

July 2011

# BANKRUPTCY

## Complex Financial Institutions and International Coordination Pose Challenges

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## Why GAO Did This Study

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) created the Orderly Liquidation Authority (OLA) that can be used to resolve failed systemically important financial institutions. However, questions continued to be raised about the effectiveness of the U.S. Bankruptcy Code (Code) and current mechanisms for international coordination in bankruptcy cases. The Dodd-Frank Act requires GAO to report on the effectiveness of the Code in resolving certain failed financial institutions on an ongoing basis.

Among its objectives, this report addresses (1) the effectiveness of Chapters 7 and 11 of the Code for facilitating orderly resolutions of failed financial institutions; (2) proposals for improving the effectiveness of liquidations and reorganizations under the Code; and (3) existing mechanisms that facilitate international coordination under the Code and barriers to coordination of financial institution bankruptcies. GAO reviewed laws, judicial decisions, regulations, data, and academic literature on resolutions, and spoke with relevant government officials, industry representatives, and experts from the legal and academic communities about the effectiveness of the Code.

GAO makes no recommendations in this report. GAO provided a draft for comment to the Administrative Office of the United States Courts, the Treasury, and the federal financial regulators, among others. All provided technical comments that GAO has incorporated as appropriate.

## BANKRUPTCY

### Complex Financial Institutions and International Coordination Pose Challenges

## What GAO Found

The effectiveness of the Bankruptcy Code in resolving failed complex financial institutions is unclear for several reasons, including that criteria are not well-developed, a paucity of data, and the complex activities and organizational structures of financial institutions. Experts agreed that maximizing asset values and minimizing systemic impacts are potential criteria for judging effectiveness, but the Code does not directly address systemic factors in bankruptcies. Even if criteria were established, few complex financial institutions have filed for bankruptcy, and those that have, have done so recently, making measuring effectiveness difficult. Nonetheless, experts generally agreed that certain attributes of complex financial institutions—highly liquid funding sources; use of derivatives; complex legal structures, including regulated and unregulated entities, that do not correspond to integrated, interconnected operating structures; and international scope of operations—complicate bankruptcy proceedings.

Financial, legal, and regulatory experts have made proposals to modify the Code, but they do not agree on specifics. These proposals generally focus on or combine several types of actions: (1) increasing opportunities for bankruptcy planning, (2) providing for regulatory input in the bankruptcy process, (3) modifying the safe harbor for certain financial contracts, (4) treating firms on a consolidated basis, and (5) improving court expertise on financial issues. For example, experts generally agree that changes need to be made regarding the safe harbor treatment of certain financial contracts. The Code exempts these contracts from the automatic stay that, in a bankruptcy, preserves assets and generally prevents creditors from taking company assets in payment of debts before a case is resolved and assets are distributed in a systematic way. However, the experts do not agree on whether the types of contracts receiving this safe harbor treatment need to be changed or whether, as with regulatory processes, a temporary stay should be adopted.

Efforts to improve international coordination continue, but existing mechanisms are not comprehensive, and international coordination generally is limited—often because national interests can play a determining role in resolution outcomes. For example, Chapter 15 of the Code promotes coordination between U.S. bankruptcy courts and foreign jurisdictions when the debtor in a U.S. bankruptcy proceeding is a company with foreign operations. However, national interests and other factors limit its effectiveness during bankruptcies of financial institutions. When national interests are aligned, even during a financial crisis, courts and regulators find ways to coordinate, but when they diverge, the need to safeguard those interests takes priority. Variations in countries' insolvency laws, differences in definitions and factors that trigger insolvencies, and limits on information sharing also constrain international coordination. Proposals have been made to improve international coordination for financial institution resolutions, but most efforts focus on regulatory, rather than judicial, processes.

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### Abbreviations

ABN AMRO	ABN AMRO Holding, NV
AOUSC	Administrative Office of the United States Courts
AIG	American International Group, Inc.
BIA	Bankruptcy and Insolvency Act
BHC Act	Bank Holding Company Act
BCCI	Bank of Credit and Commerce International
BIS	Bank of International Settlement
BNY	Bank of New York Mellon Corporation
Herstatt	BankHaus Herstatt
Barclays	Barclays PLC
BNY trustee	BNY Corporate Trustee Services Limited
CDIC	Canada Deposit Insurance Corporation
CDIC Act	Canada Deposit Insurance Corporation Act
CIT	CIT Group, Inc.
CCCA	Companies' Creditors Arrangement Act
Co-Co	contingent convertible bonds
CDS	credit default swap
DIP	debtor-in-possession
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
Drexel	Drexel Burnham Lambert Group, Inc.
EU	European Union
FDI Act	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FRBNY	Federal Reserve Bank of New York
Federal Reserve	Board of Governors of the Federal Reserve System
Fortis	Fortis Bank, SA/NV
G10	Group of Ten
G20	Group of 20
IMF	International Monetary Fund
ISDA	International Swaps and Derivatives Association
JPMC	JPMorgan Chase and Co.
LBF	Lehman Brothers Finance
LBHI	Lehman Brothers Holdings, Inc.
Lehman	Lehman Brothers Holdings, Inc. and subsidiaries
LBI	Lehman Brothers, Inc.

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LBIE	Lehman Brothers International Europe
LBSF	Lehman Brothers Special Financing, Inc.
LTCM	Long-Term Capital Management
MOU	memorandum of understanding
Nordea	Nordea Group
Nortel	Nortel Networks, Inc.
NAFTA	North American Free Trade Agreement
NPR	notice of proposed rulemaking
OTS	Office of Thrift Supervision
OLA	Orderly Liquidation Authority
Perpetual	Perpetual Trustee Company Limited
P&A agreement	Purchase and Assumption Agreement
QFC	qualified financial contracts
Saphir	Saphir Finance Public Limited Company
Section 23A	Section 23A of the 1913 Federal Reserve Act
SEC	Securities and Exchange Commission
SIPA	Securities Investor Protection Act
SIPC	Securities Investor Protection Corporation
Swedbank	Swedbank AB
TLGP	Temporary Liquidity Guarantee Program
TARP	Troubled Asset Relief Program
UK	United Kingdom
UNCITRAL	United Nations Commission on International Trade Law
Code	U.S. Bankruptcy Code
D.C. District Court	U.S. District Court for the District of Columbia
Washington Mutual	Washington Mutual, Inc.
WMPF	Washington Mutual Preferred Funding LLC
WURA	Winding Up and Restructuring Act

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### Congressional Committees

The recent financial crisis and its attendant bailouts and bankruptcies of complex financial institutions led lawmakers and other government officials to question the adequacy of the then existing U.S. and international frameworks for resolving complex financial institutions and addressing systemic risk. In response, Congress created a new Orderly Liquidation Authority (OLA) in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), enacted in July 2010, that can be used when certain insolvent financial companies pose a risk to the financial stability of the United States.<sup>1</sup> Under certain circumstances, the Dodd-Frank Act authorizes the Secretary of the Treasury to appoint the Federal Deposit Insurance Corporation (FDIC) as a receiver, and requires FDIC to liquidate such financial companies so as to maximize the value of the company's assets, minimize losses, mitigate systemic risk, and minimize moral hazard. Since the passage of the Dodd-Frank Act, FDIC has not been appointed receiver of any failing financial company as part of OLA; OLA has not yet been tested.

Leading up to the passage of the Dodd-Frank Act, some members of Congress and some legal and financial experts had raised (and continue to raise) 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>2</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.

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<sup>1</sup>OLA may be used when, among other things, a financial company is in "default or in danger of default," a condition we refer to in this report as "insolvent." See Dodd-Frank Act, Pub. L. No. 111-203 § 203.

<sup>2</sup>As discussed later in this report, insured depository institutions and insurance companies may not be debtors under the Code, and broker-dealers qualify for liquidation, but not reorganization.

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Consequently, the Dodd-Frank Act requires that GAO report on issues relating to OLA's judicial review process, the effectiveness of the Bankruptcy Code, and international coordination in bankruptcies of financial companies. As required under section 202 of the Dodd-Frank Act, this report examines (1) actions taken by the U.S. District Court for the District of Columbia (D.C. District Court) in response to the judicial review provision of the OLA; (2) the effectiveness of Chapters 7 and 11 of the Code in facilitating orderly liquidations or reorganizations of financial institutions; (3) proposals for improving the effectiveness of liquidations and reorganizations under the Code; and (4) mechanisms that facilitate international coordination and any barriers to coordination of financial institution bankruptcies.<sup>3</sup>

To address these objectives, we reviewed a rule issued by the U.S. District Court under the OLA judicial review provision. We also monitored proposed rules issued by U.S. regulators charged with implementing OLA and legal developments in selected other countries. To assess the effectiveness of the Code, the strengths and weaknesses of proposals, and the extent of international coordination, we reviewed laws, judicial decisions, regulatory proceedings, and academic literature. During that review, we focused on identifying potential criteria for determining the effectiveness of bankruptcy proceedings, factors that complicate or facilitate bankruptcies, or those that limit or facilitate coordination during bankruptcies or insolvencies of internationally active institutions. Also, we interviewed experts including law professors, practicing attorneys, bankruptcy judges, economists, and regulators both in the United States and in selected other countries and the European Union (EU). The countries included Canada, Germany, Mexico, the Netherlands, Switzerland, and the United Kingdom (UK) and were chosen because of their importance to the U.S. financial system and their geographic scope. To supplement these activities, we developed information from court documents, including examiner and Securities Investor Protection Act (SIPA) Trustee reports, and interviews about the three largest financial institution bankruptcies in the United States—CIT Group (CIT), Lehman

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<sup>3</sup>Pub. L. No. 111-203 §§ 202(e), (f). The mandate requires that we report on the judicial review for OLA and the effectiveness of the Code annually for 3 years after the passage of the act and every fifth year thereafter. The Administrative Office of the U.S. Courts is also required to address Pub. L. No. 111-203 § 202(e), and the Board of Governors of the Federal Reserve System (Federal Reserve) has mandates to address issues similar to those GAO is addressing in Pub. L. No. 111-203 §§ 216, 217.

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Brothers Holdings, Inc. and its subsidiaries (Lehman), and Washington Mutual, Inc. (Washington Mutual). In addition, we collected information from prior GAO reports, court and regulatory documents, and academic studies on a number of other financial institution failures or near failures. Finally, we analyzed available data on U.S. bankruptcies and determined that they were sufficiently reliable to provide some background information on the number of large financial institution bankruptcies that occurred between 2000 and 2010. See appendix I for more information on our objectives, scope, and methodology for this report.

We conducted this performance audit from August 2010 to July 2011, 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

Bankruptcy is a federal court procedure conducted under rules and requirements of the U.S. Bankruptcy Code. The goal of bankruptcy is to give individuals and businesses a “fresh start” from burdensome debts by eliminating or restructuring debts they cannot repay and help creditors receive some payment in an equitable manner through liquidation or reorganization of the debtor. The filing of a bankruptcy petition operates as an “automatic stay” that stops lawsuits, foreclosures, and most other collection activities against the debtor. Under the Code, secured creditors—those with liens or other secured claims against the debtor’s property—are more likely to get some portion of their debt repaid than unsecured creditors. In addition, creditors typically receive payment of their debts before shareholders receive any return of their equity.

Business debtors that are eligible for protection under the Code may qualify for liquidation, governed by Chapter 7 of the Code, or reorganization, governed by Chapter 11. A Chapter 7 proceeding is a court-supervised procedure by which a trustee takes over the assets of the debtor’s estate, 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. Debtors that are commercial enterprises desiring continuation of some or all of the debtor’s operations ordinarily seek to reorganize under Chapter 11 as a way to satisfy creditor claims. Under Chapter 11, typically the debtor remains in control of its assets, and is therefore called a debtor-in-possession (DIP). If, however,

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the bankruptcy court determines that this is not in the best interest of creditors, the court can appoint a trustee to oversee the debtor. The reorganization is consummated when the reorganization plan developed by the debtor (or other interested party) is confirmed by the court. The plan sets forth the means by which it will be implemented, including disposition or retention of property, mergers, and issuance of securities.<sup>4</sup> The plan also, among other things, divides creditors into classes and sets forth the manner in which the creditor classes will be paid. The debtor also can terminate burdensome contracts and leases, recover assets, and rescale its operations in order to return to profitability. Chapter 11 proceedings often involve financing under what is called DIP financing.<sup>5</sup> Proceedings under both Chapters 7 and 11 can be voluntary (initiated by the debtor) or involuntary (generally initiated by at least three creditors and infrequent).<sup>6</sup> Since 2001, the courts have overseen nearly 350,000 Chapter 7 and Chapter 11 business cases (those with primarily business debt). Almost all of the debtors that were larger businesses—those with assets of at least \$100 million—initially filed under Chapter 11; however, because smaller businesses often file under Chapter 7, Chapter 7 cases made up almost 75 percent of all business filings.

The U.S. bankruptcy system involves multiple federal entities. Bankruptcy courts are located in 90 federal judicial districts; however, the Southern District of New York (which includes Manhattan) and the District of Delaware adjudicate a majority of larger corporate or business bankruptcy cases, many of which constitute “mega cases” involving companies with assets of at least \$100 million and at least 1,000 creditors.<sup>7</sup> The Judicial Conference of the United States serves as the judiciary’s principal policymaking body and recommends national policies and legislation on all aspects of federal judicial administration.<sup>8</sup> In addition, the

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<sup>4</sup>See 11 U.S.C. § 1123.

<sup>5</sup>DIP financing is available under 11 U.S.C. § 364.

<sup>6</sup>Voluntary cases are permitted under 11 U.S.C. § 301. Involuntary cases are subject to 11 U.S.C. § 303.

<sup>7</sup>The Administrative Office of the U.S. Courts defines a “mega” Chapter 11 case as a single case or set of jointly administered or consolidated cases that involve \$100 million or more in assets and 1,000 or more creditors. See GAO, *Federal Bankruptcy Judges: Measuring Judges’ Case-Related Workload*, [GAO-09-808T](#) (Washington, D.C.: June 16, 2009).

<sup>8</sup>See <http://www.uscourts.gov/FederalCourts/JudicialConference.aspx>.

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Administrative Office of the United States Courts (AOUSC) serves as the central administrative support entity for the Judicial Conference and the federal courts, including bankruptcy courts. For example, AOUSC provides administrative, legal, financial, management, and information technology functions for the federal 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 U.S. Department of Justice's Trustee Program and the Bankruptcy Administrator Program oversee bankruptcy trustees and promote integrity and efficiency in the bankruptcy system by overseeing the administration of bankruptcy estates.<sup>9</sup>

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## Financial Institutions and the Bankruptcy Code

Large financial institutions operating in the United States engage in a broad range of financial services including commercial banking, investment banking, and insurance.<sup>10</sup> Many of them are organized as holding companies with a variety of subsidiaries, including regulated subsidiaries such as depository institutions, insurance companies, broker-

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<sup>9</sup>See [http://www.justice.gov/ust/eo/ust\\_org/about\\_ustp.htm](http://www.justice.gov/ust/eo/ust_org/about_ustp.htm). 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.

<sup>10</sup>Section 201(a)(11) of the Dodd-Frank Act defines a financial company as an entity organized under federal or state law that is (1) a bank holding company as defined in the Bank Holding Company Act of 1956, as amended (BHC Act); (2) a nonbank financial company supervised by the Federal Reserve, as defined in section 102(a)(4)(D) of the Dodd-Frank Act; (3) any company (other than a bank holding company or nonbank financial company supervised by the Federal Reserve) predominantly engaged in activities the Federal Reserve has determined to be financial in nature or incidental thereto under the BHC Act; or (4) any subsidiary (other than an insured depository institution or an insurance company) of one of the three types of entity if the subsidiary is predominantly engaged in such financial activities. To be “predominantly engaged” in financial activities, the company’s revenues from those activities must constitute 85 percent or more of its total consolidated revenues, as FDIC, in consultation with the Department of the Treasury, establishes by regulation. Insured depositories, federally chartered Farm Credit System institutions, and certain other governmental or regulated entities are not financial companies for purposes of OLA. Throughout this report we use the term financial institutions to refer more broadly to institutions engaged in financial activities.

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dealers, and futures commission merchants, as well as other nonregulated subsidiaries that engage in a wide variety of financial activities. Many of these businesses have centralized business functions that may be housed in the holding company. Smaller banking institutions also are organized as holding companies, but many of these hold few, if any, assets outside a depository institution and generally engage in a narrower range of activities.

Certain financial institutions, specifically insured depositories, domestic insurers, and branches and agencies of foreign banks may not file as debtors under the U. S. Bankruptcy Code, and other entities face special restrictions in using the Code. These institutions are resolved through regulatory processes or face some restrictions, as follows:

- Under the Federal Deposit Insurance Act (FDI Act), FDIC serves as the conservator or receiver for insured depository institutions placed into conservatorship or receivership under applicable law.<sup>11</sup> FDIC, as receiver, is charged with liquidating these failed depository institutions' assets. Often, FDIC will arrange for all or part of the assets and liabilities of the failed depository institution to be purchased and assumed by a single or several other financial institutions. To the extent such a purchase and assumption is not possible or the assuming institution or institutions do not purchase all of the assets of the failed depository institution, FDIC will liquidate such assets over time.
- Insurers are generally subject to oversight by state insurance commissioners, who have the authority to place them into conservatorship, rehabilitation, or receivership.
- Broker-dealers can be liquidated under SIPA or under a special provision of Chapter 7 of the Code. However, broker-dealers may not

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<sup>11</sup>12 U.S.C. § 1821(c).

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file for reorganization under Chapter 11.<sup>12</sup> Similarly, commodity brokers, also known as futures commission merchants, are restricted to using only a special provision of Chapter 7 for bankruptcy relief.

- Covered financial companies—those financial companies that the Secretary of the Treasury determines meet the conditions specified under OLA, including that their failure would pose a threat to the financial stability of the United States—are to be resolved under an FDIC receivership, generally similar to that currently used to resolve insured depositories.<sup>13</sup> Under this receivership, FDIC can create a bridge financial institution and can divide the company’s assets so they can be sold, liquidated, or transferred to such a bridge institution.

Other financial institutions that have not been determined to pose a threat to the financial stability of the United States may qualify as debtors under the Code. These would include holding companies that own insured depository institutions or other firms, such as broker-dealers, that are not permitted to be debtors under Chapter 11. Large complex financial institutions that are eligible to file for bankruptcy generally file under Chapter 11 of the Code. A financial institution going through a Chapter 11 bankruptcy generally will pass through several stages, ranging from the filing of a petition and implementation of the automatic stay, through “first-day motions,” to submission of a written disclosure statement and judicial

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<sup>12</sup>The limitation of stockbrokers and commodity brokers to Chapter 7 proceedings is set forth at 11 U.S.C. § 109(d) of the Bankruptcy Code. Chapter 7 contains special provisions for the liquidation of stock brokers and commodity brokers. 11 U.S.C. §§ 741-753 (Stockbroker Liquidation), 753, 761-767 (Commodity Broker Liquidation). Under SIPA, the Securities Investor Protection Corporation (SIPC) initiates a liquidation proceeding, the primary purpose of which is to protect investors against financial losses arising from the insolvency of their brokers. Once a protective decree has been applied under SIPA, any other pending bankruptcy proceeding involving the debtor stockbroker is stayed, and the court where the application is filed has exclusive jurisdiction of 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 many of the stockbrokers discussed in this report are also dealers registered with the Securities and Exchange Commission as broker-dealers, we generally use the term broker-dealer rather than stockbroker in this report. The Code contains special provisions for commodity broker liquidation (11 U.S.C. §§ 753, 761-767), and the Commodity Futures Trading Commission’s rules relating to bankruptcy are set forth at 17 C.F.R. Part 190.

<sup>13</sup>See Dodd-Frank Act, Pub. L. No. 111-203 §§ 204, 210. FDIC’s receivership authority is set forth mainly at 12 U.S.C. §§ 1821, 1822, and 1823.

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approval of a reorganization plan, as shown in figure 1.<sup>14</sup> 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 claim—and obtaining DIP financing, if any. The disclosure statement filed after the filing of the bankruptcy petition must include information on the debtor's (financial institution's) assets, liabilities, and business affairs sufficient to enable creditors to make informed judgments about the debtor's plan of reorganization.<sup>15</sup> Creditors need to understand the reorganization plan because the court may not confirm the plan unless, among other things, a sufficient proportion of allowed creditors has either accepted the plan or is not impaired by the plan.<sup>16</sup> The court's approval also depends on whether or not there are dissenting classes of creditors. The possible outcomes of a Chapter 11 bankruptcy, which can be used in combination, include liquidating the assets of the company with the approval of the court (as opposed to liquidation by a bankruptcy trustee under Chapter 7), sale of the company, in whole or in part, which is sometimes called a section 363 sale because that is the section of the Code that applies to sales that are free and clear of creditor claims, and actual 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. During the bankruptcy proceeding, the debtor, or one or more creditors with an allowed claim, and other interested parties, may initiate adversary proceedings—in effect, a lawsuit within the bankruptcy case. Debtors initiate adversary proceedings to preserve or recover money or property for the estate; for example, property that may have been

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<sup>14</sup>Financially distressed firms seeking to restructure may file prepackaged bankruptcies or conduct out-of-court restructurings. In a prepackaged bankruptcy, the firm files a plan of reorganization at the same time as its Chapter 11 petition, with the reorganization plan negotiated out-of-court. The plan is subject to the court's approval.

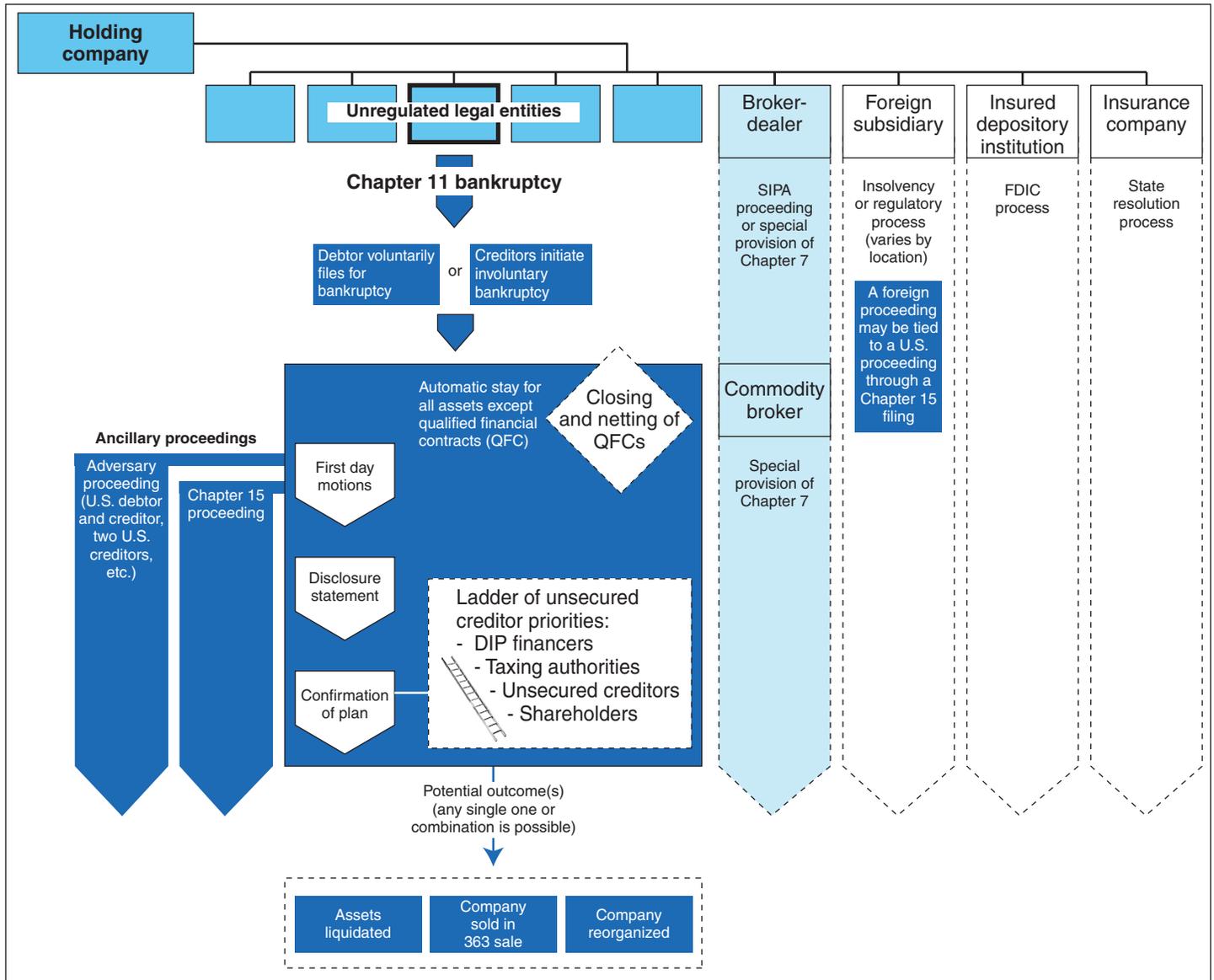
<sup>15</sup>Requirements for the content of a disclosure plan filed after the filing of a bankruptcy petition are set forth at 11 U.S.C. § 1125. A debtor generally has an exclusive right to file a plan of reorganization within 120 days of filing the petition, with the possibility of extending the period up to 18 months. After this exclusivity period has ended, creditors may file plans as well. Generally, the debtor has 180 days after the petition date to obtain acceptance of its plan from certain creditors; however, the court may extend (up to 20 months) or reduce this acceptance period for cause. See 11 U.S.C. § 1121(b) and (d).

<sup>16</sup>11 U.S.C. § 1129(a). An entire class of claims, such as secured creditors, unsecured creditors, or shareholders, is deemed to accept a reorganization plan if it is accepted by claimants that hold at least two-thirds in amount and more than one-half in number of the allowed claims in the class. See 11 U.S.C. § 1126(c) and (d).

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transferred in the resolution of a regulated entity such as an insured depository. Creditors may initiate adversary proceedings to subordinate a claim of another creditor to their own claims or for other similar reasons.

**Figure 1: Chapter 11 Bankruptcy Process for a U.S.-Headquartered Financial Institution as of June 2011**



Source: GAO analysis of U.S. Court information.

Note: Qualified Financial Contracts are contracts specified in the Bankruptcy Code as exempt from the automatic stay. These contracts are discussed in more detail throughout the body of this report and in appendix VII. Chapter 15, which is also discussed throughout this report, governs judicial cross-border coordination and foreign subsidiaries may be engaged in Chapter 15 cases. 363 sales are denoted as such because they are governed by section 363 of the Bankruptcy Code.

As shown in table 1, only a few large financial institutions—those with assets of at least \$100 million and at least 1,000 creditors or more—actually filed for bankruptcy under Chapter 11 from 2000 through 2009.

**Table 1: Chapter 11 Mega Bankruptcy Filings, by Total Filings and Financial Institution Filings, 2000–2009**

Year	Chapter 11 mega filings	
	Total number of filings	Number of financial institution filings
2000	63	2
2001	101	1
2002	88	2
2003	73	1
2004	54	0
2005	31	2
2006	25	0
2007	13	4
2008	79	4
2009	118	6
<b>Total</b>	<b>645</b>	<b>22</b>

Sources: GAO analysis of AOUSC and New Generations Research, Inc. data.

## Financial Institutions Can Be Parties to Contracts That Receive Safe Harbor Protection

Although the automatic stay is one of the central provisions of the Code, it is subject to exceptions, one of which can be particularly important in a financial institution bankruptcy.<sup>17</sup> Commonly referred to as a “safe harbor,” this exception pertains to certain financial and derivative contracts, often referred to as “qualified financial contracts” (QFC), that are defined in the

<sup>17</sup>The automatic stay provision is 11 U.S.C. § 362.

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Code.<sup>18</sup> They include derivative financial products, such as futures contracts and swap agreements that financial institutions, as well as individuals and nonfinancial institutions, use to hedge against losses from other transactions or to speculate on the likelihood of future economic developments. Repurchase agreements, collateralized instruments that provide short-term financing for financial institutions and others, also receive safe harbor treatment.

