Global Holdings, Ltd.; and Washington Mutual, Inc. discussed in our July 2011 and July 2012 reports, we sought available information—for example, trustee reports and reorganization plans—on these cases from CFTC, FDIC, Federal Reserve, and SEC; AOUSC, the Department of Justice, and Treasury. In addition, we collected information from prior GAO reports, bankruptcy court documents, and the trustees in each case. To determine whether there were new bankruptcy filings of large financial companies such as those in our case studies, we inquired of AOUSC, CFTC, FDIC, Department of Justice, Treasury, Federal Reserve, and SEC. We also conducted a literature review, which did not show evidence of any new bankruptcy cases filed by large financial companies.

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<sup>3</sup>BaFin refers to the German financial regulator, *Bundesanstalt für Finanzdienstleistungsaufsicht*, meaning “Federal Financial Supervisory Authority”.

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We conducted this performance audit from June 2014 to March 2015 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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# Appendix III: GAO Contact and Staff Acknowledgments

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## GAO Contact

Cindy Brown Barnes, (202) 512-8678 or [brownbarnesc@gao.gov](mailto:brownbarnesc@gao.gov)

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## Staff Acknowledgments

In addition to the individual named above, Karen Tremba, Assistant Director; Nancy S. Barry; Patrick Dynes; Risto Laboski; Marc Molino; Barbara Roesmann; Jessica Sandler; and Jason Wildhagen made key contributions to this report. Technical assistance was provided by JoAnna Berry.

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