Under these provisions, counterparties that entered into a transaction with the debtor that qualifies for safe harbor treatment under the Code may exercise their contractual rights even if doing so would otherwise violate the automatic stay.<sup>19</sup> Typically these contractual rights are described in an *ipso facto clause*, which gives the parties to a contract the right to terminate it or modify its terms upon a counterparty's insolvency or the commencement of bankruptcy proceedings.<sup>20</sup> Such an occurrence constitutes a default, and the nondefaulting party may liquidate, terminate, or accelerate the contract, and may offset (net) any termination

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<sup>18</sup>These safe harbors are primarily located in the following sections of the Code, which list types of contracts and instruments exempt from the automatic stay: 11 U.S.C. §§ 362(b)(6), (b)(7), (b)(17), 546, 556, 559, 560. Related definitions are set forth in 11 U.S.C. § 101. This same class of contracts is defined in the FDI Act (and FDIC regulations, see 12 C.F.R. 360.5) and under the OLA authority as “qualified financial contracts.” See 12 U.S.C. § 1821(e)(8)-(10) (FDI Act); Dodd-Frank Act, Pub. L. No. 111-203 § 210(c)(8)-(10). Financial industry participants typically refer to these instruments generally as QFCs. Because safe harbor contracts and QFCs generally refer to the same types of contract, in the remaining discussion we use the term “QFC” to refer both to contracts under the safe harbor provisions of the Code and to the instruments defined as QFCs under the FDI Act and the Dodd-Frank Act. Although a specific type of instrument might not be covered under both sets of provisions, this general reference is consistent with industry practice. Additionally, the FDI Act and the Dodd-Frank Act treat QFCs in an analogous manner to the Code, with one notable exception—the ability of FDIC to prevent the termination of these QFCs by transfer within 1 business day—this will be discussed later in this report.

<sup>19</sup>The Code defines the types of entities that can benefit from the safe harbor (“counterparty limitations”). See 11 U.S.C. §§ 362(b), 101(22A), (46), (53C).

<sup>20</sup>Ordinarily, an *ipso facto* clause in an executory contract is unenforceable against a debtor in bankruptcy due to the automatic stay, and the exercise of the right to recover property or act against the property of the debtor is prohibited by the automatic stay. 11 U.S.C. §§ 365(e), 362. In bankruptcy, an executory contract is one in which both parties to the contract have future performance obligations that, if unperformed by either party, would result in a material breach. See *Regen Capital I, Inc., v. Halperin*, 547 F.3d 484 (2d Cir. 2008); *Olah v. Baird*, 567 F.3d 1207 (10<sup>th</sup> Cir. 2009).

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value, payment amount, or other transfer obligation arising under the contract when the debtor files for bankruptcy.<sup>21</sup>

As with the Code, the FDI Act and the Dodd-Frank Act permit QFC counterparties to move quickly to enforce their contractual rights, notwithstanding the appointment of a receiver.<sup>22</sup> After its appointment as receiver, FDIC has three options in managing the institution's QFC portfolio. FDIC can retain the QFCs in the receivership; transfer the QFCs to another financial institution; or repudiate (reject) the QFCs. Subject to some requirements described below, FDIC can apply different options to QFCs with different counterparties.

FDIC's first option is similar to the safe harbor provisions under the Code. If FDIC retains QFCs in the receivership, the counterparty may terminate the contract and exercise any contractual right to net any payment the counterparty owes to the institution against the payment the institution owes to the counterparty on a different QFC.<sup>23</sup> While this right is immediate under the Code's safe harbor, the QFC counterparty generally cannot exercise it against a failed insured depository institution in FDIC receivership until after 5:00 p.m. (eastern standard time or eastern daylight time) on a normal business day following the date of appointment of FDIC as receiver.<sup>24</sup> Because bank regulators almost always close depository institutions on Fridays, the stay remains in effect until 5:00 p.m. the following Monday. The second option involves FDIC's transfer of QFCs to another financial institution or permissible entity. If FDIC transfers a QFC to another financial institution, the counterparty cannot

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<sup>21</sup>An offset provision enables the nondefaulting party to offset (net) obligations owed against collateral pledged to the debtor. 11 U.S.C. § 553. The safe harbors include "master netting agreements" for cross-product netting. 11 U.S.C. §§ 101(38A), (38B), 362(b)(27), 546(j), 561. The debtor and the counterparty presumably would arrive at a net sum owed either to or from the debtor.

<sup>22</sup>As discussed previously, the Code does not apply to insured depository institutions. The OLA provisions of the Dodd-Frank Act state that "the provisions of this title shall exclusively apply to and govern all matters relating to . . ." an institution placed into receivership under the OLA authority. Pub. L. No. 111-203 § 202(c)(2). For QFCs involving a bank in receivership, see 12 U.S.C. § 1821(e)(1), (8); for those involving an institution in OLA receivership, see Pub. L. No. 111-203 § 210(c)(1), (8).

<sup>23</sup>See e.g., 12 U.S.C. §§ 1821(c)(8)(E), 4403, concerning the netting of bilateral netting rights between financial institution counterparties.

<sup>24</sup>See FDI Act, 12 U.S.C. § 1821(e)(8)-(10); Dodd-Frank Act, Pub. L. No. 111-203 § 210(c)(8)-(10).

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exercise its contractual right to terminate the QFC solely as a result of the transfer, the insolvency, or the appointment of the receiver.<sup>25</sup> Under the third option, FDIC may repudiate (reject) a QFC, within a reasonable period of time, if FDIC determines that the contract is burdensome.<sup>26</sup> However, FDIC must pay actual direct compensatory damages, which may include the normal and reasonable costs of cover or other reasonable measure of damages used in the industry for such claims, calculated as of the date of repudiation. If FDIC decides to transfer or repudiate (reject) a QFC, all other QFCs entered into between the failed institution and that counterparty, as well as those QFCs entered into with any of that counterparty's affiliates, must be transferred to the same financial institution or repudiated at the same time.<sup>27</sup>

Safe harbor treatment was first added to the Code in 1982 for forward contracts, commodity contracts, and security contracts, and over time the Congress has expanded the types of contracts and counterparties covered.<sup>28</sup> The most recent changes to the treatment of safe harbor contracts under the Code in 2005 and 2006 expanded the safe harbor treatment to contracts related to mortgage-backed securities and repurchase agreements, an overnight source of funding used by financial institutions, and included provisions to strengthen and clarify the enforceability of such contracts.<sup>29</sup> According to legislative history and

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<sup>25</sup>12 U.S.C. § 1821(e)(10)(B)(i)(II). Under the Code, the assignment and assumption of QFCs not terminated by their counterparties may be assigned if approved by the court. See, e.g., *In re Lehman Brothers Holdings, Inc.*, (Bankr. S.D.N.Y. 08-13555(JMP)) "Order Approving Consensual Assumption and Assignment of Prepetition Derivative Contracts," Jan. 28, 2009.

<sup>26</sup>See FDI Act, 12 U.S.C. § 1821(e)(11); see also Dodd-Frank Act, Pub. L. No. 111-203 § 210(c)(11).

<sup>27</sup>12 U.S.C. § 1821(c)(9),(11); see also Dodd-Frank Act, Pub. L. No. 111-203 § 210(c)(9), (11).

<sup>28</sup>See H.R. Rep. No. 97-420 at 2 (1982), 1982 U.S.C.C.A.N. 583, 584-85; H.R. Rep. No. 101-484 (1990), reprinted in 1990 U.S.C.C.A.N. 223.

<sup>29</sup>Bankruptcy Abuse Prevention and Consumer Protection Act (2005), Pub. L. No. 109-8 (BAPCPA); Financial Netting Improvements Act of 2006, Pub. L. No. 109-390; see H.R. Rep. No. 109-648, pt. 1 at 2 (2006). Because safe harbor contracts and QFCs generally refer to the same types of contract, in the remaining discussion we use the term "QFC" to refer both to contracts under the safe harbor provisions of the Code and to the instruments defined as QFCs under the FDI Act and the Dodd-Frank Act. Although a specific type of instrument might not be covered under both sets of provisions, this general reference is consistent with industry practice.

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FDIC regulations, the purpose of these safe harbors and the QFC provisions in the FDI Act is to maintain market liquidity and reduce systemic risk, which we define as the risk that the failure of one large institution would cause other institutions to fail or that a market event could broadly affect the financial system rather than just one or a few institutions.<sup>30</sup>

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

In 2005, the United States adopted Chapter 15 of the U.S. Bankruptcy Code.<sup>31</sup> Chapter 15 is based on the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvency, which is intended to promote coordination between courts in different countries during insolvencies and has been adopted in 19 jurisdictions.<sup>32</sup> Over 450 Chapter 15 cases have been filed since its adoption, with over half filed in the Southern District of New York and the District of Delaware.

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, are among the stated objectives of Chapter 15.<sup>33</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>30</sup>See, e.g., H.R. Rep. No. 101-484 at 1-3 (1990) (regarding Code safe harbor); see 73 Fed. Reg. 78162 (Dec. 22, 2008) (FDIC depiction of purpose of pertinent QFC provisions in FDI Act).

<sup>31</sup>BAPCPA, Pub. L. No. 109-8.

<sup>32</sup>See, H.R. Rep. No. 109-31, pt. 1 at 105-07 (2005). As of the end of 2010, legislation based upon the UNCITRAL Model Law had been enacted in Australia (2008); the British Virgin Islands (2003); Canada (2009); 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); UK (2006), and the United States (2005).

<sup>33</sup>11 U.S.C. § 1501(a).

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- 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>34</sup>

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<sup>34</sup>11 U.S.C. § 1506.

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## D.C. District Court Has Issued Rules to Implement Required Judicial Review under the Orderly Liquidation Authority

OLA provisions establish a process for judicial review when a financial company's board of directors (or the functional equivalent) does not accept the appointment of FDIC as receiver following a determination by the Secretary of the Treasury.<sup>35</sup> Under OLA, the Secretary is to make the determination, in consultation with the President, based on seven factors, three of which are that the company is a financial company, its insolvency would pose a threat to the financial stability of the United States, and it is or is likely to be "in default or in danger of default" (insolvent).<sup>36</sup> After making this determination, the Secretary must appoint FDIC as receiver for the company unless the company refuses to "acquiesce or consent" to the appointment. In that case, the Secretary must file a petition with the D.C. District Court for an order authorizing the Secretary to appoint FDIC as receiver.<sup>37</sup> The court has 24 hours to review the petition and provide an opportunity for a hearing. The court may decide only whether the Secretary acted arbitrarily or capriciously in finding either that the company was a financial company under OLA or that the company was in default or in danger of default. The law does not authorize the court to review other aspects of the Secretary's determination, such as whether the company posed a threat to the financial stability of the United States (the systemic risk determination). Although the D.C. District Court's decision can be appealed on an expedited basis to the U.S. Court of Appeals for the District of Columbia Circuit and thereafter to the Supreme Court, the District's decision is not subject to any stay or injunction while any appeal is pending.

The judicial review provision requires the D.C. District Court to establish rules and procedures "as may be necessary" to ensure the orderly

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<sup>35</sup>Dodd-Frank Act, Pub. L. No. 111-203 § 203(b),(c)(4). The OLA defines a company subject to the determination as a "covered financial company."

<sup>36</sup>The factors to be addressed are set forth in section 203(b) of the Dodd-Frank Act. Before the Secretary of the Treasury, in consultation with the President, makes a decision to appoint FDIC as receiver of a covered 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. In the case of a broker-dealer, the recommendation must come from the Federal Reserve and the Securities and Exchange Commission, in consultation with FDIC, and in the case of an insurance company from the Federal Reserve and the Director of the Federal Insurance Office, in consultation with FDIC.

<sup>37</sup>Dodd-Frank Act, Pub. L. No. 111-203 § 202(a). The Secretary of the Treasury must file the petition under seal to ensure confidentiality.

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conduct of the proceeding and to publish them and transmit them to specific Congressional Committees—the Senate Committees on the Judiciary and on Banking, Housing, and Urban Affairs and the House Committees on the Judiciary and Financial Services—within 6 months of the enactment of the Dodd-Frank Act.<sup>38</sup> On January 19, 2011, the D.C. District Court issued a rule (Local Civil Rule 85) in response to this requirement, which is printed in its entirety in appendix II of this report. Generally the rule reiterates the procedural requirements in the Dodd-Frank Act. It provides for a 24-hour review, during which the financial institution has the right to oppose the Secretary’s petition. The rule also defines the possible outcomes. If the court does not rule on the petition within the 24-hour period, or rules in favor of the Secretary, the receivership goes forward immediately. If the judge rules that the Secretary’s determination was arbitrary and capricious with respect to one of the two elements, the Secretary has the right to amend the petition and file it again. The rule also acknowledges that the receivership will go forward immediately even if the financial company decides to take its opposition to it to a higher court, such as the U.S. Court of Appeals. However, the rule also contains a mechanism not specified in the law that may make the process more efficient and effective. It requires the Secretary of the Treasury to notify the D.C. District Court under seal at least 48 hours before the filing of a petition, which would give the court time to prepare for the review. However, in March 2011, FDIC and Treasury sent letters to the D.C. District Court expressing concern that the 48-hour requirement would be impossible to meet and could threaten U.S. financial stability. As of June 2011, the D.C. District Court was considering comments on the rule.

The court has not yet tested the effectiveness of the rule because, as of the time of FDIC’s March 23, 2011, notice of proposed rulemaking (NPR) the Secretary had not yet appointed FDIC as receiver, and FDIC said that it did not have any expectation that it would be appointed as receiver for any covered financial company in the near future.<sup>39</sup> Additionally, FDIC remains engaged in a rulemaking relating to whether an institution is a financial company subject to OLA, which the court might consider during

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<sup>38</sup>Dodd-Frank Act, Pub. L. No. 111-203 § 202(b).

<sup>39</sup>FDIC’s proposed rule sets standards for determining whether a company is “predominantly engaged in activities that are financial in nature or incidental thereto.” 76 Fed. Reg. 16324 (Mar. 23, 2011).

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its judicial reviews. FDIC addressed the definition of a financial company for OLA purposes in its March 23, 2011 NPR. Under Title II of the Dodd-Frank Act, the definition of a financial company includes a bank holding company, a nonbank financial company supervised by the Board of Governors of the Federal Reserve System (Federal Reserve), and a company that receives at least 85 percent of its consolidated revenues from activities that are financial in nature or incidental under the BHC Act. In the March NPR, FDIC proposed to rely primarily on the consolidated financial statements of a company over a 2-year period to determine if 85 percent of revenues in either year came from financial activities. As stated in the Dodd-Frank Act, the consolidated revenues are to include revenues from subsidiary depository institutions, which are excluded from the definition of covered financial companies. The comment period for this NPR closed on May 23, 2011. As of July 8, 2011, FDIC had not proposed rules to further define insolvency. However, under the Dodd-Frank Act, a financial company shall be considered to be in default, or in danger of default, if the company has filed or is likely to file promptly for bankruptcy, has depleted or is likely to deplete its capital, has assets that are less than or likely to be less than its liabilities, or is or is likely to be unable to pay its debts.<sup>40</sup>

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<sup>40</sup>Dodd-Frank Act, Pub. L. No. 111-203 § 203(c)(4).

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## The Effectiveness of the Bankruptcy Code in Resolving Complex and Internationally Active Financial Institutions Is Unclear

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### Potential Criteria for Judging Effectiveness Include Maximizing Asset Value but Not Minimizing Duration of Bankruptcy

Most experts we interviewed agreed that maximizing asset values was the most important criterion for judging the effectiveness of the bankruptcy process. Under Chapter 7, in which a bankruptcy trustee liquidates the debtor's assets and disperses the proceeds according to a strict ladder of creditor and shareholder priorities, experts told us that maximizing the return for creditors was the most important criterion for judging the effectiveness of the process. Under Chapter 11, in which the debtor and its creditors negotiate a reorganization plan, experts agreed that the goal is to maximize the value of a business as a going concern, or a functioning entity. In either case, having to sell assets at "fire sale" prices—below the asset's fundamental value—would reduce returns to creditors and going concern values.<sup>41</sup> However, as we have noted in a previous report, a substantially lower asset price may be consistent with the fundamental value of that asset.<sup>42</sup>

Various stages of the bankruptcy process can affect the ultimate value of the debtor's assets. Some experts told us that having a plan for proceeding with a bankruptcy is important; the time and resources spent planning for the possibility of bankruptcy could increase returns to creditors and thus improve the effectiveness of the process. Some experts with whom we spoke highlighted the importance of prebankruptcy planning by noting the bankruptcy of CIT—a bank holding company engaged in small business lending and leasing. In the CIT case, CIT reached an agreement with creditors before filing the bankruptcy petition,

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<sup>41</sup>See appendixes III-VI for additional information about many of the financial institutions discussed in this objective and information on other failed financial institutions.

<sup>42</sup>GAO, *Financial Markets Regulation: Financial Crisis Highlights Need to Improve Oversight of Leverage at Financial Institutions and across System*, [GAO-09-739](#) (Washington, D.C.: July 22, 2009).

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which led to what some experts considered an orderly bankruptcy process and reorganization. On July 5, 2011, CIT was valued at \$9.0 billion. In contrast, some experts described the Lehman bankruptcy as disorderly, in part, because the institution did not plan sufficiently for the possibility of bankruptcy.<sup>43</sup> Attorneys in the Lehman bankruptcy said management did not seriously consider bankruptcy until about a week before filing, and an official of the Securities and Exchange Commission (SEC) told us that Lehman did not try to arrange for the sale of various components of the institution until the week before its collapse. In part because of Lehman's rush to sell certain assets, Lehman later claimed that the buyer underpaid for those assets and sought additional compensation. See appendixes III and IV for more information about the CIT and Lehman bankruptcies, respectively.

Bankruptcy experts also told us that the automatic stay frees debtors from creditor actions that could further deplete a firm's asset values. The stay allows parties to gain control over the distribution of assets. In a Chapter 7 bankruptcy, the bankruptcy trustee has full control over the liquidation of the firm's assets. Legal experts told us that, although control may be dispersed among different parties under Chapter 11, the process is still considered predictable because it follows a long-standing legal tradition, transparent because it occurs under judicial review, and equitable because assets are distributed either according to a strict ladder of creditor priorities or through negotiated settlements in which all parties can participate. Some legal experts stated that control over assets in a bankruptcy is similar to that gained when a regulator—FDIC or a state insurance commissioner—becomes the receiver of a depository institution or insurer. However, some legal experts said that FDIC's processes are less predictable and less transparent than the bankruptcy processes, because FDIC resolutions do not operate under court supervision.

Because a debtor's estate faces costs—such as attorneys' fees—during a bankruptcy, the longer the company spends in bankruptcy, the higher the costs are likely to be, reducing the value of a firm's estate. However, the experts with whom we spoke generally agreed that minimizing the overall time spent in bankruptcy was not an important criterion for judging the effectiveness of a bankruptcy. Some bankruptcies of financial institutions

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<sup>43</sup>By contrast, some academics disagreed that the Lehman bankruptcy was disorderly and believed instead that difficulties in the markets during the fall of 2008 were the result of government actions.

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take a long time to resolve, but a longer bankruptcy can lead to increased creditor recoveries. For example, Bank of Credit and Commerce International (BCCI), a multinational financial institution that failed in 1991, had not been fully resolved as of June 2011. Despite this 20-year process, creditors have benefited from increasing recoveries. Some experts we interviewed also said that professional costs are likely too high, and debtors' estates pay not only the fees of professionals assisting the estate but also for attorneys and other professionals used by creditors' and shareholders' committees. Nonetheless, an expert said that these costs were relatively small compared with the overall value of the assets at stake in a bankruptcy. This view that the overall time in the bankruptcy may not be an important criterion for judging the effectiveness of the process is supported by a study conducted by research staff at the Federal Reserve. The study found that the value of creditors' claims (bonds) in a bankruptcy tended to increase over time up to a point and then tended to decrease.<sup>44</sup> However, this study did not specifically address financial institution bankruptcies or consider a time of financial crisis when the time frames for resolving insolvent financial institutions could be of greater importance. Experts also noted that complex companies that rushed through the bankruptcy process might file for bankruptcy again if their reorganizations were not well conceived. As a result, experts said that the total length of time of a bankruptcy should not be a main focus in judging the Code's effectiveness.

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**Potential Criteria for Judging Effectiveness Also Include Systemic Impacts, Which the Code Does Not Directly Address**

Systemic impacts are one reason that regulators supervise financial institutions and have often been the rationale for providing government assistance for certain markets or failing financial institutions. Certain financial institutions—sometimes designated as systemically important financial institutions—play a central role in key financial markets and thus affect general credit availability or have an effect on credit availability through their impact on other financial institutions. For example, the Lehman failure affected credit availability by lowering values in the commercial paper market, which is used by employers throughout the

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<sup>44</sup>Daniel M. Covitz, Song Han, and Beth Ann Wilson, "Are Longer Bankruptcies Really More Costly?" Federal Reserve Working Paper No. 2006-27 (Washington, D.C.: February 2006).

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economy to finance payrolls.<sup>45</sup> According to researchers at the Federal Reserve Bank of New York (FRBNY), market participants saw the failure of Lehman, an active commercial paper issuer, as a signal that the risks of what had been perceived as a relatively safe, low-cost investment had increased and no longer was consistent with the low interest rates offered by issuers.<sup>46</sup> The Lehman bankruptcy also had an impact through its effect on money market funds. Because money market funds hold large quantities of commercial paper, Lehman's bankruptcy led the Reserve Primary Fund, a large money market fund with \$65 billion of assets under management, to lose \$785 million in holdings of Lehman commercial paper and, for the first time, caused a retail money market fund's shares to fall below one dollar. This caused investors in money market funds to lose confidence and begin to remove their money from this and similar funds. In response, the Department of the Treasury extended a temporary government guarantee to eligible participating money market funds. In addition, the Federal Reserve authorized the Commercial Paper Funding Facility and the Asset-Backed Commercial Paper Money Market Mutual Funding Liquidity Facility.<sup>47</sup>

As noted, the government often has provided assistance to offset or prevent systemic effects and has also taken action to prevent firms whose failure might have systemic effects from filing for bankruptcy. For example, in 1998, Long-Term Capital Management (LTCM)—a hedge fund that held \$1.4 trillion in derivatives whose largest creditors and counterparties were major domestic and foreign banking institutions and investment firms—faced major liquidity problems. Thus, its failure likely would have had a broad impact on other financial institutions and the availability of credit throughout the economy. As a result, FRBNY called together 14 of LTCM's counterparties, and these industry participants

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<sup>45</sup>Commercial paper is a promissory note with a term of 270 days or less issued in the open market that represents the obligation of the issuing corporation. Large corporations (financial and nonfinancial) with strong credit ratings issue commercial paper as an alternative to bank borrowing. To pay off holders of commercial paper, issuers generally use the proceeds obtained by selling new commercial paper. Most commercial paper is issued by financial institutions and mutual funds purchase a large amount of the commercial paper issued.

<sup>46</sup>Adrian, Tobias, Karin Kimbrough, and Dina Marchioni, "The Federal Reserve's Commercial Paper Funding Facility," *Economic Policy Review* 17, no.1 (May 2011): 25-39.

<sup>47</sup>GAO, *Federal Reserve System: Opportunities to Strengthen Policies and Processes for Managing Emergency Assistance*, GAO-11-696 (forthcoming).

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organized a gradual liquidation of LTCM outside of the bankruptcy process.<sup>48</sup> At the time, Federal Reserve officials expressed concern that the rapid closing out of derivative contracts with LTCM would have led not only to LTCM's insolvency but possibly to the insolvency of other firms as well. More recently, after noting that the American International Group, Inc. (AIG) faced the imminent prospect of declaring bankruptcy, the Federal Reserve authorized the extension of emergency credit to AIG, citing that its failure would have been disorderly and likely to have systemic effects on already fragile financial markets.<sup>49</sup>

Economists and regulators have expressed the view that systemic factors—such as the extent to which a financial institution's failure has an impact on other firms' asset values or on broader economic stability—should be used to judge the effectiveness of the bankruptcy process. Some economists with whom we spoke explained that, if failed financial institutions were forced to sell assets at fire sale values, the market value of those assets would decrease. Under current mark-to-market accounting rules, which require that firms change the value of the assets on their balance sheets to reflect changes in the market prices of the assets, other financial institutions holding similar assets could be forced to mark down their asset values as well. The Department of the Treasury also has noted that during the financial crisis, asset sales made in a highly leveraged environment led to a vicious cycle in which declining asset prices triggered further deleveraging and reductions in market liquidity, which in turn led to further asset price declines.<sup>50</sup> However, as noted earlier, lower asset prices may be consistent with the prevailing fundamental values of those assets. Those in the legal community that are involved in financial institution bankruptcies, and those working with economists and others on proposals to improve the Code's ability to handle financial institutions, also recognized the importance of considering systemic factors in judging the effectiveness of the Code in facilitating the orderly liquidation or reorganization of financial institutions.

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<sup>48</sup>For more information on the failure of LTCM, see GAO, *Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk*, [GAO/GGD-00-3](#) (Washington, D.C.: Oct. 9, 1999).

<sup>49</sup>See GAO, *Troubled Asset Relief Program: Status of Government Assistance to AIG*, [GAO-09-975](#) (Washington, D.C.: Sept. 21, 2009).

<sup>50</sup>Treasury, *Public-Private Investment Program, \$500 Billion to \$1 Trillion Plan to Purchase Legacy Assets*, White Paper.

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The Congress also recognized the importance of systemic factors when it adopted OLA, which includes minimizing systemic risk as one of its goals.

Nevertheless, the Code does not directly address systemic risks. According to some legal experts, the practice of bankruptcy courts is to deal only with the matters before them; systemic issues are not considered. When asked about the impact of a bankruptcy on other firms, legal experts who did not have significant experience with financial institutions said that they did not think it relevant to judging the effectiveness of a bankruptcy. However, the Code does address systemic risks indirectly by providing safe harbor treatment, such as protection from the automatic stay, for certain contracts—QFCs—widely used by financial institutions (see app. VII). Financial and legal experts have noted that to offset some systemic factors, such as those associated with the LTCM failure, safe harbor treatment was expanded in 2005 to include additional types of contracts—such as repurchase agreements.

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### Several Factors Add to the Difficulty of Measuring Effectiveness of the Code for Resolving Failures of Complex, Internationally Active Financial Institutions

Measuring the effectiveness of the Code for facilitating orderly liquidations or reorganizations of complex and internationally active financial institutions is difficult because few of these firms have filed for bankruptcy and many of the more complex and global institutions have filed only recently.

*Few large-scale bankruptcies.* The paucity of complex or internationally active financial institutions among large-scale bankruptcies has resulted, in part, from (1) alternative resolution requirements and (2) governmental assistance to complex and internationally active financial institutions. Depository institutions and insurance companies cannot file for bankruptcy protection, and broker-dealers cannot file for reorganization under Chapter 11, as noted earlier. In addition, the government often has provided financial or other assistance, such as facilitating industry action, to complex financial institutions, such as LTCM and AIG, that otherwise might have declared bankruptcy, because they posed systemic risks. Assessing the bankruptcies that have occurred is also difficult, because many of the most complex cases are recent, and their outcomes are still unclear. One bankruptcy expert told us that if a firm still were operating effectively 2-3 years after emerging from bankruptcy, he would say the proceedings had been successful. The two largest financial institution bankruptcy cases in the United States—Washington Mutual and Lehman—still are ongoing, so it is difficult to provide a definitive assessment of the effectiveness of these cases at this time.

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*Lack of data.* For those financial institutions that have declared bankruptcy, data are not readily available for evaluating the effectiveness of the Code. AOUSC has collected some data on bankruptcy outcomes, such as the closing date for large cases. But it neither specifically collects information on cases involving financial institutions, nor does it track the value of creditor returns or the value of firms emerging from bankruptcy. The bankruptcy courts only collect data on the type of business in which an institution is engaged if the data are pertinent to provisions of the Code. Thus, the court tracks whether a bankruptcy involves a broker-dealer because it needs to know whether the bankruptcy courts would be operating under SIPA or specific provisions of the Code relative to liquidating broker-dealers. It does not track financial institutions beyond those cases because no special legal considerations arise. In addition, because data come directly from filings by the firms' attorneys, the courts generally rely on self-reported data, and AOUSC staff said they would do the same for other potential data that could be collected such as whether the firm is a financial institution. AOUSC staff said that, while they generally rely on self-reported data, they do perform certain data checks, including looking for outliers. Some organizations and researchers have taken the court data and augmented it with other kinds of data that might allow users to identify financial institutions, but researchers have not used these data to study how bankruptcies of financial institutions differ from other types of bankruptcies or how a systemic market event could impact the effectiveness of the bankruptcy process. However, researchers have studied the impact of certain factors on the effectiveness of bankruptcies, including the Federal Reserve study of the impact of time and studies of the effect of filing in particular courts on the effectiveness of bankruptcies.<sup>51</sup>

*Government involvement.* Even when the government does not step in to prevent complex financial institutions from filing for bankruptcy, evaluating the bankruptcy process is difficult. Even in cases where financial institutions have declared bankruptcy, the government often has provided assistance either before or during the bankruptcy. In two of the three largest bankruptcies of financial institutions—CIT and Lehman—the government provided financial assistance. In the case of CIT, the debtor was able to emerge as a going concern and come through reorganization quickly (within 1 month), which some said indicated a successful

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<sup>51</sup>See Covitz et al.

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resolution. However, the success of this bankruptcy was, in part, facilitated by CIT receiving government assistance in the form of Troubled Asset Relief Program (TARP) funding. Although CIT received this funding 10 months before declaring bankruptcy, and at a time when it hoped to avoid doing so, the funding allowed CIT the time to more effectively plan for the bankruptcy, including time to negotiate with its creditors to develop an acceptable restructuring plan. Because TARP assistance was structured in a way that gave the government low priority in case of a bankruptcy, it received no repayment in the bankruptcy process.<sup>52</sup> Similarly, the Federal Reserve authorized FRBNY to provide assistance to broker-dealers through its Primary Dealer Credit Facility. Under that facility, FRBNY extended \$28 billion in credit to Lehman Brothers, Inc. (LBI), the broker-dealer and commodity broker subsidiary of Lehman Brothers Holding, Inc. (LBHI), on September 15, 2008, the same day the parent company filed for bankruptcy.<sup>53</sup> However, the terms of the facility provided FRBNY with a position as a secured creditor of the firm, giving it higher priority in the event of a bankruptcy. LBI continued to borrow under the Primary Dealer Credit Facility for 2 more days, and, on September 18, 2008, the day before Barclays PLC assumed many of LBI's accounts, Barclays borrowed more than \$47 billion through the same facility.<sup>54</sup> This additional liquidity allowed LBI, the broker-dealer subsidiary, to remain a going concern until some of its assets and liabilities could be sold to Barclays and, thus, affected the value of the estate more broadly. The remaining parts of LBI are the subject of a SIPA proceeding. According to the Federal Reserve, LBI and Barclays repaid their overnight loans with interest.

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<sup>52</sup>Under TARP, the Department of the Treasury assisted institutions holding troubled assets by purchasing preferred shares in those institutions. As a shareholder, the government would rank below secured and unsecured creditors during a bankruptcy proceeding. Existing shareholders rarely receive any compensation in a bankruptcy.

<sup>53</sup>[GAO-11-696](#).

<sup>54</sup>See <http://www.federalreserve.gov/newsevents/files/pdof.xls> (listing of all borrowers under the Primary Dealer Credit Facility by name, date, amount, and other information).

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## Complex Financial Institutions Pose Challenges for Liquidations or Reorganizations

Our review of literature on bankruptcies and financial institutions, as well as interviews with experts in these fields, identified several characteristics of complex financial institutions that pose challenges for liquidations and reorganizations. Some of the legal and economic experts we interviewed told us that large financial institutions would not necessarily be any more difficult than other large firms to take through bankruptcy. Complex financial institutions, regardless of their size, were viewed as more difficult because of the nature of their businesses and their interconnected organizational structures. Specifically, the characteristics of complex financial institutions that make their liquidation or resolution through bankruptcy difficult include the highly liquid nature of financial institutions' funding sources, their use of derivatives and other financial contracts not subject to the Code's automatic stay, and institutions' separate yet interconnected legal structures (separate entities often created to gain tax and regulatory advantages) that are not congruent with their integrated operational structures.

## Funding Sources and Use of Derivatives

Some financial institutions are dependent on short-term, highly liquid funding sources to finance assets that have longer-term maturities and are not easy to sell. When depositors, lenders, counterparties, or investors lose confidence in an institution, the institution may be subject to a run—a sudden removal of its liquid funding sources—that will force the institution to sell assets at fire sale prices, impairing its solvency in a way that could ultimately lead to its failure. The existence of runs in retail depository institutions has long been acknowledged, but the 2008 financial crisis demonstrated that complex financial institutions that lend money to other financial institutions in what is referred to as the wholesale market also are subject to runs. Although deposit insurance is designed to limit these runs, for larger institutions, runs continued to play a role during the 2008 crisis. Runs created by the loss of depositor confidence contributed, in part, to the failures of IndyMac, FSB, and Washington Mutual Bank, and fear of a depositor run was one of the reasons the government cited for providing assistance to Citigroup Inc. during the crisis. Similarly, in 2008, uncertainty about the financial condition and solvency of financial institutions caused other financial institutions to raise the prices they charged for short-term funds in wholesale markets, and interbank lending slowed substantially. For example, in 2008 after Bear Stearns and Co.—an investment firm participating in wholesale markets—failed, the then-SEC Chairman noted that the firm failed when many lenders, concerned that the firm would suffer greater losses in the future,

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stopped providing funding, even on a fully secured basis with highly-rated assets as collateral.<sup>55</sup> Lehman also faced a liquidity crisis when banks refused to lend money for its brokerage and other services. An official familiar with Lehman's bankruptcy proceedings said that just before the institution declared bankruptcy, Lehman had to roll over borrowing of about \$100 billion dollars every day to pay off maturing commercial paper and other commitments.

Complex financial institutions are principal users of derivative contracts, and this is another factor that makes their bankruptcy proceedings more challenging. The exemption from the automatic stay for these QFCs was designed to help ensure that financial markets and institutions remained liquid during bankruptcies. The concern is that, if these markets froze, credit would not be available in the economy generally. However, when a financial institution itself is the debtor, the exemption can negatively affect it and lead to a number of adversary proceedings related to the safe harbor treatment. For example, a bankruptcy attorney familiar with the Lehman bankruptcy case told us that much of the value in Lehman declined after the institution's counterparties used the safe harbor to terminate contracts where they stood to gain (and Lehman lose) and keep those alive where they would have experienced losses (and Lehman gains). Approximately 80 percent of the derivative counterparties to Lehman's primary U.S. derivatives entity terminated their contracts within 5 weeks of Lehman's bankruptcy filing. Questions have also arisen over the course of the bankruptcy about the setoff rights of QFC counterparties. For example, Swedbank AB, a Swedish bank, that was a creditor of Lehman Brothers Holdings, Inc., sought to offset Lehman's payment obligations under prepetition swaps with deposits Lehman had made at Swedbank after filing for bankruptcy. The Bankruptcy Court of the Southern District of New York ruled against Swedbank, concluding that offset rights under the Code only exist when, among other things, "mutuality" exists. That is, mutuality would exist when the debtor's claim against the creditor and the debt owed to the creditor are mutual, as determined under principles of bankruptcy and contract law. However, the court held that no mutuality existed because the funds in the Swedbank

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<sup>55</sup>See Senate Committee on Banking, Housing and Urban Affairs, *Testimony Concerning Recent Events in the Credit Markets* (testimony of Christopher Cox, Chairman, Securities and Exchange Commission, 110th Cong., 2d sess., Apr. 3, 2008); and SEC Office of Inspector General, *SEC's Oversight of Bear Stearns and Related Entities: Broker-Dealer Risk Assessment Program*, Report No. 446-B (Washington, D.C.: Sept. 25, 2008).

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## Organizational Structures and Interconnectedness

account were deposited after the bankruptcy petition was filed, while Lehman's payment obligations under the swaps arose before the petition was filed.<sup>56</sup> In another proceeding involving the Lehman bankruptcy, a lender, Bank of America, seized the debtor's account funds, which were unrelated to any safe harbor transaction. The court ruled that the bank's use of the funds to set off the transactions violated the automatic stay.<sup>57</sup> Also, experts have noted that the exemption from the stay could weaken market discipline because creditors do not stand to lose as much from bankruptcy as they would with other types of financing.

Financial institutions often have complex legal structures that do not reflect their operational and strategic alignment and include both regulated and unregulated subsidiaries.<sup>58</sup> To the extent that institutions' operating structures increase their value through economies of scope and scale, splitting them up by legal entity likely would lower their value. However, the complex arrangement of the legal entities and various regulatory insolvency processes can pose significant challenges in bankruptcy, as judges and regulators must attempt to resolve pieces of an interconnected institution separately. These challenges are especially evident when regulators become involved in the resolution of nonregulated entities.

The organizational structure, including the number and types of subsidiaries in a financial institution, usually develops over time for different business reasons, but it typically does not coincide with the institution's operational or strategic business functions, as economists, government officials, and financial institution executives have noted.<sup>59</sup>

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<sup>56</sup>In re Lehman Bros. Holdings, Inc., 2010 WL 1783395 (Bankr. S.D. N.Y. May 5, 2010) ("Memorandum Decision Granting Debtors' Motion Pursuant to Sections 105(a) and 362 of the Bankruptcy Code for an Order Enforcing the Automatic Stay Against and Compelling Payment of Post-Petition Funds by Swedbank AB").

<sup>57</sup>Bank of America, N.A. v. Lehman Brothers Holdings, Inc., 439 B.R. 811 (Bankr. S.D. N.Y. 2010).

<sup>58</sup>We have been highlighting this feature of financial institutions for some time. See for example GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, [GAO-09-216](#) (Washington, D.C.: Jan. 8, 2009); GAO, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, [GAO-05-61](#) (Washington, D.C.: Oct. 6, 2004).

<sup>59</sup>See, for example, C. Cumming and R. Eisenbeis, "Resolving Troubled Systemically Important Cross-Border Financial Institutions: Is a New Corporate Organizational Form Required?" Working paper: February 8, 2010.

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Instead, the legal entities often are set up to benefit from tax or regulatory differences or to obtain higher credit ratings. For example, institutions obtain tax advantages by setting up a holding company structure that allows subsidiaries to transfer tax savings to the parent company.<sup>60</sup> And, at some failed institutions, regulatory advantages were gained by placing subprime mortgage assets that had been securitized in an off-balance sheet vehicle that was not subject to regulatory capital adequacy requirements imposed on the consolidated entity, although the entity retained significant risk.<sup>61</sup> Institutions also set up legal entities called special purpose vehicles, legally separate from the parent entity, to issue specific structured finance products such as asset backed securities. As a result, rating agencies could rate products higher than the parent institution's debt.<sup>62</sup> Because the financial institution usually operates its businesses without regard for the legal separateness of these entities, breaking it up along legal entity lines for the purposes of bankruptcy likely would lower the value of the consolidated entity.

Although some bankruptcy cases are administered together in what is called procedural consolidation, the courts still must separate assets so that creditors of a given legal entity receive payouts only on the basis of that entity's assets. For example, in the Lehman bankruptcy, many legal entities in the United States filed separate cases, which have been procedurally consolidated under a single judge in the Southern District of New York. However, the complex interrelationships among Lehman's entities have to be unwound so that the claims of creditors of the different entities can be addressed. Reports by the Lehman bankruptcy examiner and SIPA trustee reports document the many ways in which the parent company—Lehman Brothers Holdings, Inc.—and its subsidiaries were

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<sup>60</sup>Pretax dividends transferred from subsidiary banks can be used by bank holding companies to pay debts, so that corporate taxes would not have to be paid on those funds.

<sup>61</sup>US-headquartered bank and financial holding companies are subject to capital adequacy requirements at the holding company level for on-balance sheet assets. By moving assets into off-balance sheet vehicles, the capital requirement for the consolidated entity is lower.

<sup>62</sup>These special purpose entities are called "bankruptcy remote" because if the parent company failed, neither trustees, debtors-in-possession, nor creditors could gain access to the assets contained in the vehicle, providing a safer (and higher-rated) investment for bondholders.

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linked.<sup>63</sup> For example, the examiner had to map Lehman’s centralized cash management system to determine which legal entities were entitled to claim certain assets.

In unusual cases, the interconnectedness of the debtor’s estate with related entities can lead to a bankruptcy court’s use of a doctrine known as “substantive consolidation.” The doctrine, developed by case law, permits a court in a bankruptcy case involving one or more related corporate entities to disregard the separate identities of entities and to consolidate and pool their assets and liabilities in order to treat them as though held and incurred by one entity. The process creates a single estate for the benefit of all creditors for all the consolidated corporations and combines the creditors into one consolidated body.<sup>64</sup> For example, in the early 1990s, the court applied the doctrine in confirming the Chapter 11 reorganization plan of Drexel Burnham Lambert Group, Inc. (a holding company for an investment group) and certain of its eligible subsidiaries.<sup>65</sup> In the Lehman bankruptcy, some creditors maintain that because the parent company guaranteed the trades for different entities, distributions should be made across all parties equally, according to the ladder of creditor priorities. Other creditors argue that there is no legal rationale for not respecting the separate corporate status of the individual Lehman debtors. On June 29, 2011, the holding company provided a new plan, agreed to by the creditors, which includes a compromise on substantive consolidation. The plan’s settlement takes into account the different outcomes that would occur if either the proconsolidation or anticonsolidation plans were approved, and subsequent litigation that would likely follow if one of those plans were adopted. (For more detail on these issues, see app. IV).

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<sup>63</sup>In re Lehman Brothers Holdings, Inc., Case No. 08-13555, *Report of Anton Valukas, Examiner*; In re Lehman Brothers, Inc., Case No. 08-01420. *Trustees Preliminary Investigation Report and Recommendations*.

<sup>64</sup>See In re Drexel Burnham Lambert Group, Inc., 138 B.R. 723, 764 (Bankr. S.D. N.Y. 1992) (citation omitted).

<sup>65</sup>In the Drexel proceeding, referenced above, the court listed the substantive consolidation factors established under case law, observing that they “must be evaluated within the larger context of balancing the prejudice resulting from the proposed consolidation against the effect of preserving separate debtor entities.” 138 B.R. at 764-65 (citations omitted).

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The complexity of a liquidation or reorganization of a consolidated financial institution likely would be even greater if the institution has regulated subsidiaries that do not qualify as a debtor under the Code, such as depository institutions or state-regulated insurance companies. When these regulated entities fail and are liquidated by regulators, the prospects for reorganization of their holding companies may be limited. In cases where the holding company's main or major assets consist of one or more regulated subsidiaries, the holding company likely will be forced to declare bankruptcy when the subsidiary fails. The subsidiaries' insolvencies, which are resolved outside of the bankruptcy process, leave fewer assets available for the holding company's creditors to recover in liquidation or for use in reorganizing the remaining parts of the firm. For example, after its primary asset—Colonial Bank—was placed into FDIC receivership, Colonial BancGroup—the parent holding company—reported liabilities of \$380 million and assets of only \$45 million in its bankruptcy filing. In the case of Washington Mutual, legal practitioners familiar with the case told us that holding company executives were generally unaware that FDIC was being appointed as receiver of their subsidiary until the day the announcement was made and, within hours, the depository institution, Washington Mutual Bank, was transferred to a third party, leaving the holding company unprepared to file for bankruptcy.

For some complex financial institutions with regulated subsidiaries, the regulator may become a creditor in the bankruptcy proceedings. FDIC is often a creditor in bank holding company bankruptcies when FDIC seeks to recover amounts associated with its role in resolving the depository institution subsidiary.<sup>66</sup> Issues can arise over the ownership of assets (i.e., whether assets such as tax refunds belong to the depository institution or the holding company) and the status of FDIC's claim as a creditor. Additionally, an issue can arise concerning the parent's financial responsibility, if any, for the bank. The Washington Mutual bankruptcy is an example of disputes over the ownership of the assets. In that proceeding, the debtor has sued FDIC to regain certain of its deposits that had been placed at the depository institution before they were

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<sup>66</sup>Section 13 of the FDI Act, authorizes FDIC to undertake various actions or provide assistance to a failing institution. FDIC is obligated to pursue a course of resolution that is the least costly to the insurance fund, except in cases involving systemic risk. 12 U.S.C. § 1823(c). See GAO, *Bank Regulation: Modified Prompt Corrective Action Framework Would Improve Effectiveness*, [GAO-11-612](#) (Washington, D.C.: June 23, 2011) for more information.

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transferred to JPMorgan Chase and Co. (JPMC). As of June 2011, the parties had reached an agreement over these and other assets, but shareholders have not accepted the agreement, and the judge is continuing to hear their claims before approving a final reorganization plan.<sup>67</sup> In the other two cases at which we looked in depth—CIT and Lehman—the holding companies and some affiliates have gone through bankruptcy while their subsidiary depository institutions continued to operate.<sup>68</sup> Experts familiar with these cases said the estates have worked with FDIC to show that keeping insured depositories open and well-capitalized was a lower-cost solution than placing them in receivership. Officials at FDIC said that it was not common for a holding company to declare bankruptcy while its depository institution subsidiaries continued to operate. They said that, in the case of the CIT and Lehman depositories, FDIC used cease and desist orders to insulate the institutions it oversees from the bankruptcies of their respective holding companies.<sup>69</sup> The cease and desist orders required prior FDIC approval for any affiliate transactions, the declaration or payment of dividends, and any other payment representing a reduction in capital.

Broker-dealers may file a petition for liquidation under Chapter 7 of the Code or may be subject to proceedings under SIPA for the protection of customers. Their parent companies and eligible affiliates may qualify for reorganization under Chapter 11; however, the interrelationships among affiliates in complex financial institutions complicates these cases. In the case of Lehman's broker-dealer, for example, determining whether affiliates of the broker-dealer were entitled to SIPA protections has posed substantial challenges for the SIPA trustee.<sup>70</sup> In addition, when affiliates of a broker-dealer or its holding company file for bankruptcy, the broker-dealer is likely to experience some negative impacts as well and may

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<sup>67</sup>See *In re Washington Mutual, Inc.*, 442 B.R. 314 (Bankr. D. Del.) (2011) (although the global settlement of claims was fair and reasonable and provided a basis for confirmation, modifications were found necessary before confirmation would be granted).

<sup>68</sup>See *In re: CIT Group, Inc.*, Case No. 09-16565, Findings of Fact, Conclusions of Law and Order (confirming reorganization plan) (Bankr. S.D. N.Y. Dec. 8, 2009); *In re: Lehman Brothers Holdings, Inc.*, 08-13555 (S.D. N.Y.) (pending).

<sup>69</sup>FDIC issued cease and desist orders for one of Lehman's institutions and CIT's bank. The Office of Thrift Supervision also issued a cease and desist order for Lehman's thrift.

<sup>70</sup>See, e.g., *In re Lehman Brothers Inc.*, No. 08-01420 SIPA. "Trustee's Third Interim Report for the Period November 12, 2009 through May 10, 2010."

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need to be liquidated. For example, when Drexel Burnham Lambert Group declared bankruptcy in the 1990s, market participants and creditors lost confidence in Drexel's solvent subsidiaries, including its large broker-dealer, and were unwilling to enter into new transactions. Following that, SEC and other regulators transferred the broker-dealer's customer accounts and wound it down.

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### Internationally Active Financial Institutions Pose Additional Challenges for the Bankruptcy Process

Financial institutions can have assets and customers throughout the world. Similar to domestic institutions, they may locate subsidiaries in particular countries to gain tax and regulatory advantages. As a result, subsidiaries, assets, and creditors may be subject to separate insolvency regimes in various countries. Differences in laws and insolvency systems and the national interests of the countries add to the complexity of bankruptcy proceedings. Several legal experts pointed out that even one contract, such as a derivative, may be written in New York and hedged in London so that a bankruptcy pulls the two-sided contract apart and subjects it to two different legal regimes—that of the United States and of England. Many of the complexities in the Lehman bankruptcy have come about because Lehman operated subsidiaries in 21 countries. These complexities included (1) having all of the cash in New York when its bankruptcy was declared, leaving foreign subsidiaries with no cash to retain employees needed to help liquidate or reorganize subsidiaries in those countries; (2) the failure to share needed information across countries; and (3) different decisions being rendered in the United States and England regarding the same securities. Similarly, in assessing the problems at AIG, economists faced challenges understanding how and to what extent its myriad U.S. and foreign subsidiaries were viable.<sup>71</sup> At the end of 2008, AIG comprised at least 223 companies and had operations in over 130 countries and jurisdictions worldwide.<sup>72</sup> Table 2 documents the extent to which large international financial institutions operate across international borders.

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<sup>71</sup>See Cumming and Eisenbeis.

<sup>72</sup>[GAO-09-975](#).

**Table 2: Thirty of the Largest International Financial Institutions (Ranked by Size) and Their Subsidiaries and Branches**

Dollars in thousands (U.S.)

<b>Financial institution<sup>a</sup></b>	<b>Total assets, year end 2010</b>	<b>Country of headquarters</b>	<b>Number of countries with operations, most recent available</b>
BNP Paribas SA	\$2,680,292,421	France	More than 80
Deutsche Bank AG	2,556,177,062	Germany	74
HSBC Holdings plc	2,454,689,000	UK	87
Barclays PLC	2,332,673,035	UK	More than 50
Royal Bank of Scotland Group plc	2,276,191,669	UK	39
Bank of America Corporation	2,264,909,000	United States	More than 41
Mitsubishi UFJ Financial Group, Inc.	2,183,944,247	Japan	More than 40
Crédit Agricole SA	2,137,530,516	France	70
JPMorgan Chase & Co.	2,117,605,000	United States	More than 60
Mizuho Financial Group, Inc.	1,671,913,220	Japan	Approximately 30
Citigroup Inc.	1,913,902,000	United States	160
ING Groep N.V.	1,667,128,102	Netherlands	49
Banco Santander SA	1,633,133,042	Spain	28
Lloyds Banking Group plc	1,554,083,934	UK	More than 30
Société Générale SA	1,518,540,577	France	83
UBS AG	1,410,932,948	Switzerland	More than 50
Wells Fargo & Company	1,258,128,000	United States	36
UniCredit SpA	1,246,797,525	Italy	Approximately 50
Credit Suisse Group AG	1,105,403,813	Switzerland	More than 50
Commerzbank AG	1,011,802,817	Germany	50
AXA Group	981,425,889	France	60
Goldman Sachs Group, Inc.	911,332,000	United States	34
Intesa Sanpaolo SpA	883,644,534	Italy	39
Allianz Group	838,289,738	Germany	70
Morgan Stanley	807,698,000	United States	28

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Dollars in thousands (U.S.)

<b>Financial institution<sup>a</sup></b>	<b>Total assets, year end 2010</b>	<b>Country of headquarters</b>	<b>Number of countries with operations, most recent available</b>
Nordea Bank AB	779,126,761	Sweden	14
Dexia SA	760,207,914	Belgium	34
Banco Bilbao Vizcaya Argentaria SA	741,432,036	Spain	More than 30
MetLife, Inc.	730,906,000	United States	More than 60
Royal Bank of Canada	712,665,358	Canada	52
<b>Average</b>	<b>\$1,532,063,476</b>		<b>Approximately 53</b>

Sources: GAO analysis of SNL Financial and publicly available company information.

<sup>a</sup>Because of their specialized function and treatment, Fannie Mae and Freddie Mac are not included in this list. The source also does not include financial institutions in certain countries such as China.

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## Whether the Bankruptcy Code Is More or Less Effective Than Alternatives Is Also Unclear

Whether resolving financial institutions through bankruptcy would be more or less effective—that is, maintain asset values and minimize systemic risk—than resolving institutions through other processes such as FDIC receivership under OLA is not clear. Both the bankruptcy courts and FDIC have had some experience addressing the failures of complex, internationally active financial institutions and have dealt with fluctuating numbers of failures, which could be important during a financial crisis. The bankruptcy courts have a long-standing tradition of administering bankruptcy cases including a number of complex cases, such as those of Enron Corp. and WorldCom, Inc. In addition, the courts have dealt with variation in the volume of bankruptcies over economic cycles (see table 1). Because FDIC has been resolving insured depositories over a long period of time, it also has some experience addressing the issues posed by financial institutions and is familiar with the dramatic variation in failure rates brought on by market events. For example, FDIC dealt with the large number of failures during the savings and loan crisis in the 1980s and 1990s and has handled more than 300 depository failures since 2007, following a period from 2004 to 2007 when failures had fallen to zero.<sup>73</sup>

However, both the bankruptcy courts and FDIC lack experience in handling failures of large numbers of complex, internationally active

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<sup>73</sup>GAO-11-612.

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institutions during a financial crisis. As noted earlier, bankruptcy courts have not dealt with a large number of bankruptcies involving such institutions for a number of reasons. These reasons include the government's ability and willingness to provide assistance to systemically important financial institutions, a practice that the Dodd-Frank Act restricts, and the majority of the assets in these institutions sometimes being in regulated subsidiaries subject to regulatory resolution processes. Similarly, while FDIC has resolved large numbers of small institutions, it has had limited experience resolving institutions with foreign subsidiaries and often has resolved a depository institution by selling it to another institution—a solution that may be less practical when large, complex financial institutions fail, especially when they fail in a short time span. Some legal experts and policymakers have noted that these acquisitions create even larger institutions, making future insolvencies more difficult to resolve. Although FDIC has not been appointed receiver for any institution under OLA, it has analyzed how it would have handled the Lehman failure under OLA. FDIC's analysis includes more effective planning by Lehman leading up to a resolution and Barclays' willingness to buy Lehman's distressed assets.<sup>74</sup> However, critics have noted that both of these options were available under the Code and that the analysis does not acknowledge the widespread weakness in financial markets that affected many financial institutions during the financial crisis. Because FDIC has not yet dealt with an actual failure under OLA, it might not be appropriate to compare its analysis of Lehman with the actual experience under the Code. However, in commenting on this report, FDIC officials noted that the OLA has several advantages over the current Code that likely would have preserved Lehman's value including the requirement to plan for a resolution and FDIC's ability to transfer QFCs to a bridge entity.

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<sup>74</sup>FDIC, "The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act," *FDIC Quarterly* 5, no. 2 (May 2011).

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## Bankruptcy Proposals Address Some Financial Institution Challenges, but There Is No Consensus on Specifics

Questions about the effectiveness of the bankruptcy process for liquidating or reorganizing financial institutions have prompted some financial and legal experts—sometimes working in interdisciplinary groups—as well as government officials to propose changes to the Code, or to the supervisory process leading up to a bankruptcy filing. These proposals generally focus on or combine several types of actions: (1) increasing opportunities for bankruptcy planning, (2) providing for regulatory input in the bankruptcy process, (3) modifying safe harbor exceptions to the automatic stay for QFCs, (4) treating firms on a consolidated basis, and (5) improving court expertise on financial issues. Experts sometimes agree on the need for a particular type of action to address challenges posed by financial institutions, but they often do not agree on the effectiveness of specific proposals.

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## Improving Bankruptcy Planning May Help Maintain Going Concern Value or Avoid Bankruptcy

Many of the experts with whom we spoke noted that a lack of planning in the Lehman bankruptcy contributed to its disorderliness and that better planning would improve the effectiveness of liquidations and reorganizations under the Code. Better planning would lessen the likelihood of precipitous declines in asset values and thus might increase the returns to creditors, enhance the likelihood that a financial institution could be successfully reorganized, and lessen the systemic impact of a financial institution bankruptcy. Nonetheless, there was little consensus on specific actions needed to achieve these desired outcomes.

The Dodd-Frank Act has created a process for the prudent supervision of large financial institutions that regulators believe will facilitate resolution planning for those institutions. Large bank holding companies and nonbank financial companies supervised by the Federal Reserve now must formulate and submit a resolution plan known as a “living will.”<sup>75</sup> Financial institutions with the potential to be systemically important are required to submit and maintain resolution plans, as well as other periodic

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<sup>75</sup>Dodd-Frank Act, Pub. L. No. 111-203 § 165(d). This provision requires each nonbank financial company supervised by the Federal Reserve and each bank holding company with total consolidated assets of \$50 billion or more to submit periodically to the Federal Reserve or FDIC, respectively, and to the Financial Stability Oversight Council a plan for the company’s rapid and orderly resolution in the event of material financial distress or failure. Such a company also must submit a report on the nature and extent of credit exposures the company has to significant bank holding companies and significant nonbank financial companies and the same types of exposures such companies have to the reporting company.

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reports, in order to allow for the rapid and orderly resolution of the company. The Federal Reserve and FDIC issued a joint proposed rule on the requirements for the plans on April 22, 2011; according to agency officials, the agencies expect to issue the final rule by January 21, 2012.<sup>76</sup> Under the proposal, companies subject to the rule would have to submit a resolution plan within 180 days of the effective date of the final rule; however, this may change as a result of comments on the rule. As described in the preamble, the proposed rule would require a strategic analysis by the covered company of how it could be resolved under Title 11 of the U.S. Code in a way that would not pose systemic risk to the financial system. According to some experts, one purpose of these resolution plans is to guide regulators and institutions through the complex legal structures of large, complex financial institutions in the event of financial distress. The plans also may be used to encourage or require financial companies to simplify their legal structures and business lines so that any resolution in case of failure would be more orderly. Some regulatory and industry experts contend that effective resolution planning will help ensure the continuance of companies' critical functions, which would maintain the company's value and reduce disruptions to the wider economy. Additionally, a Pew Research report setting out standards for the plans has acknowledged that these plans might be useful in a bankruptcy case itself.<sup>77</sup> However, some experts have noted that the plans themselves have drawbacks, and when facing an actual bankruptcy, might be of limited use. Institutions and trade associations have responded to the planning requirements by noting that breaking up institutions or otherwise changing their structure would decrease their value. In addition, some financial and legal experts said that although resolution plans might help institutions and regulators increase their understanding of the complexities of financial institutions, the plans (which would generally be revised annually or within 45 days of a material event) might not be as helpful as hoped during times of financial distress because so much of a company's contracts, assets, and liabilities could change dramatically from day to day.

Two related proposals, which could improve planning, and perhaps avoid bankruptcy, are to either allow or require firms to hold contingent

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<sup>76</sup>76 Fed. Reg. 22648 (Apr. 22, 2011). The comment deadline was June 10, 2011.

<sup>77</sup>Pew Financial Reform Project, *Standards for Rapid Resolution Plans* (Washington, D.C.: May 2011).

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convertible capital. Contingent convertible bonds, sometimes known as “Co-Cos,” are bonds that convert to equity at a contractually determined trigger point, typically when a company falls below capital requirements or otherwise experiences some measure of financial distress. The required version of the proposed convertible bond instruments, sometimes called “bail-ins,” convert from debt to equity when a regulatory triggering event occurs. The purpose of requiring systemically important financial institutions to hold these instruments is to create a class of bondholders that share the burden of rescuing a company in financial distress and give these creditors an incentive to push a distressed financial institution to make changes, such as replacing management, before the trigger event. Financial experts suggest that contingent convertible capital bonds could provide a financial cushion that would give financial institutions facing bankruptcy more time to recover from their difficulties or to prepare for bankruptcy. Some institutions in Europe—Credit Suisse Group AG and Lloyds Banking Group plc—have introduced such bonds, and European regulators are considering requiring institutions to hold contingent capital for regulatory purposes. Critics of Co-Cos and bail-ins question who would purchase such instruments or whether they could be sold only at a premium (high interest rates). Some experts noted that the most likely holders of these securities would be insurance companies, but insurance regulators may require conservative regulatory treatment of these investments or, in some cases, may prohibit their purchase. However, experts expect that the holders of these debt securities likely would be other financial institutions. As a result, weaknesses at one financial institution may be transmitted to others, and this would be particularly problematic during a financial crisis, when having many institutions converting debt to equity at the same time could have a widespread systemic impact.

Another proposed action to improve planning is to require failing financial institutions to notify regulators at least 10 days before filing a petition for bankruptcy. This notice period is intended to provide the regulator with some time to facilitate actions to minimize the systemic impact of the bankruptcy. During this time, the regulator may be able to find ways to maintain critical functions, facilitate an asset sale, or identify potential creditors that would provide financing for the debtor during the bankruptcy proceeding—DIP financing. This extra time for preparation could help to maintain the going concern value of the institution and reduce disruptions to the wider economy. However, during the rapidly developing financial crisis, some institutions’ financial conditions deteriorated so rapidly that a 10-day notification would not have been possible. For example, the senior management of Bear Stearns gave FRBNY a 1-day notification when they

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said that Bear Stearns would file for bankruptcy protection the following day unless it received an emergency loan.

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### Actions to Increase the Role of Regulators May Better Account for Systemic Risk in the Bankruptcy Process

The Code does not explicitly address systemic risk. As a result, legal and financial experts have proposed bringing regulators or other government officials who are currently outside the court system into the bankruptcy process to address issues related to systemic risk. However, some legal experts believe that such a move could weaken the role of debtors and creditors in the bankruptcy process.

Proposed actions to increase the role of regulators in the bankruptcy process include allowing a financial institution's primary regulator to file an involuntary petition for bankruptcy and to do so prior to actual insolvency. Currently, only creditors can initiate an involuntary petition for bankruptcy.<sup>78</sup> Some regulatory and legal experts suggest that early intervention by regulators such as allowing regulators to file for bankruptcy would help to place the institution into bankruptcy before its value was depleted and thus help to preserve its going concern value. In addition, providing regulators with this authority would thereby allow them to take into account the potential disruption to other companies, and the economy as a whole, that would be caused by the timing of the decision to file for bankruptcy. Currently the debtor or creditors of a financial institution only take into account the value of the firm or the risk to creditors in the decision to file for bankruptcy. If a regulator was to have standing, despite its lack of creditor status, and the debtor institution was reluctant to file for bankruptcy, the regulator could choose to file an involuntary petition if a later bankruptcy filing would pose a greater threat to the greater economy or the going concern value of the institution. Some bankruptcy experts said this would weaken the role of debtors and creditors in the bankruptcy process, and some experts have also noted that regulators have not always been able to determine when financial institutions are likely to fail or have a systemic impact.

A second proposal to increase the bankruptcy role of government officials currently outside the court system would be to allow the government to provide DIP financing by serving as a lender to the estate. DIP financing for large systemically important financial institutions in bankruptcy

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<sup>78</sup>See 11 U.S.C. § 303.

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necessarily would be substantial, and few outside the government may have adequate resources. Allowing the government to provide DIP financing might make filing for bankruptcy a more viable option for systemically important financial institutions. In addition, depending on the nature of the financing, as a DIP financier, the government would have super priority—it would be near the top rung of the creditor priority ladder—for any assistance provided, and would therefore be among the creditors receiving the first repayment of their loans. This contrasts with the assistance provided to CIT, where the government received no repayment. However, the assistance to CIT was part of widespread government assistance to financial institutions aimed at maintaining financial stability, not assistance narrowly aimed at a specific institution, and therefore might not be strictly comparable. Some experts have suggested that allowing the government to provide DIP financing ultimately would minimize the costs to taxpayers of a financial institution failure, because an adequately funded debtor in bankruptcy would have less systemic impact than an underfunded one. However, following the financial crisis, there has been widespread opposition to adopting resolution mechanisms that would place the government at risk of future financial losses.

One group of experts also has proposed allowing regulators, in addition to debtors and creditors, to propose plans of reorganization. They argue that, in the case of financial institutions, those who were managing the institution before the bankruptcy usually have been replaced by firms specializing in resolution management and, as a result, the institution no longer has an interest in continuing as a going concern. In addition, a regulatory plan could better take account of systemic factors. However, in this system, as opposed to a purely regulatory system, the judge in the case also would consider proposals by the creditors, preserving their due process. Because this proposal was not made until recently, other experts have not yet commented on it.

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### Proposals to Modify the Safe Harbor Treatment for QFCs May Affect Systemic Risk and Market Discipline

Legal and financial experts have made a number of proposals to change the treatment of QFCs. These contracts are exempt from the automatic stay in bankruptcy and allow counterparties access to posted collateral, including cash, as soon as the debtor defaults or declares bankruptcy. This 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. In addition, a variety of experts expressed concern about counterparties not imposing market discipline, such as monitoring the creditworthiness of their counterparties, or

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signatories on certain contracts, because they are less likely to suffer the consequences of a bankruptcy.

Proposed actions to modify safe harbor treatment for QFCs include changing the types of exempted contracts and protected counterparties. These proposals vary greatly and include retaining protections for contracts backed by the most liquid collateral assets, excluding certain types of counterparties, or eliminating all QFC exceptions and subjecting each contract's protection to judicial discretion. Some experts with whom we spoke suggested that modifying the safe harbor treatment may help to avoid or mitigate the precipitous decline of assets typical in financial institution bankruptcies. For example, some have suggested that the treatment of QFCs in the Lehman bankruptcy contributed to a significant and rapid loss of asset values to the estate. Some experts also suggested that the current treatment contributes to systemic risk and lessens market discipline because it removes the incentive for fully collateralized counterparties to monitor each other's risk-taking behavior. However, some experts said determining which counterparties or contracts should be protected would be difficult. In addition, some experts argued that modifying the current exceptions would exacerbate systemic risk when a financial institution enters bankruptcy. 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 subsequent systemic financial crisis. Officials at the Commodity Futures Trading Commission also noted 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.

A second proposal to modify safe harbor treatment for QFCs would preserve current exceptions for financial institutions deemed systemically important and remove all such exceptions for other companies. Some experts suggest that the nondefaulting counterparties of systemically significant financial institutions also are likely to be systemically significant. Thus, to avoid spreading losses from one financial institution to another and ultimately to the rest of the economy, these counterparties need the safe harbor protections. These experts further assert that nonfinancial and nonsystemic financial institutions do not need this same safe harbor protection, because their being subject to the automatic stay would not have an effect on credit markets throughout the economy. However, other financial experts argue that preserving safe harbor treatments for certain financial institutions only raises equity concerns,

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giving an unfair advantage to systemically important financial institutions that could lead to those institutions gaining even larger shares of the market for financial services.

A third proposed action to modify safe harbor treatment for QFCs would provide a limited stay for these contracts. The length of these proposed stays varies, from 1 day to 30 days. Imposing a limited stay for QFCs in bankruptcy would align this resolution process with other regulatory insolvency processes. For example, the new OLA and the resolution process for banks under the FDI Act use a 1 business-day stay.<sup>79</sup> One legal expert has noted that providing a limited stay would allow debtors enough time to determine which contracts to assume and which to terminate and this would, in part, effectively reverse advantages that nondefaulting counterparties now have over the debtor. Other experts have argued, however, that it is difficult to determine how long a stay may be necessary to make these determinations, and that any stay for these contracts would cause considerable market disruption and increase the cost, and reduce the availability, of capital.

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### Although Proposals to Treat Institutions on a Consolidated Basis in Bankruptcy May Improve Efficiency, Challenges Exist

As noted throughout this report, large financial institutions are legally, structurally, and financially complex, and they often operate both regulated and unregulated subsidiaries in multiple jurisdictions. To the extent that these structures increase value through economies of scope and scale, splitting them up likely will lower their value. As a result, proposals have been made to treat firms on a more consolidated basis to better address the significant challenges faced in bankruptcies, where judges and regulators currently attempt to resolve only one piece of an interconnected institution. The proposals are as follow:

*Eliminate existing exclusions.* Proposed options to treat financial institutions on a consolidated basis include eliminating existing bankruptcy exclusions for insured depositories, insurance companies, broker-dealers, or commodity brokers. As discussed previously, insured

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<sup>79</sup>Under the OLA and the FDI Act, in the case of an FDIC receivership, a QFC counterparty generally cannot exercise a right to terminate or offset under an “*ipso facto*” provision until after 5:00 p.m. (eastern standard time or eastern daylight time) following the date of appointment of FDIC as receiver. Dodd-Frank Act, Pub. L. No. 111-203 § 210 (c)(8)(F); 12 U.S.C. § 1821(e)(10)(B)(i)(II). This allows FDIC to transfer the QFCs so as to prevent their termination by the counterparty.

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depositories and insurance companies have separate and distinct resolution processes—FDIC resolves insured depositories, and state insurance regulators resolve domestic insurance companies. Broker-dealers may be debtors only in Chapter 7 or SIPA liquidations, while commodity brokers can be debtors only under Chapter 7. By eliminating these exclusions under the Code for systemically important financial institutions, a financial institution could enter bankruptcy as one consolidated entity, and a judge with appropriate authority could involve the corresponding regulators and regulatory procedures under his or her authority. For example, one proposal says that, to the extent possible, insurance policyholders should be treated in the same way they are treated under regulatory resolution practices. In addition, this proposal calls for maintaining SIPC and the Commodity Futures Trading Commission’s ability to participate in the bankruptcy proceeding. Some experts suggested that eliminating these exclusions could reduce the potential for conflicts among different resolution authorities with competing interests. However, regulatory experts expressed doubt that the resolution of their jurisdictional entities under a bankruptcy judge would remain as effective. In addition, some regulatory experts expressed concern about the ability of a bankruptcy process to protect bank depositors, insurance policyholders, and customers of commodity brokers, who have special protections under current processes. U.S. insurance regulators specifically noted that insurance policyholders rely on state insurance commissioners’ abilities to wall off insurer’s assets from bankruptcy claims so they can be used to meet policyholders’ claims rather than those of other unsecured creditors. They said that eliminating these assurances would likely disrupt insurance markets.

*Require procedural consolidation.* A second proposed option is to require procedural consolidation, which currently may be ordered by the court for cases pending in the same court. Procedural consolidation, also known as joint administration, involves assembling together all bankruptcy proceedings for each entity within a financial institution for administrative purposes, so that one judge ultimately has authority over all such related cases. Under the Federal Rules of Bankruptcy Procedure, the court may order consolidation of cases if two or more petitions “by or against the same debtor” are pending in the same court. Also, if a joint petition, or two or more petitions, are pending in the same court against a debtor and an affiliate, the court may order joint administration of the estates.<sup>80</sup> Some

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<sup>80</sup>Fed. R. Bankr. P. 1015(a), (b).

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experts suggest that mandating procedural consolidation for financial institutions predetermined as systemically important would minimize the cost of the proceeding.

*Substantive consolidation.* A third proposed option is to treat financial institution groups on a consolidated basis through substantive consolidation. Unlike procedural consolidation, in substantive consolidation, the intercompany liabilities of related companies are eliminated, the assets of these companies are pooled, and the companies' liabilities to third parties are satisfied from the single pool of assets. No direct statutory authority exists for substantive consolidation; the courts have developed the doctrine through case law. The courts have stated that this doctrine should be used rarely, and only in specific instances—when, prior to a bankruptcy filing, the institution acted on an integrated basis that led creditors to assess risks across legal entities or after a bankruptcy filing, the assets and liabilities of the legal entities were so intermingled that separating them would be prohibitive and hurt all creditors. Although pooling assets could increase the value of the consolidated entity and encourage creditors to assess consolidated risks, legal and economic experts said that creditors can and do monitor the risk being taken by individual legal entities. And, they said, consolidating assets in a bankruptcy likely would drive up the cost of capital because creditors would be less willing to provide funds to financial institutions if they could not distinguish the legal entities receiving the funds from other more risky entities in the consolidated institution. Substantive consolidation has been proposed in the Lehman case, where one of the two creditors' reorganization plans proposes it; other creditors have filed a competing plan. On June 29, 2011, the debtor issued a new plan based on an initial agreement with the competing creditors. The agreement, which lays out the factors that support consolidated supervision and those that argue against it, may be modified. Nonetheless, the plan asserts that although the majority of the factors indicate that Lehman operated as a centralized business, certain critical factors, such as the ease of segregating the assets and liabilities of each entity, argue against substantive consolidation.

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**Measures to Improve Court Expertise Have Been Proposed, but Some Experts Said They Are Not Necessary**

Some experts contend that bankruptcy courts require more expertise to conduct financial institution bankruptcy proceedings than they currently have. As we discussed earlier in this report, the complex legal structures, innovative products, regulatory requirements, and internationally active business lines of systemically important financial institutions pose considerable challenges for the bankruptcy process. If court officials do

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not have specialized knowledge related to financial institutions, the time needed to acquire that knowledge could be especially detrimental in a financial institution case because assets may lose value quickly.

Proposed options to improve court expertise on financial issues include creating a specialized panel of judges or a standing group of financial experts. Some academic and legal experts have suggested establishing a special panel of judges technically trained on both bankruptcy and financial institution issues, although opinions vary on the process for assigning cases and what effect their rulings should have on other courts. These experts contend that the limited number of systemically important financial institution bankruptcies warrant a dedicated group of special masters who would best understand how to equitably and efficiently resolve such complex financial institutions. However, other experts with whom we spoke expressed concerns that the rare occurrence of these bankruptcies would prevent such special masters from gaining or utilizing their expertise. In addition, experts commented that some current complex financial bankruptcies are in courts with highly qualified judges. A related proposal would create a standing group of financial experts to serve the court during a financial institution bankruptcy case. Some experts noted that courts already have the right to appoint examiners as they did in the Washington Mutual and Lehman cases. As with the proposal for a special panel of judges, the rare occurrence of these bankruptcies may argue against creating such a standing group.

Another proposal would grant special standing to regulators to be parties or otherwise participate in bankruptcy court proceedings on matters relevant to regulatory issues. While regulators currently may be involved in bankruptcies—such as FDIC’s role in Chapter 11 bankruptcies of bank holding companies—no regulator has a special role in these bankruptcies. Experts contend that regulated institutions have more complicated legal structures and products than others. Thus, having regulatory expertise would provide more timely information to the judge and could lead to resolutions that better preserve asset value. Some legal experts expressed doubt that the bankruptcy process required further financial expertise. A few bankruptcy judges stated that increasing court expertise is unnecessary. Although financial institutions do present unique issues in bankruptcy, they explained that the judge’s role is to hear the facts of the case as presented by both sides before entering judgment and, ultimately, the burden of educating the judges as to the unique issues of the institution’s structure or products falls on the attorneys representing the debtors, creditors, shareholders, or any other parties in the case.

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These proposals generally aim to address some potential criteria for assessing the effectiveness of the Code, including maximizing asset values and minimizing the impact of one type of systemic event. However, we (and others) have identified at least two types of events that could have a systemic impact on the financial system and thus destabilize the U.S. economy. First, the failure of a single financial institution could have a systemic impact on other institutions that are counterparties or creditors of the failing institution. Second, a market event, such as the crisis in the subprime mortgage market, can have a systemic impact by threatening the stability of a large number of financial institutions at a point in time. The proposals described here address primarily the first type of systemic event, even though the recent financial crisis that generated these proposals is associated more broadly with the second type of event—a market event that affects many financial institutions and markets at the same time. Some government officials and industry participants have also noted that OLA is not likely to address fully a widespread financial crisis involving the possible failure of multiple institutions.<sup>81</sup> In addition, a group of law professors and economists who have created a proposal for a new chapter of the Code told us that this new chapter would be designed to address the first type of systemic event but not the second type. They told us that their group may consider proposals to address widespread systemic impacts caused by market events after it addresses another difficult issue encountered in resolving systemically important financial institutions—the global nature of those institutions.

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<sup>81</sup>See, for example, Office of the Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress, January 26, 2011* (Wash., D.C.).

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## Courts and Regulators Have Mechanisms for International Coordination, but National Interests and Other Factors Limit Coordination

In a prior report on assistance provided to financial and other companies during the recent financial crisis, we noted that widespread financial problems, such as those that occurred in the crisis, require comprehensive, global actions that must be closely coordinated.<sup>82</sup> Efforts to improve international coordination in the resolution of financial institutions continue, but coordination mechanisms are not currently comprehensive, and international coordination generally is limited—often because national interests can play a determinant role in resolution outcomes. Differences in countries’ insolvency and resolution systems also can limit coordination. These include diverse terminologies, disparate treatment of contracts, limits on information sharing, and the exclusion of various types of financial institutions from judicial bankruptcy proceedings. These differences were evident in a number of financial institution failures during the crisis. Proposals for improving coordination call for harmonizing definitions, insolvency triggers, and other aspects of judicial and regulatory systems. However, most of the efforts to promote harmonization following the 2008 financial crisis have centered on activities that could be undertaken outside a judicial system.

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## Countries’ Insolvency or Regulatory Systems Combine Models

Countries often differ in the extent to which their insolvency or regulatory systems combine universalism or territorialism. In a universal system, all the operations of a company would be subject to the legal process and resolution system of the country in which the company is headquartered. In a bankruptcy proceeding, the debtor’s home country would consolidate the debtor’s worldwide assets into a single pool and treat creditors from any country equally under the home country’s priority scheme. Similarly, in a universal system, a financial institution would be regulated under its home country’s rules regardless of asset or customer location. By contrast, in a territorial system, each country would segregate or “ring fence” companies’ assets in its country, regardless of the headquarters’ location. Then, if a company declared bankruptcy, each country in which it operated would reserve the assets located there for that country’s creditors. Similarly, each country would use its own rules to regulate financial institution activities occurring there regardless of company structure. Territorial systems sometimes require financial institutions

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<sup>82</sup>GAO, *Financial Assistance: Ongoing Challenges and Guiding Principles Related to Government Assistance for Private Sector Companies*, [GAO-10-719](#) (Washington, D.C.: Aug. 3, 2010).

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headquartered abroad to set up separate legal entities to operate in their country.

The EU's method for overseeing and resolving banking institutions and their branches follows a universal system. Any institution with a banking license in an EU country can operate branches in other countries while following the rules of its home country. Thus, if the institution fails, the institution, including its branches in other EU countries would be resolved under the home country's rules; however, branches in non-EU countries may be subject to territorial systems in those countries. In contrast, in the United States, which some experts consider more territorial, the State of New York may seize a local branch of a financial institution headquartered in another country and all of its assets if the foreign parent becomes insolvent.<sup>83</sup> Most internationally active financial institutions headquartered abroad maintain branches in New York because of its importance as a financial center. Similarly, a U.S. subsidiary of a financial institution headquartered abroad has to maintain assets sufficiently in excess of liabilities or it risks FDIC resolution. For example, when a UK institution, the Royal Bank of Scotland, failed and was partially nationalized, its U.S. depository subsidiary, Citizens Bank, was able to continue operations in the United States because it was well-capitalized independently of its UK parent.

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### Mechanisms to Coordinate Internationally during Insolvencies Are Not Comprehensive

Because institutions can operate across these divergent legal and regulatory models, nations, and their regulators have adopted different mechanisms, such as the UN Model Law, in an attempt to facilitate international coordination on bankruptcies. The UNCITRAL Model Law on Cross-Border Insolvency is one of the main mechanisms governing such coordination. Chapter 15 of the Code incorporates the Model Law.<sup>84</sup> Generally, under Chapter 15, U.S. court officials may communicate directly with foreign court officials to obtain information or assistance. To facilitate coordination, the courts also may appoint personnel, communicate information by any appropriate means, coordinate administration and supervision of the debtor, approve or implement coordination agreements, and coordinate concurrent proceedings.

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<sup>83</sup>See, e.g., *In the Matter of the Liquidation of the New York Agency and Other Assets of Bank of Credit and Commerce International, S.A.* 683 N.E. 2d 756 (1997).

<sup>84</sup>H.R. Rep. No. 109-31, pt. 1 at 105-07 (2005).

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Chapter 15 cases allow foreign representatives to sue or be sued in a U.S. court and apply for relief such as a stay against U.S. creditors seizing the assets of a foreign debtor in a U.S. court. In addition, foreign representatives can apply to a U.S. court to have a foreign proceeding recognized as the main case—the foreign case would take precedence over a U.S. case.

Chapter 15 was used in the Lehman Bankruptcy. For example, in February 2009, administrators for Lehman Brothers Finance (LBF) filed for dismissal of a Chapter 11 proceeding in the Southern District of New York and petitioned under Chapter 15 for recognition of an ongoing insolvency proceeding in Switzerland. The administrators argued that LBF’s registered office was in Switzerland, and it had no offices or employees in the United States. In March 2009, the U.S. Bankruptcy Court recognized the Swiss proceeding as a foreign main proceeding and dismissed the Chapter 11 proceeding. The court noted that this would promote the efficient administration and maximization of LBF’s assets.<sup>85</sup>

A Chapter 15 proceeding is available in one of four circumstances: (1) when a bankruptcy proceeding is taking place in a foreign country, a representative of that country’s legal system or courts may apply to a U.S. court for assistance in obtaining assets held in the United States, or when an issue in the case involves a U.S. creditor; (2) when a party in the United States seeks assistance from a foreign court in connection to a U.S. bankruptcy case; (3) when a foreign and a U.S. bankruptcy case concern the same debtor; or (4) when foreign parties seek to participate in a U.S. bankruptcy case. 11 U.S.C. § 1501.

The typical Chapter 15 case begins when a foreign representative files a petition for recognition.<sup>86</sup> Recognition is the entry of an order conferring status on the foreign representative to proceed before the U.S. court.<sup>87</sup> Once the court grants recognition, that representative may commence a bankruptcy case under the U.S. Bankruptcy Code. In such a case, foreign creditors would have the same rights as U.S. creditors. Foreign representatives can intervene in any proceeding, state or federal, in which the debtor is a party. Under Chapter 15, a court may authorize a person from the United States, such as a trustee or examiner participating in a U.S. bankruptcy case, to operate as a representative of the debtor’s

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<sup>85</sup>In re Lehman Brothers Finance, AG, in Liquidation, Case No. 09-10583; In re: Lehman Brothers Holdings, Inc., Case No. 08-13555, Order Dismissing Chapter 11 Case of Lehman Brothers Finance AG, (Bankr. S.D. N.Y. 2009).

<sup>86</sup>11 U.S.C. § 1504. The Code defines a “foreign representative” as a person or body “authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor’s assets or affairs or to act as a representative of such foreign proceeding.” 11 U.S.C. §101(24).

<sup>87</sup>11 U.S.C. § 1502(7). The Code permits a foreign representative to make a limited appearance in an involuntary case without being submitted to the U.S. court’s jurisdiction. 11 U.S.C. § 306. Also, the Code permits a bankruptcy court to dismiss a case, after notice and a hearing, if, among other things, recognition of a foreign proceeding has been granted under Chapter 15. 11 U.S.C. § 305.

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estate in a foreign country under that country's laws.<sup>88</sup> In August 2009, the U.S. Bankruptcy Court authorized the debtors' estate of the parent company of Lehman, LBHI, to act as foreign representatives for that estate in the UK. As a result, debtors could seek recognition of their U.S. Chapter 11 case in the UK and request that the UK courts assist in protecting LBHI's assets.

Some experts from the legal community here and abroad told us that Chapter 15 and the Model Law have had a positive impact on international coordination. One legal expert said that, before several countries adopted the Model Law, international recognition did not really exist. A foreign court official also told us that Chapter 15 has allowed him to operate effectively in U.S. bankruptcy courts. Several experts pointed to the bankruptcy of Nortel Networks, Inc. (Nortel), a telecommunications company headquartered in Canada, which filed for bankruptcy along with 14 of its subsidiaries in January 2009, as a successful Chapter 15 case. The U.S. courts recognized the Canadian proceeding as a foreign main proceeding under Chapter 15. In June 2009, the U.S. courts also recognized a petition by a representative of a UK subsidiary to have the English proceeding for that subsidiary recognized as a foreign main proceeding. However, the Nortel bankruptcy was still ongoing as of June 2011.

Some legal experts believe that the international framework based on the Model Law has some drawbacks, especially as it relates to financial institutions.<sup>89</sup> Among those countries that have adopted the Model Law, some experts said that determining the home country or center of main interest for a financial institution that has subsidiaries in a number of countries is difficult and can reduce the effectiveness of the Model Law.<sup>90</sup> For example, in the Lehman case, there are multiple centers of main interest, each determined by the home country of the various subsidiaries. For the parent and many of the subsidiaries that filed for

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<sup>88</sup>11 U.S.C. § 1505.

<sup>89</sup>11 U.S.C. §§ 1525, 1526.

<sup>90</sup>Section 1516 of the Code states that "in the absence of evidence to the contrary, the debtor's registered office is presumed to be the center of the debtor's main interests." 11 U.S.C. § 1516(c). However, this presumption has been contested, and courts look to credible indicators of the center of main interest. See Louise DeCarl Adler, "Managing the Chapter 15 Cross-Border Insolvency Case," *A Pocket Guide for Judges* (Federal Judicial Center: 2011).

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bankruptcy in the Southern District of New York, the United States is the center of main interest. For Lehman Brothers Finance, Switzerland is the center of main interest. The effectiveness of Chapter 15 for financial institutions is further limited because it exempts many companies engaged in financial activities, including U.S. state-regulated insurance companies, U.S.-insured depositories, foreign banks that have branches in the United States, entities subject to a SIPA proceeding, broker-dealers, and commodity brokers. In addition, an academic expert told us that since the Model Law had not been widely adopted, its effectiveness is limited worldwide. Only 19 countries have adopted the Model Law. For instance, Germany, France, and the Netherlands—significant financial centers with strong connections to U.S. financial markets—have not implemented the Model Law.<sup>91</sup>

The American Law Institute guidelines state that if there is an insolvency proceeding in one of the NAFTA countries, all NAFTA countries should recognize that proceeding and once the courts recognize the proceeding, they should impose a stay on creditors in the other countries. The guidelines also state that all parties should disclose information about insolvency cases, allow foreign representatives the same rights to obtain information as domestic representatives, and have courts communicate directly with each other or through administrators. The guidelines further advise courts not to discriminate against foreign representatives when seeking possession of debtors' assets or when seeking to transfer those assets to another country.  
General Principle 3, Procedural Principle 4.

Courts overseeing a bankruptcy with international components can augment coordination by permitting adoption of insolvency protocols.<sup>92</sup> Protocols aim to promote certainty, clarify expectations, reduce disputes, prevent jurisdictional conflict, facilitate restructuring, reduce costs, and maximize value. For instance, they could assign court responsibility for certain matters to avoid duplication of effort or address the sharing of information. Guidelines exist for drawing up effective protocols. Some experts directed us to the American Law Institute's guidelines for facilitating coordination in the North American Free Trade Agreement (NAFTA) country bankruptcies.<sup>93</sup> The Lehman Brothers Cross-Border Insolvency Protocol and Order issued by the U.S. Bankruptcy Court for the Southern District of New York includes approval and adoption of the

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<sup>91</sup>Note that eight of the largest financial institutions listed in table 2 are located in these countries.

<sup>92</sup>An informative discussion of protocols and other aspects of cross-border insolvency cooperation can be found in the United Nations, *UNCITRAL Practice Guide on Cross-Border Insolvency Cooperation* (New York: 2010).

<sup>93</sup>American Law Institute, *Transitional Insolvency: Cooperation among the NAFTA Countries, Principles of Cooperation among the NAFTA Countries* (Philadelphia, Pa: 2003).

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American Law Institute's "Guidelines for Court-to-Court Communications in Cross-Border Cases."<sup>94</sup>

However, experts disagreed on the effectiveness of insolvency protocols. Some experts pointed out that protocols have been used successfully to coordinate proceedings, allow communication between courts, and conduct joint proceedings. In addition, a group of legal experts said that protocols could be more useful in facilitating coordination than Chapter 15 because they do not require that the courts determine a main proceeding. As a result, financial institutions, which encompass many different subsidiaries and business lines, may benefit more from protocols than from proceedings under Chapter 15. Other experts were skeptical about the effectiveness of protocols. One court official told us that aside from the sharing of information they were ineffectual. In his experience entities may refuse to participate in a protocol due to legal differences or only if they seek to maximize returns for creditors in their country. If a protocol is not comprehensive—all of the important countries do not participate—its usefulness will likely be limited.

Official representatives from nine countries involved in the Lehman bankruptcy have signed a protocol to cover issues that arise from the international nature of the Lehman case.<sup>95</sup> The protocol's goals include facilitating the coordination of the proceedings and enabling cooperation in the administration of the various estates. Among other things, the protocol gives representatives the right to appear in all proceedings and states that the representatives should keep each other informed of all relevant information. Beginning in July 2009, the official representatives from these countries have held regular meetings. Initially, the intent of these meetings was to discuss broad issues of administering estates, sharing information such as private client information, and how to deal with intercompany claims. A legal expert told us that, currently, these meetings focus on the Chapter 11 reorganization plan in the United States. However, the effectiveness of the protocol is limited because London-based Lehman Brothers International Europe has not signed on

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<sup>94</sup>In re Lehman Brothers Holdings, Inc., Docket No. 08-13555, Order Approving The Proposed Cross-Border Insolvency Protocol For the Lehman Brothers Group of Companies (June 17, 2009). See American Law Institute, Guidelines Applicable to Court-to-Court Communications in Cross-Border Cases (Washington D.C.: 2000).

<sup>95</sup>"Cross-Border Insolvency Protocol for The Lehman Brothers Group of Companies," execution copy, as of May 12, 2009.

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to the protocol. Instead, this London-based unit is opting to participate in bilateral agreements with individual affiliates. Many of the creditors from nations that signed the protocol dealt primarily with Lehman Brothers International Europe, which entered insolvency administration in the UK.

In addition to the mechanisms discussed above, regulators have signed various memorandums of understanding (MOU) to promote international coordination. A number of federal U.S. regulators have MOUs with their counterpart agencies in other countries. For example, the Commodity Futures Trading Commission and SEC both have MOUs with several countries important to the U.S. financial system, such as Canada, China, France, Germany, Japan, the Netherlands, Switzerland, and the UK. According to officials at the Federal Reserve, these MOUs have typically dealt with information sharing; however, more recently they have focused on crisis management and resolution of institutions. For example, regulators from Sweden, Denmark, Norway, and Finland have signed an MOU specifically designed for the resolution of Nordea Group (Nordea)—a universal bank with branches and subsidiaries in multiple Nordic countries. The MOU specifies how supervisors may share sensitive or confidential information and grants Swedish authorities leadership responsibilities among the supervisors. The MOU directs authorities to monitor the potential for a crisis in their countries, plan for a crisis situation, and facilitates close cooperation during a crisis.

However, experts generally felt that MOUs were not effective mechanisms for international insolvency coordination because they would break down in a crisis. According to a report on international insolvency by the Basel Committee on Banking Supervision, supervisors generally enter MOUs with the goals of cooperating and sharing information during the course of their regular oversight roles rather than to resolve an entity.<sup>96</sup> An expert familiar with the Nordea MOU further cautioned that, although the Nordic countries have similar legal regimes, national interest provisions in the MOU still might impede its effectiveness in a crisis.

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<sup>96</sup>Basel Committee on Banking Supervision, *Report and Recommendations of the Cross-border Resolution Group* (Basel, Switzerland: March 2010).

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## National Interests May Take Precedence over Efforts to Coordinate in a Bankruptcy

Although the importance of international coordination is generally recognized, national interests may take precedence over coordination during resolutions of insolvent financial companies and often did during the recent financial crisis. For example, when an international financial institution fails, regulators in each country generally look to protect entities in their own countries and focus on minimizing losses to their citizens and legal entities, as well as preventing national economic instability. During the recent global economic instability, countries took actions to mitigate impacts in their own countries. For instance, under EU laws, Iceland had full authority to resolve its banks that failed in 2008 (including UK branches) as a single entity. However, the UK government invoked antiterrorism laws that allowed it to seize and ring fence assets in UK branches of the Icelandic banks for the benefit of local depositors, local creditors, and UK commitments for deposit insurance.

The Fortis Bank, SA/NV (Fortis) failure further illustrates the difficulty of overcoming national interests in a financial institution failure. According to an academic expert, the Dutch and Belgians had good relations, including a strong relationship between their central banks, before the 2008 economic crisis. However, when Fortis—a financial institution with operations in Belgium, the Netherlands, and Luxembourg—nearly failed during the 2008 crisis, national interests kept regulators and other officials from cooperating to maintain the value of the bank. Belgian and Dutch officials both considered Fortis to be systemically important in their countries and proposed conflicting resolution plans. According to a report by the International Centre for Monetary and Banking Studies on the failure, the Belgians favored a joint solution that would keep Fortis as a consolidated entity, headquartered in Belgium.<sup>97</sup> However, Fortis recently had participated in a joint acquisition of the Dutch financial institution, ABN AMRO Holding, NV (ABN AMRO). The Dutch wanted ABN AMRO operations to remain in country and favored a solution that split the company. In the end, Fortis was broken up, with the Dutch nationalizing 100 percent of the Dutch banking subsidiaries, and the Belgians initially

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<sup>97</sup>The International Centre for Monetary and Banking Studies (ICMB) is an independent, nonprofit foundation to foster exchanges of views between the financial sector, central banks, and academics on issues of common interest. It is financed through grants from banks, financial institutions, and central banks. In association with The Centre for Economic Policy Research—a network of over 700 research fellows and affiliates throughout Europe—the ICMB produces the Geneva Reports on the World Economy. ICMB, *A Safer World Financial System: Improving the Resolution of Systemic Institutions*, Geneva Reports on the World Economy 12 (Geneva, Switzerland: 2010).

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nationalizing the Belgian banking subsidiary and, ultimately, selling 75 percent of it to French bank BNP Paribas. An expert familiar with the Fortis failure said that the ultimate cost might have been lower under a consolidated solution. See appendix VI for more information about the Fortis failure.

However, when national interests align, authorities find ways to coordinate. When Dexia faced a liquidity crisis in 2008, Belgium and France, with minor participation by Luxembourg, orchestrated a coordinated rescue by establishing a joint guarantee mechanism. Dexia was a key provider of municipal finance, especially in France, and was a key depository in Belgium. Thus, it was in France's interest to ensure continued finance for local governments and in Belgium's interest to prevent the failure of an important financial institution. As a result, Dexia emerged from the crisis relatively intact.

According to experts with whom we spoke, insolvency laws in some countries limit the ability of bankruptcy estate administrators to cooperate. These experts noted that bankruptcy administrators in some countries could be found liable for malpractice if they did not attempt to ring fence or otherwise protect domestic creditors while resolving subsidiaries of companies headquartered in other countries. Experts familiar with the Lehman case said that the UK had not signed the Lehman insolvency protocol because Lehman Brothers International Europe administrators had certain duties under UK law that limited their participation. As a result, parties in other countries said they could not obtain needed information because Lehman Brothers International Europe maintained the books and records for European and Asian operations. Nonetheless, in a recent SIPA trustee report, the trustee noted that Lehman Brothers International Europe had provided him with vast amounts of information.

Furthermore, national laws and regulations may restrict supervisors from sharing information with foreign entities. While there may be good reasons for the restrictions, they can prevent the timely sharing of information. Additionally, other national rules, such as privacy laws, can limit agreements to share information. Some supervisors' resolution systems also may not empower them to share information or may allow them to share information that does not have the specific details needed to coordinate the resolution of a large, global financial institution. Regulators also may not want to share bad or embarrassing news with foreign entities. For example, foreign regulators discovered that a trader in the New York office of a foreign firm lost \$1.2 billion over the course of

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a decade due to improper actions, but they did not promptly share that information with U.S. regulators.

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### Differences in Insolvency Systems, such as Definitions and Priority Structures, Also Limit International Coordination

In addition to national interests, differences between insolvency systems can limit international coordination of bankruptcies or resolutions. This includes differences in the mandated responsibilities of various actors involved in the proceedings; payment rankings for creditors; definitions of certain terms; treatment of contracts; and the extent to which judicial bankruptcy codes cover certain financial institutions.<sup>98</sup> Differences in legal traditions can also limit coordination. Civil law systems tend to rely on codes and not on case law, as in common law systems, such as in the United States.<sup>99</sup> Thus, judges may play a different role in insolvency proceedings depending on the legal system of the country. A legal expert explained that the effectiveness of international coordination mechanisms and agreements is limited in Mexico, a civil law country, due to its legal tradition that discourages courts from coordinating. In the Netherlands and Germany (civil law countries), judges are less active than in the United States and Canada (common law countries), leaving the resolution of the company to court-appointed administrators. A German court official said that a U.S. judge probably would have to coordinate with an administrator in Germany. These differences may complicate efforts to coordinate during insolvency proceedings, in particular proceedings in which time is critical. In another example, ladders of priority in insolvency proceedings differ. In the United States, wage claims generally rank below secured creditors, while in some European countries, such as Luxembourg and France, employee wage claims rank ahead of secured creditors. In France, employee wage claims are prioritized ahead of any

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<sup>98</sup>See appendix VIII for some detailed information on insolvency systems in selected countries.

<sup>99</sup>A common law system gives broad discretion to the judge so that a body of law is developed through court decisions in addition to law enacted through legislation. A civil law system is one that places emphasis on the language of the statute and predictability. See Robert Adriaansen, "At the Edges of the Law: Civil Law v. Common Law," A Response to Professor Richard B. Capalli, *Temple Int'l & Comp. L.J.* 107 (1998). For bankruptcy purposes, one legal writer described the difference as follows: "Whereas the U.S. bankruptcy court is a court of equity and a U.S. judge asks under the concept of common law whether there is anything in the Code that restrains him from granting the order, the German judge needs under civil law principles a provision in the Act which allows him to grant the action in question." See "Lies, Sale of a Business in Cross-Border Insolvency: The United States and Germany." *Am. Bankr. Inst. L.10 Rev.* 363 no. 65 (spring 2002).

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other class. See table 6 in appendix VIII for more information on countries' payment priorities.

Differences in definitions and standards for commencing insolvency or resolution proceedings between countries also can limit coordination. Different countries may have different definitions for terms such as debtor, center of main interest, proceeding, and relief. The following are some of the examples given by experts. The Dutch system does not have a term that means "relief" as exists in the U.S. bankruptcy system. The closest equivalent to the U.S. "stay" is the idea of a "cooling off period." Only recently could a debtor apply for an ad hoc "stay" similar to the U.S. automatic stay. In other parts of Europe, what might be a "liquidator" in one country is an "administrator" in another. Different countries may have different thresholds for when to take action to resolve a failing bank. Some countries intervene when a bank is no longer solvent or liquid. In other countries, such as the United States, regulators can intervene before a bank technically is considered insolvent. Countries also define banks differently. In the United States, the term "bank" often refers only to an insured depository institution, but in European countries with universal banks, the term would apply to an institution offering insurance, broker-dealer, and other investment firm services as well.

Provisions of contracts between creditors and debtors often dictate how issues are to be resolved in a bankruptcy; however, contract law differs across countries. An English case related to the Lehman bankruptcy proceeding illustrates how these differences can play out in a bankruptcy case. One London-based Lehman subsidiary, Lehman Brothers International Europe, had issued a series of notes under Saphir Finance Public Limited Company (Saphir), a special purpose legal entity. Saphir was also counterparty to a series of swap agreements. Another Lehman subsidiary, Lehman Brothers Special Financing (LBSF), was the other counterparty for the series of notes in question. Normally, the contracts were written to give the swap counterparty, LBSF, priority to the collateral over the noteholder, Perpetual. However, a special clause in the contracts, sometimes called a flip clause, specified that if LBSF, the swap counterparty, defaulted, the priorities would flip so that Perpetual, the noteholder, would have rights to the collateral ahead of LBSF. Following LBSF's bankruptcy filing in October 2008, the English courts ruled that the flip clause was valid and in effect. However, the U.S. Bankruptcy Court ruled that the flip clause was unenforceable because it violated

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U.S. bankruptcy law.<sup>100</sup> In his ruling, the U.S. bankruptcy judge stated that the English courts appeared not to take into account principles of U.S. bankruptcy law and that those courts understood that the outcome of the dispute might be different under U.S. law. Observing that the “courts will not extend comity to foreign proceedings when doing so would be contrary to policies or prejudicial to the interests of the United States,” the judge noted that the United States has a strong interest in having U.S. bankruptcy courts resolve issues of bankruptcy law. However, the judge also recognized the uncertainty created by conflicting U.S. and English rulings, and he recommended that given the complexity of the case, it would be better if all parties involved could find a way to harmonize and reconcile the decisions. On December 16, 2010, the U.S. court approved a settlement between the parties. For more information on these cases see appendix IV.

All of these limitations are only relevant to the extent that financial institutions are resolved under a judicial code. Whether this is the case or not varies across countries. As noted earlier, in the United States, insured depositories and state-regulated insurance entities are exempt from the Code, and broker-dealers cannot file under Chapter 11. In addition, the United States has now adopted OLA, which, if triggered, will exempt certain systemically important companies from the bankruptcy process. Similarly, Canadian law provides separately for the reorganization or restructuring of federally insured depository institutions and for the resolution of insolvent financial institutions.<sup>101</sup> Some countries have not traditionally exempted financial institutions from their corporate insolvency systems, but in response to the 2008 crisis the UK and Germany have increased the role of regulators and regulatory processes in the resolution of certain financial institutions. For example, UK regulators now can

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<sup>100</sup>In re Lehman Brothers Holdings, Inc., Case No. 08-13555, Lehman Brothers Special Financing Ince. V. BNY Corporate Trustee Services, LTD, Adversary Proceeding 09-01242, Memorandum Decision Granting Motion for Summary Judgment and Declaring Applicable Payment Priorities (Bankr. S.D. N.Y. Jan. 25, 2010).

<sup>101</sup>Depository institutions insured by Canada’s federal government are subject to restructuring and/or reorganization by the Canada Deposit Insurance Corporation (CDIC) under the Canada Deposit Insurance Corporation Act (CDIC Act). Provincial loan and trust corporations whose deposits are CDIC-insured also may be subject to the act if the relevant province has entered an agreement with the federal government. The Winding Up and Restructuring Act (WURA) applies to federal and provincial banks, loan companies, and insurance corporations. The WURA in effect provides a liquidation regime for these financial institutions.

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resolve depository institutions in ways that are similar to FDIC's rules in the United States. However, any assets remaining after a purchase and sale agreement or the creation of a bridge bank would be resolved under corporate bankruptcy laws. The UK is considering extending these rules to investment firms. In addition, the UK government can temporarily take ownership of certain financial institutions if, among other factors, it is necessary to resolve or reduce a serious threat to the stability of the financial systems of the UK. Germany's special resolution regime grants regulators several options when dealing with a distressed bank. At first, the regulator can facilitate voluntary debt restructuring or the provision of new financing. If that does not work, the regulator can put the bank through a judicial process similar to Chapter 11. Finally, the regulators can take the bank into conservatorship.

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### Experts Have Proposed Harmonized Standards and Use of Existing Supervisory Coordination Mechanisms to Improve International Coordination

In response to the financial crisis, a number of international organizations—those addressing economic and regulatory issues, as well as those addressing judicial issues—have been considering regulatory reforms that include improving international coordination during insolvencies. Some of these organizations have established general principles for improving international coordination, and some have proposed harmonizing specific standards for resolving institutions, such as insolvency triggers, and have also proposed using existing coordination mechanisms, such as colleges of supervisors, in resolving these institutions. The experts with whom we spoke agreed that these were key elements for improving coordination. For example, they noted that having a few key countries, such as the United States, UK, Germany, France, and Japan, adopt similar procedures might be sufficient to create meaningful coordination.

In support of the Group of 20 (G20) countries, the Financial Stability Board has released a set of high-level principles for international

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coordination for future financial crises.<sup>102</sup> The principles include developing common tools for crisis management, having authorities meet regularly to discuss possible resolutions of specific firms, sharing information across countries on specific firms, and having firms develop resolution plans. The work of the Financial Stability Board is part of a larger G20 financial reform agenda that seeks to establish a new financial regulatory framework, including new bank capital and liquidity standards, as well as measures to better regulate and effectively resolve systemically important financial institutions. For example, the G20 stated in September 2009, and again in November 2010, that internationally active, systemically important institutions should be subject to a sustained process of international recovery and resolution planning that includes institution-specific crisis cooperation agreements developed within crisis management groups.

In addition, the United States and the EU have worked on the convergence of U.S. and international accounting systems through the ongoing U.S.-EU dialogue and could work within the dialogue or other forums to harmonize certain insolvency and regulatory resolution features. This would likely be successful only if the EU managed to harmonize features within the EU through directives that create minimum standards for its member countries. Although the EU hopes eventually to create a single European Resolution Authority, its shorter-term goal is to harmonize resolution powers across EU countries. As a first step in promoting harmonization, it has released consultation papers. A foreign expert said that European reform is moving at two speeds. While the EU has been moving more slowly on its reports and proposals, some member states have been moving more quickly. For example, Germany,

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<sup>102</sup>The Group of 20 (G20) is a group of finance ministers and central bank governors from 19 countries—including the United States—and the EU. The Financial Stability Board brings together from the G20 countries central banks officials, finance and treasury officials, and financial institution regulators; officials of the International Monetary Fund and World Bank, and representatives from non-G20 countries to address issues related to global financial stability. Originally authorized by the Group of Seven countries—Canada, France, Germany, Italy, Japan, UK, and United States—in 1999 as the Financial Stability Forum, in April 2009, the G20 changed its name to the Financial Stability Board and strengthened and broadened its authority. The mandates of the board currently includes promoting coordination among authorities responsible for financial stability and contingency planning for cross-border crisis management, particularly for systemically important financial institutions. Financial Stability Forum, *FSF Principles for Cross-border Cooperation on Crisis Management* (Apr. 2, 2009).

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the Netherlands, and the UK all have enacted new special resolution regimes for financial institutions.

Specific proposals for harmonization of judicial systems have focused on a few key areas, such as similar treatment of creditors and financial collateral and common triggers for, or definitions of, insolvency. Through colloquia held by INSOL, judicial experts also have begun to consider whether and how to modify the Model Law to make it more useful when dealing with corporations that have subsidiaries in a number of different countries.<sup>103</sup> UNCITRAL has recommended that insolvency laws recognize the existence of consolidated corporate entities, which it calls “enterprise groups,” and allow for courts to coordinate enterprise group insolvencies in the same manner as insolvencies of a single, international debtor entity. As noted earlier in this report, having multiple main proceedings can create conflicting rulings and otherwise limit coordination. Judicial experts also pointed to the International Insolvency Institute’s draft guidelines on enterprise groups.<sup>104</sup> These guidelines suggest that courts allow all parts of an enterprise group, such as subsidiaries incorporated in various countries, and other affected parties to be heard in determining the group’s center of main interest. The court can choose to determine the “coordination center” and recognize a coordination center representative who will have standing in any matter involving the group.

Experts also recommended harmonization of any special resolution regimes for financial institutions, whether combined or separate from the judicial system. However, most of the efforts to promote international harmonization following the 2008 financial crisis have centered on activities that could be undertaken outside a judicial system. The proposals generally specify a number of activities that government officials should be allowed to undertake, including

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<sup>103</sup>INSOL is a global group of national associations of insolvency experts, including attorneys and accountants.

<sup>104</sup>International Insolvency Institute, *Judicial Guidelines for Coordination of Multinational Enterprise Group Insolvencies* (2009). The International Insolvency Institute is a global organization of insolvency experts.

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- intervening prior to actual insolvency as with the prompt corrective action in the United States,<sup>105</sup>
  - establishing a bridge institution,<sup>106</sup>
  - ensuring that creditors receive at least the compensation they would have had if the institution had failed and been liquidated instead of resolved,
  - restructuring an institution's capital structure or merging it with another entity,
  - transferring certain assets and liabilities to other entities,
  - nationalizing an institution temporarily, and
  - imposing a temporary stay on the termination of financial contracts.

The principles the G20 and others have been establishing, as well as the opinions of experts with whom we spoke, stressed the importance of having regulatory authorities coordinate on financial institution resolution before crisis situations developed because the value of such institutions deteriorates rapidly during insolvencies, leaving no time to set up structures for coordinating. For example, experts such as officials at the International Monetary Fund (IMF) have recommended building on the framework created under the Basel Committee on Banking Supervision, in which supervisors from various countries meet regularly to better coordinate supervision of an ongoing financial institution.<sup>107</sup> And some have recommended a college of resolution authorities that would use companies' required resolution plans to develop a more cohesive plan, promote effective coordination, and determine how the burden of financing such actions would be shared across countries. However, some

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<sup>105</sup>Prompt corrective action is the requirement that regulators take increasingly intensive actions as an institution's capital situation worsens. See 12 U.S.C. § 1831o.

<sup>106</sup>A bridge institution is an institution established to facilitate the transfer of assets and liabilities from one institution to another.

<sup>107</sup>The IMF, an organization of 184 countries, works to help foster global monetary cooperation and secure financial stability, among other aims. The staffs of these institutions have also conducted research related to these activities.

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legal experts were concerned that financial and regulatory officials have not been relying on court insolvency officials who are more familiar with existing bankruptcy proceedings and unnecessarily have been creating duplicative systems.

Both international organizations focusing on judicial issues and those focusing on economic and regulatory issues continue to work on improving international coordination regarding the resolution of insolvent firms operating across national borders. However, much of the specific focus on financial institutions has taken place in those organizations focusing on economic and regulatory, rather than judicial, issues. Some experts noted that there is a tradition for agreeing voluntarily to regulatory harmonization that was established originally at Basel. However, after the passage of the Dodd-Frank Act, which intended to limit assistance to individual financial institutions, there is continued debate as to whether governments will individually provide assistance to specific failing financial institutions or will ring fence assets when possible insolvencies threaten the stability of their national economies. And, countries such as the UK, continue to provide for the possibility of such assistance through a temporary public ownership provision in their recently enacted banking laws. Although some experts told us that a comprehensive treaty would help to ensure that countries have coordination mechanisms that are strong enough to withstand another global financial crisis, prospects for a treaty in this area appear limited.

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## Agency Comments and Our Evaluation

We provided a draft of this report to the AOUSC, Commodity Futures Trading Commission, Departments of the Treasury and State, Federal Deposit Insurance Corporation, Federal Judicial Center, Federal Reserve, National Association of Insurance Commissioners, SEC, and SIPC for review and comment. We received technical comments from the AOUSC, Commodity Futures Trading Commission, Departments of the Treasury and State, Federal Deposit Insurance Corporation, Federal Judicial Center, Federal Reserve, National Association of Insurance Commissioners, SEC, and SIPC, which we incorporated as appropriate. We also requested comments and received technical comments and perspectives on drafts of the case studies from relevant legal experts and the judges associated with the cases, 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, the Secretary of the Treasury, the Secretary of State, the Chairman of the Federal Deposit Insurance Corporation, the Director of the Federal Judicial Center, the Chairman of the Board of Governors of the Federal Reserve System, the Chief Executive Officer of the National Association of Insurance Commissioners, the Chairman of the Securities and Exchange Commission, and the Chairman of the Securities Investor Protection Corporation, and other 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 Alicia Puente Cackley at (202) 512-8678 or [cackleya@gao.gov](mailto:cackleya@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 X.



Alicia Puente Cackley  
Director, Financial Markets and  
Community Investment

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*List of Committees*

The Honorable Tim Johnson  
Chairman  
The Honorable Richard C. Shelby  
Ranking Member  
Committee on Banking, Housing, and Urban Affairs  
United States Senate

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

The Honorable Spencer Bachus  
Chairman  
The Honorable Barney Frank  
Ranking Member  
Committee on Financial Services  
House of Representatives

The Honorable Lamar Smith  
Chairman  
The Honorable John Conyers, Jr.  
Ranking Member  
Committee on the Judiciary  
House of Representatives

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# Appendix I: Objectives, Scope, and Methodology

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As required under section 202 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), this report examines (1) actions taken by the U.S. District Court for the District of Columbia (D.C. District Court) in response to the judicial review provision of the Orderly Liquidation Authority (OLA) of the Dodd-Frank Act; (2) the effectiveness of Chapters 7 and 11 of the U.S. Bankruptcy Code (Code) in facilitating orderly liquidations or reorganizations of financial institutions; (3) proposals for improving the effectiveness of liquidations and reorganizations under the Code; and (4) mechanisms that facilitate international coordination and any barriers to coordination of financial institution bankruptcies.<sup>1</sup>

To address all of our objectives, we reviewed relevant laws such as the Code and the Dodd-Frank Act as well as GAO reports that addressed bankruptcy issues and financial institution failures. We also reviewed economic and legal research on bankruptcies, especially bankruptcies of financial institutions. As part of this review, we conducted two literature searches, one on federal government documents, and one on published research on bankruptcy effectiveness, especially as related to financial institutions. The latter search relied on Internet search databases (including EconLit and Proquest) to identify studies published or issued after 2000. We reviewed these articles to further determine the extent to which they were relevant to our engagement, that is, whether they discussed criteria for effectiveness of the bankruptcy process, key features of the bankruptcy process, proposals for improving the bankruptcy process, or international coordination. The search of the published research databases produced 106 articles. A little over half of these documents were relevant to our objectives. Specifically, among the documents written by authors we did not interview, 15 documents discussed issues related to criteria for judging effectiveness, 11 discussed issues related to the treatment of qualified financial contracts and proposals for modifying the Code, 10 discussed issues related to international coordination, and 4 discussed the Lehman bankruptcy. We augmented this research with articles provided by those we interviewed

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<sup>1</sup>Pub. L. No. 111-203, §§ 202(e), (f). The mandate requires that we report on the judicial review for OLA and the effectiveness of the Code annually for 3 years after the passage of the act and every fifth year thereafter. The Administrative Office of the U.S. Courts is also required to address Pub. L. No. 111-203, § 202(e), and the Board of Governors of the Federal Reserve System (Federal Reserve) has mandates to address issues similar to those GAO is addressing in Pub. L. No. 111-203, §§ 216, 217.

or obtained from conferences. In addition, we reviewed a number of prior GAO reports related to bankruptcy issues, financial institutions, and the financial crisis. These are listed in “Related GAO Products” at the end of this report.

To provide explicit examples throughout our report, we conducted in-depth reviews of three bankruptcy cases of financial institutions and developed some information on the bankruptcies or failures of another 11 companies. We chose three companies for in depth reviews—CIT Group, Inc. (CIT), Lehman Brothers Holdings, Inc. and subsidiaries (Lehman), and Washington Mutual, Inc.—on the basis of their size and the variety of experiences and structures such as the types of businesses in which they engaged, amount of planning for bankruptcy, their organizational structures included regulated subsidiaries, the extent of their international operations, and their having entered bankruptcy after 2005 when the Code was revised. These cases represent the three largest financial institution bankruptcies as measured by consolidated asset levels in their most recent 10-K filing before filing for bankruptcy.<sup>2</sup> They also represent a range of company types and experiences. For example, CIT, which became a bank holding company only in 2008, provided commercial lending and leasing products, management advisory services, and small and mid-market business finance. Lehman provided a range of investment banking and broker-dealer services that involved it in a number of contracts that received safe harbor treatment under bankruptcy law. Washington Mutual was a thrift holding company whose major holdings were insured depository institutions. The companies also had a range of bankruptcy experiences—CIT was a prepackaged bankruptcy, while Lehman and Washington Mutual had engaged in little planning before their filings. In addition, the Lehman bankruptcy involved extensive

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<sup>2</sup>A 10-K filing is the Form 10-K filed with the Securities and Exchange Commission (SEC). The 10-K is an annual report required by SEC of every issuer of a registered security, every exchange-listed company, and any company with 500 or more shareholders or \$1 million or more in gross assets. The form provides for disclosure of total sales, revenue, and pretax operating income, as well as sales by products for each of a company’s separate lines of business. The Form 10-K becomes public information when filed with the SEC.

activities in other countries.<sup>3</sup> The Lehman and Washington Mutual cases also help to elucidate the role of the special resolution regimes for broker-dealers and insured depositories. We did not include a company that was engaged primarily in insurance activities because few holding companies with extensive insurance operations have gone through the bankruptcy system in recent years. For these case studies, we reviewed judicial proceedings including examiner reports, confirmation opinions, and disclosure statements, and conducted interviews with experts familiar with the cases. We concluded that the quantitative information in these sources were sufficiently reliable for our purposes. Appendixes III, IV, and V cover these cases in detail.

In addition to these case studies, we chose a number of financial institution failures or near failures that provided examples of specific aspects of the bankruptcy process or other aspects of financial institution failures. These were examples provided by those we interviewed or had been used in research articles. The examples include American International Group, BankHaus Herstatt, Bank of Credit and Commerce International, Bernard L. Madoff Investment Securities, Colonial Bancgroup, Drexel Burnham Lambert Group, Inc., Dexia SA, Fortis Bank SA/NV, the Icelandic banking crisis, Long Term Capital Management, and Nextbank. Appendix VI includes information on these examples that we use throughout the report.

During our review, we conducted structured interviews with private sector experts, including practicing attorneys, law professors, economists, accountants, and trade associations, who have expertise on bankruptcy and financial institutions (see app. IX for the organizational affiliations of those we interviewed). These experts were chosen because they best met certain criteria—they had published multiple articles on relevant issues, made proposals to modify the Bankruptcy Code, been involved in the bankruptcies we chose for our case studies, testified before Congress, and been recommended by agency officials. We also conducted similar in-depth interviews with U.S. and foreign government

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<sup>3</sup>Prepackaged bankruptcies are those where creditors and others necessary for approval of a plan accept a reorganization plan before the company files for bankruptcy. The provisions of any applicable nonbankruptcy law such as federal securities law governing communication with shareholders of public companies must be complied with, and those solicited must have been provided with "adequate information" in connection with the solicitation of their vote. See 11 U.S.C. 1126.

officials, including regulators, judges, and other court officials. Specifically, we met with officials at the Administrative Office of the U.S. Courts (AOUSC), Commodity Futures Trading Commission, Federal Deposit Insurance Corporation (FDIC), Board of Governors of the Federal Reserve System (Federal Reserve), Federal Judicial Center, National Association of Insurance Commissioners, SEC, Securities Investor Protection Corporation, U.S. Department of State, and U.S. Department of the Treasury, and at the Southern District of New York and Delaware District Bankruptcy Courts. We conducted in-depth interviews with these officials and with practicing attorneys, economists, and law professors to help develop criteria for effectiveness, determine critical factors in the bankruptcy system, determine what company characteristics complicate bankruptcies, identify mechanisms for and limitations on international coordination, and collect views on proposals to change the bankruptcy process and improve international coordination. Because each of the experts with whom we spoke had differing experiences with bankruptcy and resolution of failed financial institutions, we generally did not aggregate their responses. Because the Dodd-Frank Act mandated AOUSC and the Federal Reserve to conduct reviews similar to those we were conducting, we met regularly with these agencies throughout the engagement.

We also undertook a number of activities specific to each objective: To address the first objective to examine the actions taken by the D.C. District Court under section 202 of the Dodd-Frank Act, we met regularly with AOUSC. We contacted staff of the relevant congressional committees to determine whether they had received the D.C. Federal District Court's rule under the Dodd-Frank Act provision requiring publication and submission of the rule to the Congress.<sup>4</sup> We also searched the Federal Register and monitored the Web sites of FDIC and the Federal Reserve to determine whether relevant rules—those that defined financial companies and those that defined the conditions for default—had been issued. During this process we also observed industry roundtables held by FDIC to help develop rules to implement OLA.

To address the second objective, we analyzed the results of the literature review and expert interviews to determine criteria for effectiveness of the Code, key elements in the bankruptcy process that pose issues for

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<sup>4</sup>Dodd-Frank Act, Pub. L. No. 111-203 § 202(b)(2).

financial institutions, and characteristics of financial institutions that pose challenges for the bankruptcy process. We also collected and analyzed available data on financial institution bankruptcies to determine if the data were useful for assessing the effectiveness of financial institution liquidations or reorganizations. We collected data from the AOUSC and New Generations Research, Inc. a company that takes data from the U.S. bankruptcy filings and augments it with industry-specific data, and from a law professor at the University of California, Los Angeles who also collects bankruptcy data. The AOUSC provided lead case data on mega cases (involving assets of more than \$100 million and more than 1,000 creditors) that included date and location of filing and some information on how closed cases were concluded (such as by sale, liquidation, or reorganization). By matching data from the New Generations with the AOUSC-provided data, we were able to provide some context on the number of Chapter 11 mega cases that represented financial institutions, and we decided the data were sufficiently reliable for that purpose. However, as noted in the report, we found that the data were not sufficient for measuring the effectiveness of the bankruptcy process for liquidating and reorganizing financial institutions because they did not provide information on returns to creditors. In addition, only a small proportion of mega cases were financial institutions. To show the extent to which large financial institutions operate across national borders, we developed information from SNL Financial and publicly available company information on 30 large financial institutions relative to their size and international operations. We concluded that these data were sufficiently reliable for our purposes.

To address the third objective, we reviewed the literature, as described earlier, to determine the range of proposals that had been made to reform the bankruptcy process for financial institutions. We categorized some of the proposals into groups, such as those that included a role for the regulators or modified the treatment of qualified financial contracts and then asked the experts looking at these categories and these specific proposals to tell us which they considered had merit and should be included for further consideration and why. We also discussed their opinion on any additional proposals. Another academic group—including some of the experts we had previously contacted—that had a multipart proposal for reforming the bankruptcy process contacted us about their proposal when interviewed by another GAO team. This occurred after we had completed our expert interviews. To the extent that this proposal for reforming the bankruptcy process included new elements, these were not included in our earlier expert interviews. We analyzed the results of the academic research and our expert interviews to determine whether the

proposals addressed the criteria specified in our second objective and to determine reasons for adopting or not adopting the various proposals.

To address the fourth objective, we supplemented our domestic interviews by interviewing international experts on resolving failed financial institutions, including economists, attorneys, court officials, and regulators from Canada, Germany, the European Union(EU), Mexico, the Netherlands, Switzerland, and the UK. We also reviewed information they provided on some key characteristics of the bankruptcy processes in 10 countries, detailed in appendix VIII. We chose these countries because of their importance to the U.S. financial system and their geographic scope. We did not independently analyze these laws or procedures; instead, we relied on assessments provided by international legal experts and country court and regulatory officials.

We conducted this performance audit from August 2010 to July 2011, 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.

# Appendix II: Local Civil Rule 85

**UNITED STATES DISTRICT COURT  
FOR THE DISTRICT OF COLUMBIA**

VOTING: Judges Kollar-Kotelly, Kennedy, Roberts, Huvelle, Walton, Bates, Hogan, Urbina, Friedman and Kessler

It is this 19<sup>th</sup> day of January, 2011 ordered that effective immediately that Local Civil Rule 85 has been adopted by the Court.

**LCvR 85**

**FILINGS UNDER THE DODD-FRANK WALL STREET  
REFORM & CONSUMER PROTECTION ACT**

This rule governs petitions by the Secretary of the Treasury ("Secretary") under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Act"), Pub.L. No. 111-203, 124 Stat. 1376, 1444 (Jul. 21, 2010), 12 U.S.C. § 5382(a)(1), for orders authorizing the Secretary to appoint the Federal Deposit Insurance Corporation as receiver for financial companies.

**(a) FILING OF THE PETITION**

A petition under this Act must contain all relevant findings and recommendations under the Act, and must be filed under seal. The original and one copy of the petition and a PDF version on a CD-ROM shall be tendered to the Clerk. The original and copy of the petition and all related documents shall be submitted securely in an envelope/box appropriate to accommodate the documents. The envelope/box containing such documents shall have a conspicuous notation as follows: "DOCUMENT UNDER SEAL."

**(b) NOTICE TO THE COURT**

At least 48 hours prior to filing the petition, the Secretary shall provide written notice under seal to the Clerk of the Court that a petition will likely be filed with the Court.

**(c) NOTICE TO THE FINANCIAL COMPANY**

A petition shall be accompanied by a certificate of counsel or other proof satisfactory to the Court, stating (1) that actual notice of the time of filing the petition, and copies of all papers filed to date or to be presented to the Court at any hearing, have been furnished to the financial company; or (2) the efforts made by the Secretary to give such notice and furnish such copies. The certificate shall also contain the name and contact information of the individual at the financial company to whom notice was given and upon whom service was effected.

**(d) OPPOSITION TO THE PETITION**

The financial company named in the petition may file an opposition to the petition under seal and may appear at a hearing to oppose the petition. The opposition shall be served on the Secretary by the most expeditious means available.

**(e) PROPOSED ORDER**

Each petition and opposition shall be accompanied by a proposed order.

**(f) ASSIGNMENT OF THE PETITION**

The petition shall be assigned to the Chief Judge or Acting Chief Judge .

**(g) CONSIDERATION OF PETITION: NOTIFICATION OF DECISION**

In considering a petition, the Court shall, on a confidential basis and without public disclosure, determine whether the Secretary's decision that the covered financial company (1) is in default or in danger of default and (2) satisfies the definition of a financial company under the Act is arbitrary and capricious.

- (1) Upon a finding that the Secretary's determination is not arbitrary and capricious, the Court shall issue an order immediately authorizing the Secretary to appoint the Corporation as receiver of the covered financial company.
- (2) Upon a finding that the Secretary's determination is arbitrary and capricious, the Court shall provide immediately for the record a written statement of each reason supporting the determination of the Court, and shall provide copies thereof to the Secretary and the covered financial company, and must afford the Secretary an immediate opportunity to amend and refile the petition.

**(h) TIMING OF DECISION**

The Court shall attempt to rule on a properly filed petition within twenty-four (24) hours of receipt of the petition. In the event that the Court does not do so, the petition is deemed granted by operation of law under the Act.

**(i) MAINTAINING PETITIONS AND SUBSEQUENT FILINGS UNDER SEAL**

The petition and subsequent filings must be maintained under seal pending further order of the Court. Upon the granting of a petition, the Secretary shall promptly notify the Court of the appointment of the receiver. The Court shall then issue an Order to Show Cause to the Secretary as to why the proceedings, or any part thereof, shall not be

unsealed.

(j) **STAY PENDING APPEAL**

The decision of the Court on a petition shall not be subject to a stay or injunction pending appeal.

FOR THE COURT:

Royce C. Lamberth  
Chief Judge

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# Appendix III: CIT Group Bankruptcy

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This appendix describes selected aspects of the CIT bankruptcy. The items discussed here provide more detail on certain aspects of the bankruptcy than we cover in the main body of the report. This appendix does not attempt to summarize the case or fully capture its complexities. Table 3 provides a timeline of selected events related to the CIT bankruptcy.

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## Background

Before filing for bankruptcy, CIT—a 100-year old, New York-based lender—had changed its business focus. According to CIT’s filings with the SEC, CIT had been involved in consumer finance before 2008, when losses in mortgage-related businesses caused it to change its business model to focus exclusively on its core businesses of commercial lending and leasing products, management advisory services, and small and mid-market-business finance. At that time, CIT was active in more than 30 industries and 50 countries. In the first quarter of 2007, CIT reported record quarterly earnings of \$271.4 million or \$1.37 per common share. The market capitalization of the common shares of the company peaked in February 2007 at \$12.17 billion. CIT relied extensively on both secured and unsecured debt capital markets for funding. The company had accessed global capital markets issuing notes denominated in euros, British pounds, Canadian dollars, and Swiss francs as well as borrowing directly from a bank in Japanese yen. In December 2008, CIT received approval from the Federal Reserve to become a bank holding company. CIT’s bank holding company, CIT Group, Inc., was incorporated in Delaware. At that time, CIT Group, Inc. had a bank subsidiary, CIT Bank, and more than 400 nonbank subsidiaries, including special purpose entities and other regulated subsidiaries in the United States and abroad. CIT Bank, based in Salt Lake City, Utah, had been a state-chartered, industrial loan company but changed its charter to a state-chartered commercial bank in 2008. CIT Bank is subject to regulation by both FDIC and the Utah Department of Financial Institutions.

From the second quarter of 2007 through the third quarter of 2009, CIT lost money in every quarter for a total of \$6.3 billion. According to the company’s filings with SEC, disruptions in the credit markets combined with the global economic deterioration that began in 2007 materially worsened CIT’s liquidity situation. Successive downgrades by the rating agencies of debt issued by CIT to below investment grade in 2008 and 2009 compounded CIT’s problems, leaving the company without access to unsecured debt markets. According to CIT’s SEC filings, during the period of 2008 through its bankruptcy, CIT obtained interim secured

financings, such as the senior credit facility detailed below, and reduced its financing needs through balance sheet contraction.

Because CIT had changed its structure to that of a bank holding company—upon receiving approval from the Federal Reserve on December 22, 2008—it was eligible to participate in the Capital Purchase Program under the Troubled Asset Relief Program (TARP). On December 31, 2008, CIT received \$2.33 billion from TARP. In exchange, the Office of Financial Stability in the Department of the Treasury received preferred equity stock and a warrant to purchase CIT's common stock.

According to CIT's filings with SEC, as part of its overall plan to transition to a bank-centric business model, CIT had applied to participate in FDIC's Temporary Liquidity Guarantee Program (TLGP). Participation in this program would have enabled CIT to issue up to \$10 billion in government-guaranteed debt. However, CIT did not receive approval to issue TLGP backed debt. CIT also applied for exemptions under Section 23A of the 1913 Federal Reserve Act (Section 23A) and the Federal Reserve's implementing regulation to transfer a significant portion of its U.S. assets to its subsidiary, CIT Bank. This transfer enabled CIT to generate liquidity by leveraging the deposit-taking capabilities of CIT Bank. In April 2009, the Federal Reserve granted CIT a partial waiver from Section 23A requirements, which govern transactions between affiliated bank and nonbank companies, to transfer \$5.7 billion of government-guaranteed student loans to CIT Bank.<sup>1</sup> In connection with this transaction, CIT Bank assumed \$3.5 billion in debt and paid \$1.6 billion in cash to CIT Group, Inc. On July 15, 2009, CIT was advised that there was no appreciable likelihood of receiving additional government support in the near term, either through participation in TLGP or further approvals of asset transfers under its remaining pending Section 23A exemption request. Following this announcement, CIT experienced higher customer usage of prior financing commitments, accelerating the degradation of its liquidity position. This liquidity situation, its continued portfolio deterioration, and the generally weak economic and credit environment all weighed heavily on CIT's financial performance.

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<sup>1</sup>See Letter to William J. Sweet, Jr. (April 13, 2009). Section 23A is codified, as amended, at 12 U.S.C. § 371c. Regulation W is set forth at 12 C.F.R. part 223.

To meet its near-term liquidity needs, CIT entered into a \$3 billion senior secured term loan facility on July 20, 2009—which was amended and restated on August 3, 2009— provided by a syndicate comprised of certain of CIT’s preexisting creditors. By August 4, 2009, CIT had drawn the entire \$3 billion in financing under this senior credit facility. Both CIT Group, Inc. and certain subsidiaries were borrowers under this facility. CIT Group, Inc. and all of its U.S.-based, wholly owned subsidiaries—with the exception of CIT Bank and other regulated subsidiaries, such as wholly owned banks in Brazil, France, Germany, Sweden, and the UK, special purpose entities, and immaterial subsidiaries—were guarantors of this senior credit facility. At the same time as announcing this facility, CIT announced that it was beginning to attempt to restructure its liabilities to improve its liquidity and capital position. This involved an offer by which certain senior notes maturing in August would be repaid by CIT at a 20 percent discount on the face value with a 2.5 percent premium payable to those who agreed to these terms by the end of July. This offer was subject to approval by holders of 90 percent of the \$1 billion in these notes outstanding. On August 3, 2009, CIT announced that only 64.97 percent of the debt holders agreed to the tender offer. Then, CIT increased the offered payout to 87.5 percent while lowering the minimum debt holder approval hurdle to 58 percent. Debt holders with 59.8 percent of the outstanding notes agreed to the tender offer and were paid out the discounted amount. The remaining 40 percent of debt holders were paid the full face value on their notes.

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## The Bankruptcy

By the end of the third quarter of 2009, CIT was negotiating with a group of its largest creditors to secure interim financing and develop a restructuring plan that included a plan to exchange debt on a voluntary basis or to serve as a prepackaged bankruptcy plan, according to an expert involved in the negotiations.<sup>2</sup> The restructuring plan would need approval from almost all the creditors, while a prepackaged bankruptcy plan would need approval only from a majority of the creditors, which would in turn provide it with emergency financing. CIT also adopted a strategy to help ensure that it would be able to preserve the deferred tax

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<sup>2</sup>Prepackaged bankruptcies are generally those where the required number of creditors and other parties of interest accept a reorganization plan before the company files for bankruptcy, as long as the solicitation of such acceptance was in compliance with any applicable nonbankruptcy law, rule, or regulation governing the adequacy of disclosure in connection with such solicitation. 11 U.S.C. §1126(b).

assets associated with the more than \$6 billion in operating losses it had borne over the prior two and a half years. On October 1, 2009 CIT announced its restructuring plan had been approved by a steering committee of the company's creditors. The plan included a series of voluntary exchange offers where existing debt holders would exchange their existing notes for a series of five newly issued securities. The plan was then presented to CIT creditors to be voted on pursuant to securities laws. Eligible creditors were asked to vote on the exchange offer and a prepackaged bankruptcy plan. The exchange offer included voluntarily replacing certain unsecured notes with secured notes at 70 cents on the dollar. The prepackaged bankruptcy plan which has a lower threshold for approval than an exchange plan, was offered in the event that creditors did not vote for the exchange offer in a high enough percentage to be binding. For the vote, creditors and equity holders were organized into 18 classes. Only Classes 6 through 13 (representing lower-priority creditors) were entitled to vote and they were subject to a partial impairment of the debt owed to them by CIT. Classes 1 through 5 and Class 17, representing senior creditors and secured creditors, as well as some unsecured creditors, holders of guarantees by CIT and CIT entities owed money by other CIT entities, were not entitled to vote; the plan called for paying their claims in full so they were deemed to have accepted the plan. Classes 14 through 16 and Class 18 primarily representing preferred and common equity shareholders were not entitled to vote and were deemed to reject the plan and received no payment. In addition, the new common equity shares in CIT were to be distributed to those creditors that were scheduled to receive principal payback less than full par value.

CIT did not receive adequate approval for the exchange plan; however, it received approval from 92 percent of the 83 percent (based on the principal balance owed) of creditors that voted on the prepackaged bankruptcy plan for a restructuring framework. CIT Group and one other financing subsidiary filed for Chapter 11 protection on November 1, 2009, in the bankruptcy court of the Southern District of New York. CIT requested that the prepetition vote be deemed a vote on a Chapter 11 plan pursuant to section 1126(b) of the Code, which provides that a prepetition vote may be binding in a prepackaged Chapter 11 if the solicitation of the vote were applicable and in compliance with securities law. CIT's plan guaranteed significant recoveries to creditors and cancelled or extinguished all of the existing equity classes, including the U.S. Treasury's preferred shares acquired through its \$2.33 billion TARP capital injection. Holders of equity interests were not entitled to retain any property or interest in the new company. On December 10, 2009, CIT

cancelled and deregistered its old common stock, which had been delisted from the New York Stock Exchange on November 2, 2009, but had continued to trade. On December 11, 2009, CIT issued 200 million shares of new stock to debt holders and other creditors and began trading on the New York Stock Exchange under the old CIT ticker symbol. CIT had effectively reduced its debt by approximately \$12.5 billion (from \$64.1 billion to \$51.6) at the end of the third quarter of 2009. In addition, it preserved its deferred tax assets that stemmed from prebankruptcy losses. Its depository institution, CIT Bank, had preserved its well-capitalized status, and it and other operating subsidiaries continued to conduct business throughout the bankruptcy. There were no new adversary proceedings filed after November 2009. Several adversary proceedings were voluntarily dismissed.<sup>3</sup>

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<sup>3</sup>See *In re CIT Group Inc., and CIT Group Funding Company of Delaware LLC*, Case No. 09-16565, Findings of Fact, Conclusions of Law and Order (1) Approving (A) The Disclosure Statement Pursuant to Sections 1125 and 1126(c) of The Bankruptcy Code, (B) Solicitation of Votes and Voting Procedures, and (C) Forms of Ballots, and (II) Confirming the Modified Second Amended Prepackaged Reorganization Plan of CIT Group Inc. and CIT Group Funding Company of Delaware LLC (Bankr. S.D. N.Y., Dec. 8, 2009).

**Table 3: Timeline of Selected Events Related to the CIT Bankruptcy, from April 2007 through December 2009**

<b>Key date</b>	<b>Event or activity</b>
Apr. 18, 2007	CIT reports record earnings of \$271.4 million or \$1.37 a share for the first quarter of 2007
Dec. 22, 2008	CIT receives approval on its application to become a bank holding company from the Federal Reserve
Dec. 31, 2008	CIT receives Capital Purchase Program investment of \$2.3 billion from U.S. Treasury
July 15, 2009	CIT is advised by regulators that there is no appreciable likelihood of receiving any further government assistance
July 20, 2009	Initial CIT Restructuring Announcement
Oct. 1, 2009	Exchange offer announced, prepackaged plan announced
Oct. 29, 2009	Exchange offer closed
Nov. 1, 2009	Voluntary petition for bankruptcy filed
Nov. 2, 2009	New York Stock Exchange delists common and preferred stock
Dec. 7, 2009	Debtors file Modified Second Amended Prepackaged Reorganization Plan
Dec. 8, 2009	Plan confirmed
Dec. 9, 2009	Registration of 600,000 new CIT common shares and 100,000 new preferred shares
Dec. 10, 2009	CIT files disclosure statement and emerges from Chapter 11 deregisters old stock
Dec. 11, 2009	New stock starts trading on the New York Stock Exchange at \$29.64 per share

Sources: GAO review of SEC filings, CIT bankruptcy filings, regulatory filings, and other official company documents.

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# Appendix IV: Lehman Bankruptcy

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This appendix describes selected aspects of the Lehman bankruptcy. The items discussed here provide more detail on certain aspects of the bankruptcy that we cover in the main body of the report. This appendix does not attempt to summarize the case or fully capture its complexities. Table 4 provides a timeline of selected events related to the Lehman bankruptcy.

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## Background

Lehman was an investment banking institution that offered equity, fixed-income, trading, investment banking, asset management, and other financial services. According to the bankruptcy examiner appointed by the bankruptcy court, Lehman originated mortgages, securitized them, and then sold the securitized assets. Although headquartered in New York, Lehman operated globally. Lehman had \$639 billion in total assets and \$613 billion in total debts as of May 31, 2008, the date of its last audited financial statements. According to Lehman's 2007 annual 10-K filing with SEC, the firm had 209 registered subsidiaries in 21 countries. Lehman included several regulated entities including Lehman Brothers, Inc (LBI), a broker-dealer subject to SEC oversight, and one state-chartered bank and one federally chartered thrift whose primary regulators at the federal level were the FDIC and the Office of Thrift Supervision, respectively.<sup>1</sup> Until it filed for bankruptcy, Lehman also was subject to SEC supervision at the consolidated level.<sup>2</sup> Although Lehman comprised numerous subsidiaries, it operated as an integrated entity.

Investment banks such as Lehman generally rely on short-term financing and engage in derivative activities. Much of what constituted Lehman's borrowings was secured with collateral, including securities. According to a legal expert, even before the financial crisis Lehman needed to refinance about \$100 billion on a daily basis. According to the Lehman bankruptcy examiner's report, as of August 31, 2008, Lehman had a net receivable (asset) of \$46.3 billion and a liability of \$24.2 billion arising

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<sup>1</sup>As of July 21, 2011, the Office of the Comptroller of the Currency will begin supervising all federal thrifts, and the Office of Thrift Supervision will cease operations 90 days later.

<sup>2</sup>In the United States, consolidated supervision generally is equated with holding company supervision at the top tier or ultimate holding company in a financial enterprise.

from its derivatives activity.<sup>3</sup> Its derivative position represented a net positive of \$22.2 billion. However, according to a legal expert, Lehman also was the guarantor to the majority of International Swaps and Derivatives Association (ISDA) derivatives contracts—an association of derivative market participants—with about 1.7 million trades and more than 10,000 counterparties.<sup>4</sup>

The examiner attributes Lehman's decline and bankruptcy to aggressive investing in areas such as commercial real estate and to exceeding internal risk controls. Starting in 2006, Lehman invested the firm's capital in real estate lending and began holding mortgages on its balance sheet rather than selling the loans to other investors. In February 2007, Lehman stock traded at a record high of \$85 per share, and its market capitalization exceeded \$45 billion; however, according to the examiner's report, by September 2008 the stock had lost around 95 percent of its value. And, in the months leading up to its bankruptcy filing, Lehman faced liquidity strains, worsened by increased collateral requirements from its clearing banks. For example, JPMC required Lehman to post additional collateral, also called a margin, worth more than the money it received from the bank. In February 2008, JPMC began increasing Lehman's margin requirements. By June 2008, JPMC required Lehman to post an additional \$5 billion. On September 9, 2008, JPMC requested another \$5 billion. Lehman agreed to post \$3 billion the next day. JPMC also requested that Lehman agree to a new arrangement giving JPMC increased authority to request and seize collateral. On September 11, JPMC again requested \$5 billion.

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<sup>3</sup>According to Lehman's accounting, a "derivative asset" is one that will yield "probable future economic benefits," and a "derivative liability" is one that will yield "probable future sacrifices of economic benefits." That is, a derivative asset is one in which Lehman was owed money and would have been paid if the counterparty wanted to close out the position. With a derivative liability, Lehman would have owed money and would have to pay current market value to close out the position.

<sup>4</sup>The expert also estimated the notional value of these contracts at \$60 trillion, although authoritative information about the actual size of the market is generally not available. Notional value means the amount underlying a financial derivatives contract.

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## The Bankruptcy

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### The Bankruptcy Filings

After government officials and those in the industry were unable to find a private-sector solution to Lehman's likelihood of defaulting on its obligations, Lehman Brothers Holdings, Inc (LBHI) filed for Chapter 11 bankruptcy on the morning of September 15, 2008. According to experts on the case, the abruptness of Lehman's filing contributed to many of the ensuing issues raised by creditors. According to its petition, LBHI had more than 100,000 creditors, with the largest being Citibank, N.A., which as indenture trustee for LBHI's senior notes held an unsecured claim of approximately \$138 billion, and the Bank of New York Mellon Corporation (BNY), which had claims of approximately \$12 billion and \$5 billion as indenture trustee of LBHI's subordinated debt and junior subordinated debt, respectively. Between LBHI's bankruptcy filing on September 15 and September 17, LBI continued to borrow funds from the New York Federal Reserve Bank.<sup>5</sup>

Between September 16 and October 5, 2008, several other Lehman subsidiaries filed for Chapter 11 bankruptcy. On October 16, the Bankruptcy Court procedurally consolidated 15 subsidiaries into the main case.<sup>6</sup> In the ruling, the court explicitly declined consideration of substantive consolidation at that time, which would have pooled the assets and liabilities of each subsidiary or other legal entity into one fund. The procedural consolidation was intended to reduce duplication of effort. For example, the court would not have to maintain separate dockets and files, and the debtors would not have to file redundant documents.

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### Reorganization Plans

On March 15, 2010, the Lehman debtors (the debtors) filed their proposed Chapter 11 plan. On December 15, 2010, an ad hoc group of LBHI senior creditors (the ad hoc group) filed an alternative plan based

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<sup>5</sup>LBI borrowed funds from the Primary Dealer Credit Facility, which offered short-term collateralized loans, following the LBHI bankruptcy. LBI borrowed \$28 billion on September 15 against \$31.7 billion of collateral, \$19.7 billion on September 16 against \$23 billion of collateral, and \$20.4 billion on September 17 against \$23.3 billion of collateral.

<sup>6</sup>Two of these debtors (Fundo de Investimento Multimercado Credito Privado Navigator Investimento No Exterior and Lehman Brothers Finance) later would have their Chapter 11 cases dismissed.

upon a substantive consolidation of the debtors' cases. On January 25, 2011, the debtors filed their first amended joint Chapter 11 plan. On April 25, 2011, a group of creditors opposed to that plan and the ad hoc group plan (the nonconsolidation creditors) filed an alternative counterplan (the nonconsolidation plan). On April 27, 2011, the ad hoc group filed an amended second counterplan. At issue was the amount of substantive consolidation of the various debtors' assets and liabilities under each plan. The debtors' plan rejected complete substantive consolidation; instead claims against specific debtors would be "satisfied primarily" by that debtor's assets and compromises among creditors would satisfy additional claims. The nonconsolidation plan rejected the debtors' compromise plan and the complete substantive consolidation of the ad hoc group. Nonconsolidation creditors argued that no legal rationale exists for not respecting the separate corporate status of the individual Lehman debtors. They stated that LBHI "expressly advised its creditors of...corporate separateness." The ad hoc group's plan was based on judicially ordered substantive consolidation. The group stated that creditors considered Lehman to be a unified economic entity and that Lehman operated as a single business entity in global markets.

On June 29, 2011, Lehman filed a disclosure statement that set out the plan for distribution of assets to the claimants of 23 Lehman debtor entities. This plan was made after extensive negotiations with representatives of major creditor groups including those that supported substantive consolidation and those that did not. The plan asserts that although Lehman operated as a centralized business enterprise, certain critical factors such as the ease of segregating each individual entity's assets and liabilities support an argument against substantive consolidation. It should be noted that although representatives of the major constituencies believe that they have reached an agreement in principle to the terms of this plan, as of June 29, 2011, there were still conditions under which the plan could be amended. The plan separated the claims against each of the 23 debtor entities and the shareholders of each debtor into classes based on the nature of the claims and the claimants' related legal rights. Allowed claims across the 23 entities totaled \$361 billion. The estate estimates that recovered assets will total nearly \$84 billion prior to total administrative expenses of \$3.2 billion, amounts due to intercompany entities of nearly \$2.9 billion, and operating disbursements of approximately \$1.9 billion for a net distributable amount of \$76.3 billion or a claim payout ratio of 21.1%. It should be noted that the plan estimates that 7 of the 23 entities will fully pay all of their claims and have remaining funds for their shareholders. These include two separately capitalized AAA rated subsidiaries through which Lehman

conducted fixed income derivatives transactions. Recoveries to general unsecured derivatives creditors of three Lehman subsidiaries through which Lehman conducted equity derivatives, commodity and energy derivatives, and foreign exchange forward contracts and options business will receive payouts of 29.6 percent (equity), 50.8 percent (commodity), and 35.8 percent (foreign exchange). Creditors of the holding company, LBHI, will receive 16 percent of their claims.

**Table 4: Timeline of Selected Events Related to the Lehman Bankruptcy, from September 2008 through April 2011**

Key date	Event or activity
Sept. 15, 2008	LBHI files for bankruptcy
Sept. 17, 2008	Motion to sell LBI to Barclays, PLC (Barclays) filed
Sept. 19, 2008	Liquidation of LBI under Securities Investor Protection Act (SIPA) commences
Sept. 20, 2008	Sale of certain assets and liabilities of LBI to Barclays authorized
Sept. 22, 2008	Sale of certain assets and liabilities of LBI to Barclays closed
Oct. 3, 2008	Lehman Brothers Special Financing (LBSF) files for bankruptcy along with Lehman Brothers OTC Derivatives, Inc. and Lehman Brothers Commodity Services, Inc.
Oct. 5, 2008	Nine other Lehman entities file for bankruptcy
Oct. 16, 2008	Procedural consolidation of Lehman case
May 12, 2009	Lehman insolvency protocol signed
Sept. 22, 2009	Bar Date for claims against the Debtors
Mar. 11, 2010	Lehman Examiner's Report filed
Aug. 25, 2010	Securities Investor Protection Act Trustee's preliminary report released
Jan. 25, 2011	Debtors file the first amended joint Chapter 11 plan
Apr. 25, 2011	Nonconsolidation creditors file Chapter 11 plan
Apr. 27, 2011	Ad hoc group files amended Chapter 11 plan

Sources: Judicial filings and decisions from the U.S. Bankruptcy Court of the Southern District of New York.

## Liquidation of Lehman Broker-Dealer

On September 19, 2008, Lehman's broker-dealer, LBI, was placed into liquidation under the SIPA in the Southern District of New York. The court appointed a SIPA trustee to oversee the liquidation of LBI's estate.<sup>7</sup> According to the trustee, his main role was to "maximize the return of customer property to customers of LBI as defined by the law, while at the same time maximizing the estate for all creditors."

<sup>7</sup>The SIPA statute requires that a SIPA proceeding be conducted in accordance with, and as though it were being conducted under the appropriate sections of Chapter 7.

The LBI resolution is the largest in SIPA history. As of April 22, 2011, the trustee handled approximately 125,000 customer claims involving potentially \$180 billion. Nearly 10,000 claims were investigated, denied customer status, and closed. More than 110,000 claims, worth over \$92 billion, were resolved through account transfers to other entities, including Barclays and Neuberger Berman, a Lehman subsidiary. Another 10,000 claims, worth about \$46 billion, were resolved by SIPC. The amount of intercompany claims revealed the level of interconnectedness in Lehman. The other Lehman entities filed 630 claims worth about \$19.9 billion against LBI. These claims came not only from LBHI and Lehman Brothers International Europe (LBIE) but also from entities in Bermuda, the Dutch Antilles, Germany, Hong Kong, India, Japan, Luxembourg, the Netherlands, Singapore, Switzerland, and the UK. More than 14,000 claims with a face value of over \$88 billion remained unresolved as of April 22, 2011, including 1,143 claims by clients of LBIE for over \$22 billion.

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## Selected Proceedings

The following cases are not intended to represent a complete legal history of the Lehman bankruptcy but to highlight certain issues presented in this report. The Lehman Brothers Special Financing (LBSF) case illustrates how a conflict between U.S. and UK law can create uncertainty. The Barclays case highlights the issues that can arise from a hurried financial institution bankruptcy. Finally, the Swedbank AB case illustrates the limits of safe harbors for qualified financial contracts.

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### Lehman Brothers Special Financing Case

At issue were competing payment priorities between Perpetual Trustee Company Limited (Perpetual), an Australia-based asset management company, and LBSF regarding collateral held by BNY Corporate Trustee Services Limited (BNY trustee). The cases were heard in U.S. and English courts. On November 6, 2009, the English Court of Appeal upheld a lower court decision in favor of Perpetual. On January 25, 2010, the U.S. court ruled in favor of LBSF and called for all parties to work together to reach an agreement.<sup>8</sup>

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<sup>8</sup>The procedural history of these proceedings is described in Lehman Brothers Special Financing Inc. (Adv. Proc No. 09-01242), In re Lehman Brothers Holdings Inc., Case No. 08-13555 (Bankr., S.D. N.Y.), Memorandum and Decision Granting Motion for Summary Judgment and Declaring Applicable Payment Priorities (Jan. 25, 2010).

In 2002, LBIE had begun to issue a series of structured notes. Perpetual had bought two series of the notes, issued by Saphir Finance Public Limited Company (Saphir).<sup>9</sup> The two series of notes were issued in the UK and written so that English law would govern their dealings. Each note was backed by collateral and included a swap agreement with LBSF, which was guaranteed by LBHI and also backed by collateral. The collateral was held by BNY trustee as a trustee for Saphir. Normally, LBSF as the swap counterparty would have priority rights to the collateral over Perpetual. However, a “flip” clause in the contracts specified that, if LBSF defaulted, the priorities would flip, and Perpetual would have rights to the collateral ahead of LBSF.

LBSF filed for bankruptcy on October 3, 2008. On December 1, 2008, Saphir exercised its termination rights on the swap agreements with LBSF. On May 20, 2009, LBSF filed a complaint against the BNY trustee for the collateral in U.S. Bankruptcy Court claiming that the flip clause was unenforceable. The U.S. Bankruptcy Code prohibits clauses (called *ipso facto* clauses) that modify a contract based on a bankruptcy filing. LBSF argued that the flip clause violated the Code because it modified the payment structure based on LBSF’s default. The BNY trustee countered that the contracts were agreed to and valid under English law, and the U.S. courts should defer to the English courts. The BNY trustee further argued that even if the flip clause normally would be unenforceable, safe harbor provisions (that is, the Code’s exemptions of qualified financial contracts from an automatic stay) protected the agreement. The BNY trustee also argued that the flip clause was a “subordination agreement” and enforceable under the Code.<sup>9</sup>

At the same time, Perpetual filed suit in the UK against the BNY trustee for the collateral to enforce the flip clause. On November 6, 2009, the English court ruled that the flip clause was valid and in effect. The court ruled that LBSF’s claim on the collateral was “always limited and conditional” and no reason existed to override the contract. On January 25, 2010, the U.S. court ruled that the flip clause was an unenforceable *ipso facto* clause. In his ruling, the judge noted that U.S. courts were not obligated to recognize a foreign court’s decisions and that the English court did not take into account the Bankruptcy Code in making its decision. He added that courts did not have to extend recognition to a

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<sup>9</sup>See 11 U.S.C. § 510.

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foreign court when doing so would be contrary to U.S. policy. The U.S. court also ruled that the safe harbor provisions of the Code did not apply to the flip clause, reasoning that the provisions referred to the “acceleration” of rights, not the “alteration” of rights; thus, they did not protect the priority changes of the flip clause. Finally, the U.S. court ruled that, even as a subordination agreement, the flip clause was unenforceable. Under normal circumstances LBSF could agree to have its priority rights subordinated to another party and this would be enforceable. However, since the subordination was triggered by a bankruptcy filing it still represented an ipso facto clause and remained unenforceable.

Further, the U.S. court noted the complex and international nature of the case. It noted that the BNY trustee was in an unfavorable position since the English courts ruled for Perpetual’s rights to the collateral while the U.S. ruled for LBSF. The U.S. court recommended that given the complexity of the case it would be better if all parties could settle the dispute. On December 16, 2010, the U.S. court approved a settlement.

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## Barclays Sale Case

The Barclays sale case illustrates the difficulties and complexities of an expedited sale of a large financial institution during bankruptcy and the finality of sale orders under the Code. At issue was Lehman’s sale of LBI to Barclays on September 22, 2008. LBHI and the committee of unsecured creditors (the committee) moved to have parts of the sale invalidated. On February 22, 2011, the U.S. Bankruptcy Court denied the motion to invalidate the sale order.<sup>10</sup>

In the week following its bankruptcy filing, Lehman wanted to sell assets, including LBI, to Barclays. Barclays had been in talks to acquire all of Lehman before the bankruptcy. On September 20, 2008, the court approved a sale of LBI to Barclays and the order was finalized on September 22. As part of the sale, the parties agreed to a “clarification letter” that clarified certain aspects of the sale and made some modifications to the agreement.

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<sup>10</sup>In re Lehman Brothers Holdings Inc., Case No. 08-13555, In re Lehman Brothers Inc., Case No. 08-01420 (Bankr. S.D. N.Y.), Opinion on Motions Seeking Modification of the Sale Order Pursuant to Rule 60(B), The Trustee’s Motion for Relief Under the SIPA Sale Order, Barclay’s Cross-Motion to Enforce the Sale Orders and Adjudication of Related Adversary Proceedings (Feb. 22, 2011).

LBHI and the committee argued that this sale order should be overturned, and Barclays should be liable for multibillion dollar claims for underpayments. They argued that Barclays withheld critical information from the court: a multibillion dollar discount in financial assets or that Barclays would not assume LBI's obligations to the Federal Reserve Bank of New York. Furthermore, they argued that certain executives were not acting in the interests of the company and were operating on behalf of Barclays as Barclays had made job offers to key decision makers. Due to these factors, the Lehman estate claimed that Barclays unfairly took advantage of LBHI and bought the assets at well below their fair value. Barclays countered that it gave the court all the information it needed. Barclays further argued that LBHI and the committee were happy to accept the deal at the time, but now regretted the sale, but that this regret was not grounds for overturning the sale order.

On February 22, 2011, the court ruled that LBHI and the committee had not established a right to relief. The new information about the deal structure, while important, would not have changed the court's previous decision allowing the sale order. The court stated that it recognized that Barclays was the only buyer available to LBHI at the time given the uncertainty in financial markets and that since LBHI was in an unfavorable bargaining position compared to Barclays, it was not unreasonable to assume that Barclays would get the better end of the deal. The sale, while profitable to Barclays, also was needed to potentially stave off further financial disaster. Furthermore, the court ruled that the Lehman estate did not prove that former Lehman executives were acting in bad faith due to future employment prospects at Barclays.

In another aspect of the Barclays Sale case, the SIPA Trustee (the trustee) disputed Barclays' claim to certain classes of assets, the 15c3-3 assets, the margin assets, and the clearance box assets.<sup>11</sup> The trustee argued that Barclays' claims for additional assets held by LBI, and the retention by Barclays of assets obtained as a result of the transfers of accounts and acquisition by Barclays of certain Lehman businesses, would reduce protection of LBI customers under applicable laws. Specifically, the trustee argued that \$769 million in assets held by LBI in

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<sup>11</sup>15c3-3 assets are securities held in reserve pursuant to Rule 15c3-3, the Customer Protection Rule promulgated by the SEC. Clearance box assets are securities held in LBI's "clearance box" accounts at the Depository Trust & Clearing Corporation. These assets facilitated securities trading by providing collateral to secure open trading positions.

the special account maintained pursuant to SEC Rule 15c3-3, known as the “Customer Protection Rule,” and \$507 million in assets held at the Options Clearing Corp., (these assets formed part of LBI’s regulatory customer reserve formula) must be available to LBI to satisfy claims of LBI’s customers, rather than provided to Barclays. In addition, the trustee argued that the terms of the Asset Purchase Agreement did not provide Barclays the right to acquire certain margin assets estimated to value \$3.5 billion, or assets valued at approximately \$1.9 billion held in LBI’s clearance box account at the Depository Trust & Clearing Corporation. Barclays disputed the trustee’s interpretation of the Asset Purchase Agreement and demanded all of the above assets in addition to those already obtained.

The court ruled that the trustee was entitled to relief regarding the \$769 million in assets held in LBI’s 15c3-3 account, and the \$507 million held at the Options Clearing Corp, and that the trustee was entitled to the significant margin assets valued at approximately \$3.5 billion. With regard to the 15c3-3 account and reserve formula assets held at the Options Clearing Corp, the court ruled that Barclays’ “self-interested construction of the language” runs counter to the deal’s specific terms that such asset transfer be effected “to the extent permitted by applicable law,” and that the trustee’s interpretation of the deal was consistent with the broad principles underlying SIPA and its objective of giving priority treatment to customers. With regard to the margin assets, the court ruled that the specific terms of the Asset Purchase Agreement excluded these assets, and that representations made to the court at the Sale Hearing were unambiguous in meaning that no such margin assets were acquired by Barclays. As to the clearance box assets held at Depository Trust & Clearing Corporation, the court agreed with Barclays that despite conflicting language in the controlling documentation of the deal, the balance of the evidence favored that transfer of these assets to Barclays.

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## Swedbank AB Case

The Swedbank AB (Swedbank, a Swedish financial institution) case illustrates the limits of safe harbors for qualified financial contracts in bankruptcy. At issue was a dispute over a deposit account LBHI had at Swedbank and whether Swedbank could exercise set-off rights (essentially, rights to balance mutual claims between parties) in connection with its liability as a derivatives guarantor against LBHI’s funds in the account. On May 5, 2010, the U.S. Bankruptcy Court ruled for LBHI

granting its motion for an enforcement of the automatic stay against Swedbank. On January 26, 2011, the U.S. district court upheld the Bankruptcy Court's decision.<sup>12</sup>

LBHI and Swedbank were counterparties in several financial derivative transactions under various ISDA master agreements. LBHI also had a regular deposit account at Swedbank's Stockholm branch. On September 15, 2008, LBHI had 2.1 million Swedish Kronor or approximately \$310,000 in the Swedbank account. Once LBHI filed for bankruptcy, the account was frozen by Swedbank, thus preventing LBHI from withdrawing any funds. However, LBHI and other entities were able to deposit additional funds into the account. By November 12, 2009, LBHI had deposited an additional 82.8 million Swedish Kronor or approximately \$10 million.

Provisions in the ISDA master agreements into which LBHI and Swedbank had entered allowed for certain rights in case one party defaulted. Specifically, the master agreements could be terminated, and the nondefaulting party could set off mutual obligations. Swedbank claimed that LBHI owed it approximately \$13.9 million or 97.5 million Swedish Kronor. On November 27, 2009, Swedbank announced that it would set off the obligations LBHI owed it with the money in the Swedbank account. The Lehman debtors contested this decision and filed suit on January 22, 2010, to force Swedbank to return the funds to the Swedbank account.

The main issue was whether the setoff violated the Code. More specifically, whether the safe harbor provisions in sections 560 and 561 permitted Swedbank to set off according to the master agreement or whether the mutuality provision in section 553 prohibited Swedbank's action. LBHI argued that Swedbank violated the automatic stay because it seized money LBHI had deposited after filing for bankruptcy. As such, the deposits lack mutuality with LBHI's prebankruptcy debts. Swedbank argued that the setoff rights in the master agreement, and the safe harbors in the Bankruptcy Code provided an exemption from the automatic stay in this case.

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<sup>12</sup>In re Lehman Brothers Holdings Inc., Case No. 08-13555 (Bankr. S.D. N.Y.), Memorandum Decision Granting Debtors' Motion Pursuant to Sections 105(a) and 362 of the Bankruptcy Code for an Order Enforcing the Automatic Stay Against and Compelling Payment of Post-Petition Funds by Swedbank AB (May 5, 2010).

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The Bankruptcy Court ruled that for Swedbank to set off debts with the deposits in the Swedbank account, the amount owed by LBHI to Swedbank had to be a “prepetition debt,” LBHI’s claim on Swedbank also had to be prepetition, and the two claims had to be mutual. The court ruled that because the funds in the Swedbank account were postpetition while the LBHI obligation to Swedbank was prepetition, no mutuality existed. Swedbank countered that even if no mutuality existed, it still could set off due to safe harbor protections in the Code. However, the court ruled that safe harbor provisions did not allow Swedbank to bypass the mutuality requirement. The court found no support to the claim that safe harbor provisions were intended to override the mutuality requirement, or any other underlying requirement, for setoff. Therefore, the court ruled that Swedbank had to return all funds deposited after the bankruptcy filing.

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# Appendix V: Washington Mutual Bankruptcy

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This appendix describes selected aspects of the Washington Mutual, Inc. (Washington Mutual) bankruptcy. The items discussed here provide more detail on certain aspects of the bankruptcy than we cover in the main body of the report. This appendix does not attempt to summarize the case or fully capture its complexities. Table 5 provides a timeline of selected events related to the Washington Mutual bankruptcy.

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## Background

Washington Mutual was a thrift holding company that had 133 subsidiaries. These subsidiaries included Washington Mutual Bank, which was the largest savings and loan association in the United States prior to its failure, with more than 2,200 branches and \$188.3 billion in deposits, according to the confirmation opinion of the U.S. Bankruptcy Court of the District of Delaware.<sup>1</sup> Washington Mutual Bank conducted most of Washington Mutual, Inc.'s primary banking activities. Washington Mutual Bank had more than \$300 billion in assets at the time of its failure and a large subsidiary of its own, called Washington Mutual Bank, FSB.<sup>2</sup> The Office of Thrift Supervision (OTS) was the primary regulator for Washington Mutual Bank and Washington Mutual Bank, FSB.<sup>3</sup> Washington Mutual also had several nonbanking subsidiaries, including two captive reinsurers, several mortgage companies, and several real estate companies. At the time of filing, Washington Mutual had approximately \$32.9 billion in total assets and total debt of approximately \$8.1 billion. Washington Mutual's common stock was listed on the New York Stock Exchange and traded at its highest level of \$46.55 per share in January 2006 for a total market capitalization at that time of \$44.9 billion.

Washington Mutual Bank was the largest bank failure in U.S. history. According to the joint report of the Offices of Inspectors General for the Department of the Treasury and FDIC on regulatory oversight at Washington Mutual Bank, Washington Mutual Bank had weak risk

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<sup>1</sup>In Re Washington Mutual, Inc. Debtors. Chapter 11. Case No. 08-122229 (MFW) Jointly Administrated. January 11, 2011.

<sup>2</sup>Washington Mutual Bank was headquartered in Henderson, Nevada and Washington Mutual Bank FSB was headquartered Park City, Utah.

<sup>3</sup>As of July 21, 2011, OTS will transfer its authority over thrift holding companies to the Federal Reserve. The Office of the Comptroller of the Currency then will supervise all federal thrifts. OTS will cease operations 90 days later.

management and pursued a strategy to pursue growth through originating, acquiring, securitizing, and servicing nontraditional loan products and subprime loans.<sup>4</sup> This strategy broke down when housing and mortgage markets began to collapse in mid-2007. Until late 2007, Washington Mutual Bank remained profitable, but loan losses caused earnings to decrease 73 percent from the second to third quarter of 2007. Further loan losses and chargeoffs caused Washington Mutual Bank to post \$1 billion in losses in both the fourth quarter of 2007 and the first quarter of 2008.

In March 2008, Washington Mutual began seeking additional capital. According to the report of the court-appointed examiner for the bankruptcy case and the Inspectors General's report, the holding company received a capital infusion of about \$7 billion from TPG Capital (formerly known as the Texas Pacific Group) in April 2008, part of which went to Washington Mutual Bank and part of which was used to pay down Washington Mutual's debt.<sup>5</sup> However, Washington Mutual Bank continued to suffer from significant depositor withdrawals as the housing market further deteriorated and IndyMac, FSB failed in July 2008. Washington Mutual Bank was a member of the Federal Home Loan Bank of San Francisco, which also began to limit Washington Mutual Bank's borrowing capacity.<sup>6</sup> Following company share price declines, Washington Mutual appointed a new chief executive officer on September 7, 2008. However, after the collapse of Lehman on September 15, 2008, Washington Mutual Bank had a net deposit outflow of \$16.7 billion (or more than 9 percent of total deposits) and experienced a second liquidity crisis. According to the Inspectors General's report, the bank was further hindered by its borrowing capacity limits, share price decline, portfolio losses, and other restrictions tied to the \$7 billion capital investment.

By September 23, 2008, OTS had found that Washington Mutual Bank had \$4.6 billion in cash to meet its liquidity obligations, and its expected

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<sup>4</sup>Department of the Treasury and FDIC Offices of Inspector General, *Evaluation of Federal Regulatory Oversight of Washington Mutual Bank*. Report No. EVAL-10-002. (Washington, D.C.: April 2010).

<sup>5</sup>Joshua R Hochberg. *Final Report of the Examiner*. In re Washington Mutual, Inc. et al. Case No. 08-12229 (MFW).

<sup>6</sup>The Federal Home Loan Banks are 12 regional cooperative banks that member financial institutions use to access credit and liquidity. Washington Mutual Bank FSB was also a member of the Federal Home Loan Bank of Seattle.

earnings would be insufficient to supplement its cash base. OTS began preparations to take over Washington Mutual Bank and appoint FDIC as the receiver. FDIC opened its Web site for potential bids for the bank. On September 24, JPMorgan Chase and Co. (JPMC), Citigroup, Inc., and Wells Fargo & Company each submitted bids to purchase Washington Mutual Bank, but both Citigroup's and Wells Fargo's bids did not meet FDIC's bid requirements. At the same time, the holding company's management was pursuing other alternatives to gain liquidity without a buyout, including using other assets to pledge as collateral to receive funding from the San Francisco Federal Home Loan Bank and the Federal Reserve Bank of San Francisco, according to the examiner's report. On September 24, Washington Mutual staff presented these alternatives to OTS but did not get a response. On Thursday, September 25, OTS found Washington Mutual Bank to be unsafe and unsound and appointed FDIC as receiver. FDIC then sold substantially all of Washington Mutual Bank's assets to JPMC through a purchase and assumption agreement for \$1.88 billion.<sup>7</sup>

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## The Bankruptcy

On September 26, 2008, Washington Mutual, Inc. filed a petition for relief pursuant to Chapter 11 of the Code. The filing for bankruptcy was completed the day after the closure of Washington Mutual Bank. Washington Mutual filed for bankruptcy to receive automatic stay protection against the seizure or dissipation of the holding company's remaining assets. The holding company's representatives maintain that they did not know which assets were transferred to JPMC when the bank was sold because they did not have access to the purchase and assumption agreement between FDIC and JPMC, so they wanted to maintain control over the remaining assets. The holding company's subsidiary WMI Investment Corp. also filed for Chapter 11 protection on September 26, and these cases were administratively consolidated into one case.

After filing its bankruptcy petition in September 2008, Washington Mutual's estate sought to recover \$4 billion in deposits and other assets from FDIC that it said were on deposit with a subsidiary of Washington Mutual Bank (Washington Mutual Bank, FSB). FDIC denied all of

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<sup>7</sup>Purchase and assumption agreements are an FDIC resolution mechanism that involves transferring some or all of the failed institution's deposits, certain other liabilities, and some or all of its assets to an acquirer.

Washington Mutual, Inc.'s claims in a letter dated January 23, 2009. The holding company sued FDIC to return its deposits, among other reasons, while JPMC also sued Washington Mutual, seeking judgment that the funds (and other disputed assets) belonged to them as a cash infusion the holding company made to the bank to maintain the depository institution's capital levels. When the depository institution and holding company became eligible for more than \$5 billion in tax refunds as the result of a change in federal tax law related to the carrying forward of more than \$14 billion in past losses, Washington Mutual, JPMC, and FDIC were able to come to an agreement in 2010 on how to split those proceeds, which would provide the holding company with value from the refunds.<sup>8</sup> This agreement is discussed in greater detail later in this appendix.

Nevertheless, Washington Mutual's shareholders were not satisfied with the settlement and sought review by a court-appointed examiner. The shareholders expressed disapproval of the global settlement plan and raised concerns about the failure of Washington Mutual Bank, including whether it was improperly assessed as unsafe and unsound or sold to JPMC for less than fair market value. In January 2010, the U.S. Trustee's Office appointed the official Committee of Equity Security Holders. In April 2010, the committee filed a motion for the appointment of an examiner because the debtors and the creditors' committee refused to provide equity holders with information. 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 that were addressed by the global settlement. The examiner's report reviewed key issues related to the global settlement agreement including the disputed assets as part of the sale and was issued on November 1, 2010. While the examiner's findings supported a determination that the settlement agreement was fair and reasonable, the Bankruptcy Court for the District of Delaware did not allow the report as evidence because the judge found the report to be

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<sup>8</sup>On March 16, 2011, FDIC filed a complaint in the U.S. District Court in the Western District of Washington at Seattle against three former executives of Washington Mutual, Inc. and their spouses, seeking to recover damages for gross negligence, ordinary negligence, breaches of fiduciary duties, and for assets FDIC said were fraudulently transferred conveyances.

based mostly on hearsay, and officials commenting in the report were not available to testify.<sup>9</sup>

In January 2011, the bankruptcy judge in the Washington Mutual proceeding entered an order denying confirmation of the proposed plan of reorganization, which incorporated the global settlement.<sup>10</sup> Although finding that the global settlement of claims was fair and reasonable and provided a basis for confirmation, the judge concluded that the plan did not adequately address the terms of a global settlement of various claims by creditors and some shareholders. The judge also found that the plan was not confirmable unless certain deficiencies were corrected. After the order was issued, the interested parties pursued a revised plan. Confirmation hearings in the case have been repeatedly delayed, but could take place as early as July 2011.

**Table 5: Timeline of Selected Events Related to the Washington Mutual, Inc. Bankruptcy, from September 2008 through July 2011**

Key date	Event or activity
Sept. 25, 2008	OTS finds Washington Mutual Bank to be unsafe and unsound and appoints FDIC as receiver. FDIC facilitates the sale of Washington Mutual Bank to JPMC for \$1.8 billion and assumption of liabilities. <sup>a</sup>
Sept. 26, 2008	Washington Mutual, Inc. files for bankruptcy protection in the U.S. Bankruptcy Court in Delaware.
Oct. 3, 2008	First day of bankruptcy court hearing.
Dec. 30, 2008	Washington Mutual, Inc. files proof of claim with FDIC related to the Washington Mutual Bank receivership.
Jan. 23, 2009.	FDIC denies all of the debtors' claims.
Mar. 20, 2009	Washington Mutual (debtor) files suit in the D.C. District Court against FDIC regarding \$4 billion in assets FDIC transferred to JPMC.
Mar. 24, 2009	JPMC files suit against Washington Mutual in U.S. Bankruptcy Court in Delaware over disputed assets in an adversary proceeding.
Nov. 6, 2009	Enactment of the Worker Homeownership and Business Assistance Act of 2009 permits businesses to use 2008 net operating losses to receive refunds on taxes paid in prior years. <sup>b</sup>
Mar. 12, 2010	Washington Mutual, FDIC, and JPMC announce that they have reached a settlement regarding the disputed property and claims (called the global settlement).

<sup>9</sup>The examiner also found that: (1) JPMC was the only potential purchaser of Washington Mutual Bank that did not want government assistance or guarantees, and the institution had an advantage in calculating the value of the bank because of its work in the spring of 2008; and (2) FDIC could be more transparent in its actions, better inform potential purchasers of the value of assets, and should require better documentation of assets being sold.

<sup>10</sup>In re Washington Mutual, Inc., 442 B.R. 314, 322 (Bankr. D.Del, 2011).

Key date	Event or activity
Apr. 12, 2010	Parties displeased with the global settlement (which included allocation of the tax refunds) file an adversary proceeding in the U.S. Bankruptcy Court in Delaware.
May 21, 2010	Washington Mutual, Inc. files amended plan of reorganization and disclosure statement reflecting agreements reached with FDIC and JPMC.
July 6, 2010	Parties displeased with the global settlement file a different adversary proceeding in the U.S. Bankruptcy Court in Delaware (known as the Trust Preferred Securities adversary proceeding).
July 28, 2010	The U.S. Bankruptcy Court in Delaware approves the U.S. Trustee's selection of an examiner to conduct an investigation into the merits of the various claims of the estate, JPMC, and FDIC which were being resolved by the global settlement. The examiner completed his report on November 1, 2010.
Oct. 6, 2010	Modification of global settlement plan.
Jan. 7, 2011	Denial of summary motion April 12, 2009, adversary proceeding.
Mar. 30, 2011	Approval of disclosure statement and solicitation procedures for revised plan
July 13, 2011	Scheduled date of confirmation hearing for plan.

Sources: Judicial filings and decisions from the U.S. Bankruptcy Court of the District of Delaware, FDIC, and OTS.

<sup>a</sup>The sale resulted in a closed bank transaction with no losses to the deposit insurance fund.

<sup>b</sup>Pub. L. No. 111-92 § 13 (2009) allows firms to apply losses in 2008 and 2009 to their taxable income for up to 5 prior years (with a limited amount for the fifth prior year), instead of the 2 years otherwise generally allowed.

## Adversary Proceedings

### Washington Mutual, Inc. and JPMC

Shortly following the sale of Washington Mutual Bank to JPMC, Washington Mutual filed a proof of claim with FDIC as receiver to recover about \$4 billion in deposits allegedly held by the holding company in a subsidiary of Washington Mutual Bank. According to representatives of the holding company, the holding company was the largest creditor for the receivership and followed timelines for an appeal of FDIC's decision to transfer the holding company's assets. FDIC denied the claim in a letter dated January 23, 2009, and Washington Mutual then sought an appellate review.

As discussed earlier, on March 20, 2009, Washington Mutual filed suit in D.C. District Court against FDIC, asserting that FDIC: (1) should review its denial of Washington Mutual's claims; (2) wrongfully dissipated Washington Mutual Bank's assets; (3) took Washington Mutual, Inc.'s property without just compensation; (4) should convert Washington Mutual, Inc.'s property back to the holding company; and (5) should void its prior disallowance of Washington Mutual, Inc.'s claim to the deposits.

This filing became known as the WMI action. Representatives of the holding company told us the holding company took a portion of the funds it raised in April 2008 and put it in a deposit account at a subsidiary of Washington Mutual Bank, called Washington Mutual Bank FSB, which also was seized by regulators. By the end of the second quarter of 2008, \$5 billion of the funds from TPG Capital went into Washington Mutual Bank. Representatives of Washington Mutual told us they filed in the D.C. District Court because FDIC's main office is located there, and the challenged action occurred there.

Four days later, JPMC filed a complaint in bankruptcy court against Washington Mutual, Inc. (known as the JPMC adversary proceeding) seeking a declaratory judgment that JPMC owned the deposited funds contested by Washington Mutual, Inc. JPMC maintained that the funds were a capital contribution to the bank rather than a deposit.<sup>11</sup> JPMC and FDIC further questioned whether the deposits were a fraudulent transfer.<sup>12</sup> On May 29, 2009, Washington Mutual, Inc. filed an answer and counterclaims to this adversary proceeding asserting ownership of the disputed assets in the deposits made to Washington Mutual Bank. Additional claims and counterclaims were made during this period both in D.C. District Court and in the Bankruptcy Court (District of Delaware). In the meantime, Washington Mutual, Inc.; JPMC; and FDIC entered into discussions on a settlement to resolve the distribution of assets.

In November 2009, the Congress passed the Worker Homeownership and Business Assistance Act of 2009, which allowed companies like Washington Mutual to use their losses in 2008 to offset income on which taxes had been paid in the prior five years.<sup>13</sup> As a result, the bank was entitled to receive refunds from federal income taxes paid in 2001-2008 of approximately \$5 billion. There were competing claims to these tax refunds; however, on March 12, 2010, Washington Mutual, Inc., JPMC, and FDIC announced that they had reached a settlement of all the issues regarding the disputed property and related claims (known as the global

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<sup>11</sup>A detailed discussion of the disputed accounts can be found in the Examiner's report.

<sup>12</sup>A fraudulent transfer could imply the holding company was trying to hinder, delay, or defraud creditors (such as FDIC) and would have to be unwound. The fraudulent transfer provision of the Bankruptcy Code is 11 U.S.C. § 548.

<sup>13</sup>Pub. L. No. 111-92 § 13.

settlement).<sup>14</sup> The plan set forth the allocation of the tax refund among all of the parties: up to \$2.2 billion to the holding company, up to \$2.2 billion to JPMC (new owner of the bank), up to \$850 million to FDIC, and \$335 million to the bank's bondholders.

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## Other Adversary Proceedings

Two other groups filed adversary proceedings claiming that the transfer of certain assets under the global settlement to JPMC free and clear of all claims was improper. First, holders of trust preferred securities, issued in private placements from a holding company subsidiary called Washington Mutual Preferred Funding LLC (WMPF) and based on portfolios of home mortgage loans, filed an adversary proceeding against Washington Mutual, Inc. and JPMC on July 6, 2010.<sup>15</sup> The bankruptcy court ruled against the trust preferred securities holders.<sup>16</sup> The second adversary proceeding stems from holders of litigation tracking warrants—securities that track and pay-off based on outcomes of litigation—from the proceeds of an ongoing lawsuit of one of Washington Mutual, Inc.'s former subsidiaries.<sup>17</sup> The court denied the motion for summary judgment for the litigation tracking warrants holders because of disputed issues of material fact.

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<sup>14</sup>See, e.g., *In re Washington Mutual, Inc.*, 442 B.R. 314, 321 (Bankr. D. Del. 2011).

<sup>15</sup>Trust preferred securities are securities having characteristics of both debt and equity that often are issued by bank holding companies through a trust. In this case, the trust preferred security holders own a preferred equity interest in Washington Mutual, Inc.

<sup>16</sup>In the proceeding brought by trust preferred securities (TPS) holders, *Black Horse Capital LP v. JPMorgan Chase Bank, N.A.*, 442 B.R. 297 (Bankr. D. Del. 2011), the court granted the defendants' motions for summary judgment and denied the TPS holders' motion for summary judgment, finding that the TPS holders no longer have any interest in the TPS because the interests were converted to interest in preferred stock of Washington Mutual, Inc.

<sup>17</sup>In the litigation tracking warrant proceeding, known in the context of the WMI bankruptcy as the "Anchor Litigation," the court ruled that although a genuine dispute remained concerning the status and valuation of the claims, the holders' interests are adequately protected by the debtor's Chapter 11 plan. See *In re Washington Mutual, Inc.*, 442 B.R. 314 at 324-25, 339-341 (Bankr. D. Del. 2011).

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# Appendix VI: Other Financial Institution Failures

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This appendix describes a number of international and domestic financial institution failures and near failures that were chosen due to their historic significance, as well as their usefulness in illustrating the complications in resolving financial institution insolvencies.

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## International Failures and Near Failures

*BankHaus Herstatt.* The 1974 failure of BankHaus Herstatt (Herstatt), which was based in Cologne, Germany, is cited as a major catalyst to several developments in international banking regulation and infrastructure.<sup>1</sup> Although ranked only the thirty-fifth largest bank in Germany (by total assets), Herstatt was active in foreign exchange markets, where it had large and risky positions, according to Bank of International Settlement (BIS) reports. Further, according to these reports, German regulators forced it into liquidation on June 26, 1974, after the 3:30 p.m. German close of business. At that time (10:30 a.m. in New York), Herstatt's New York correspondent bank suspended outgoing U.S. dollar payments from Herstatt's account to Herstatt's counterparties that had already delivered the corresponding German currency to Herstatt. There were reports of similar difficulties with a correspondent bank in London. In part due to the Herstatt failure, the Group of Ten (G10) central bank governors in December 1974 established the Basel Committee on Banking Regulations and Supervisory Practices.<sup>2</sup> The failure also

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<sup>1</sup>Bank of International Settlements, *History of the Basel Committee and its Membership*, (Basel, Switzerland, August 2009), and *BIS Chronology – 1970 to 1979*, (Basel, Switzerland, August 2009), and Federal Reserve Bank of New York, “*Developments on the Management of Foreign Exchange Settlement Risk*” Remarks by Ernest T. Patrikis, First Vice President, Federal Reserve Bank of New York before the Bankers Association for Foreign Trade, the 74<sup>th</sup> Annual Convention Tucson, Arizona, April 30, 1996.

<sup>2</sup>The Group of Ten comprised Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, and Switzerland, the UK, and the United States. The Basel Committee on Banking Supervision, as it is known, provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable. In this regard, the committee is best known for its international standards on capital adequacy; the Core Principles for Effective Banking Supervision; and the Concordat on cross-border banking supervision. The committee's current members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the UK, and the United States.

stimulated other enhancements to the international payments system, including moving to same day settlement.

*Drexel Burnham Lambert Group, Inc.* The 1990 failure of the Drexel Burnham Lambert Group (Drexel) provides an example of a bankruptcy of a complex financial institution that was relatively orderly, resulted in significant recoveries to creditors, and was completed within a relatively short time frame. Drexel was an investment bank that operated with a holding company structure that had subsidiaries including a large securities affiliate and broker-dealer (Drexel Burnham Lambert, Inc.) that had been active in the leveraged buy out and junk bond markets in the 1980s. Drexel filed for Chapter 11 bankruptcy protection in February 1990 after experiencing severe liquidity strains. This was the result of legal issues during the late 1980s, which culminated in it pleading guilty to six counts of securities and mail fraud and having to pay large civil disgorgement and penalty payments in the year prior to its bankruptcy filing. The unsecured creditors of Drexel Burnham Lambert, Group, Inc. organized into a committee with 18 members within 2 weeks of the bankruptcy filing.

Subsequent to Drexel's bankruptcy filing, market participants and creditors lost confidence in Drexel's solvent subsidiaries, including Drexel Burnham Lambert, Inc. and were unwilling to enter into new transactions with the firm. As a result, according to the estate's disclosure statement, the Drexel bankruptcy estate, with assistance from SEC, National Association of Securities Dealers (now the Financial Industry Regulatory Authority), and the Federal Reserve Bank of New York (FRBNY), transferred the customer accounts of Drexel Burnham Lambert, Inc., its securities affiliate and broker-dealer subsidiary, to other broker-dealers. This was necessary due to the legal prohibition against a stockbroker filing under Chapter 11 of the Bankruptcy Code. A stockbroker is defined as an entity that has customers and executes transactions either for the accounts of other securities industry participants or for the general public. As a stockbroker (or broker-dealer) the alternative would have been to use a SIPC process for liquidation. However, Drexel believed this would have created greater losses for Drexel and its creditors because the SIPC trustee would have liquidated the assets very quickly. Once Drexel Burnham Lambert, Inc.'s customer accounts were transferred, it effectively ceased being a stockbroker. Drexel, Burnham Lambert, Inc. then was able to file for Chapter 11 reorganization on May 29, 1990. Also in May 1990, another Drexel subsidiary, Drexel Burnham Lambert Trading Corporation, was forced into bankruptcy by creditors. Separate creditor committees formed for each of the two additional cases.

The bankrupt entities—Drexel and its two subsidiaries—had 13 additional legal entity subsidiaries, but the cases were procedurally consolidated into a single case. As a result, the creditor and equity committees worked with the bankruptcy estates and the court to negotiate and draft a single plan for distributing the assets of the three bankrupt entities. The plan called for the creditor and equity classes to be substantively consolidated across the bankrupt entities. This led to the creation of three new asset pools with a total of 25 creditor and equity classes. In January 1992, this plan was distributed to creditors for a vote by the end of February. In early March 1992, upon approval by the majority of the creditors and less than 25 months after Drexel's initial filing, the judge confirmed the plan that detailed the payments to be made on claims to all creditor classes and resulted in warrants being given to equity class members in a successor entity named New Street Capital, which emerged from bankruptcy as a going concern.<sup>3</sup>

*Bank of Credit and Commerce International.* The 1991 failure of the Bank of Credit and Commerce International (BCCI) illustrates how the complicated organizational structure of a financial institution with multiple entities based in different sovereign jurisdictions can slow the resolution process. BCCI failed on July 5, 1991, affecting more than a million depositors across the world, many in developing countries in which deposit insurance was not available. At the time of its demise, BCCI was a London-based branch of a Luxembourg-incorporated bank headquartered in Abu Dhabi (United Arab Emirates). Its majority shareholder was the government of Abu Dhabi, with another principal bank subsidiary incorporated in the Cayman Islands. BCCI had branches in at least 69 countries, including the United States. Specifically, BCCI secretly controlled seven commercial banks in six states and the District of Columbia through a bank holding company structure. U.S. and state regulators seized certain of these banks on July 5, 1991. The causes of BCCI's failure were significant accounting fraud discovered by an external auditor, poor performance, and substantial nonperforming loans made to large shareholders and employees. Also in July 1991, the Bank of England triggered the liquidation of the Luxembourg-based bank in a petition to the UK High Court, which appointed a liquidator. Later in the month, a receiver was appointed for the Cayman Islands bank by the Grand Court of the Cayman Islands. In the United States, FDIC mitigated

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<sup>3</sup>New Street Capital was acquired in December 1993 by Green Capital Investors, L.P.

its losses by ringfencing the assets of several of BCCI's U.S. subsidiaries.<sup>4</sup> Doing so allowed FDIC to pay domestic creditors, including uninsured depositors, in full. For example, Independence Bank of Encino California was placed into receivership with FDIC in January 1992 upon discovery that BCCI management had fraudulently and secretly acquired ownership and control over the bank along with First American Bankshares, which was also a subsidiary of Independence Bank's holding company (First American Corporation, based in Washington, D.C.). To avoid a run on the deposits of the larger First American Bankshares, FDIC paid off more than 33,000 Independence Bank domestic creditor accounts the next day, including insured and uninsured depositors. Ultimate payouts totaled more than \$500 million, of which at least \$21 million were to uninsured depositors.

On an international level, the liquidation for the four main BCCI entities was to a certain extent consolidated, with a pooling agreement and cost and recovery sharing agreements put in place by 1993 covering entities in seven different countries. The view was that the affairs of BCCI's principal companies were intermingled to such an extent that it would have been impracticable to determine their respective assets and liabilities without considerable expense and delay. These agreements set out the proportions of the costs to be borne and recoveries to be received by the English, Luxembourg, Japanese, Cypriot, Bahraini, United Arab Emirates, and Chinese estates. The UK-based liquidators since have made recoveries through successful legal claims against parties that either previously failed to repay loans owed to BCCI entities, committed fraud against BCCI, or been negligent in the discharge of professional duties to BCCI. As of January 2011, the BCCI liquidation still was active and had collected a total \$8.6 billion since July 1991 compared with total claims of \$8.5 billion (creditors were entitled to make claims through March 2010). The liquidators expect that processing claims will take several more years. However, as of January 2011, \$6.5 billion had been paid out to secured and unsecured creditors in a series of seven dividends between December 1996 and December 2008. According to a February 2011 report issued by the BCCI liquidators, the liquidating company is committed to making at least one additional payment and currently expects the final recovery amount to reach nearly 90 percent of all

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<sup>4</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.

nominal claims, with the potential for further recoveries beyond this level. Total costs to the estate were \$1.7 billion through January 2011.

*Long-Term Capital Management.* The 1998 near collapse of Long-Term Capital Management (LTCM) illustrates coordinated private-sector action in response to the threat of failure of a relatively small, but systemically interconnected, financial institution. This potential systemic failure led to a Federal Reserve Bank of New York-organized, private sector-funded solution. In 1998, LTCM was one of the largest U.S. hedge funds, which specialized in arbitrage—“market-neutral” fixed-income trades—intended to take advantage of what it viewed as market inefficiencies to make money, regardless of the direction of the broader markets.<sup>5</sup> As we have previously reported, LTCM’s strategy used leverage or borrowing to amplify its arbitrage returns.<sup>6</sup> Prior to its crisis, LTCM held \$1.4 trillion in notional value of off-balance-sheet derivatives contracts of which \$500 billion were traded on futures exchanges, and at least \$750 billion were over the counter derivatives. In August 1998, following the announcement of the Russian debt moratorium, investors began to seek superior credit quality and higher liquidity, and credit spreads widened in markets around the world, creating losses for LTCM. It soon lost 90 percent of its capital. FRBNY officials said they became aware of LTCM’s problems in early September 1998 through their routine market surveillance activities, which included discussions with industry officials about current market conditions and developments. On September 18, 1998, LTCM officials contacted FRBNY officials about their financial problems and invited a team to visit LTCM to discuss the situation. During the resulting September 20, 1998, visit, LTCM officials informed FRBNY and Department of the Treasury representatives of the extent of LTCM’s problems and the size and scope of its positions in markets around the world.

Concerned about potential systemic implications if a rapid and potentially disruptive liquidation of LTCM were to occur, FRBNY officials said they invited Goldman Sachs Group, LP; Merrill Lynch & Co. Inc; and JPMC—the three firms the FRBNY believed had the greatest knowledge of the

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<sup>5</sup>Although no statutory definition of hedge funds exists, the term commonly is used to describe private investment vehicles that often engage in active trading of various types of securities and commodities.

<sup>6</sup>See [GAO/GGD-00-03](#) and [GAO-09-739](#).

situation—to their office to discuss LTCM's situation and possible ways to resolve it. This core group of three was later expanded to include UBS AG. Ultimately, the discussions were expanded to include 12 of LTCM's other major creditors and counterparties. Bear Stearns and Co. and Credit Agricole were included in these discussions, but they later declined to participate in the recapitalization consortium.

On September 23, 1998, 14 major domestic and foreign banks and securities firms agreed to recapitalize LTCM through the creation of a consortium. On September 28, 1998, they contributed about \$3.6 billion, representing 90 percent of the net asset value of the fund on that date leaving 10 percent of the equity with the LTCM partners. The 14 firms were Chase Manhattan Corporation; Goldman Sachs Group, LP; Merrill Lynch & Co. Inc.; JPMC; Morgan Stanley Dean Witter & Co.; Salomon Smith Barney (Travelers Group); Credit Suisse First Boston Company; Barclays PLC; Deutsche Bank AG; UBS AG; Bankers Trust Corporation; Société Generale; BNP Paribas AB; and Lehman. These firms appointed a smaller group of employees from several of the firms to manage LTCM's resolution. The portfolio was slowly wound down with oversight from a committee representing the 14 institutions. According to an announcement that was made in early 2000, LTCM closed down and a final payment of \$925 million was distributed to the 14 institutions.

*American International Group.* The 2008 American International Group, Inc. (AIG) near-failure illustrates the complications presented by the prospect of the failure of an extremely complicated global financial firm. These complications include regulatory and international issues accentuated by the complexities posed by dealing with a large and opaque derivatives portfolio. The Federal Reserve authorized FRBNY to extend credit to AIG after determining that AIG faced the imminent prospect of declaring bankruptcy, according to the minutes of a Federal Reserve meeting on September 16, 2008, the date it approved the initial Federal Reserve extension of credit to AIG. The Federal Reserve determined that a failure would have been disorderly and would be likely to have systemic effects on financial markets that already were experiencing a significant level of fragility. AIG, a multinational insurer that was a major participant in the financial derivatives market, ran into significant financial difficulty during the severe market disruptions of the

first 2 weeks of September 2008.<sup>7</sup> As we have reported previously, these difficulties arose from two sources: securities lending and credit default swaps (CDS), which are insurance-like contracts that offer credit protection against specified credit events. AIG had been an active seller of CDS with large exposures to complex, structured securities and had written CDS contracts with a large number of counterparties, including domestic and foreign-based financial institutions. According to FRBNY's bankruptcy counsel, in a bankruptcy, the CDS contracts would have been treated as qualified financial contracts (QFC) because they would have been considered "swap agreements" as defined under the Bankruptcy Code. Thus, according to FRBNY's bankruptcy counsel, following a bankruptcy of either AIG or the subsidiary through which it conducted its CDS business, counterparties would have had the right to liquidate, terminate, or accelerate each of the CDS contracts. And according to the International Swaps and Derivatives Association, counterparties could determine the early termination amount AIG owed. This amount was subject to the determination of the appropriate date ("early termination date") for calculating the market value of the contract. The counterparty would have been able to choose either the bankruptcy filing date or any other date thereafter for determining the closeout payment AIG owed. However, as occurred with Lehman Brothers Holdings, Inc., had AIG filed for bankruptcy protection, it likely would not have been able to pay the aggregate mark-to-market early termination amounts for all its positions due to the aggregate size of its derivatives exposures. Counterparties that had collateral agreements likely would have fared better than those without such agreements. Those counterparties that did not have collateral agreements that entitled them to instant payment would likely have been treated as creditors in the bankruptcy process and faced delayed payments. Considering the number and geographic diversity of AIG's counterparties and ongoing disruptions in credit markets worldwide, these delays might have posed systemic problems.

FRBNY's bankruptcy counsel identified an additional complication that could have arisen under an AIG bankruptcy scenario: the likely

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<sup>7</sup>We have issued several reports on federal assistance to AIG, including GAO, *Federal Financial Assistance: Preliminary Observations on Assistance Provided to AIG*, [GAO-09-490T](#) (Washington, D.C.: Mar. 18, 2009); *Troubled Asset Relief Program: Status of Government Assistance Provided to AIG*, [GAO-09-975](#) (Washington, D.C.: Sept. 21, 2009); [GAO-10-325T](#); and *Troubled Asset Relief Program: Update of Government Assistance Provided to AIG*, [GAO-10-475](#) (Washington, D.C.: Apr. 27, 2010).

commencement of legal insolvency proceedings against non-U.S. subsidiaries in overseas jurisdictions. As of the end of 2007, 37 percent of AIG's consolidated assets were located outside of the United States and Canada in approximately 100 different countries. Within the United States, AIG had wholly owned subsidiaries in at least 25 states as well as Puerto Rico. Because many overseas jurisdictions have laws that prohibit "trading while insolvent," the filing of bankruptcy proceedings would have had implications for the ability of subsidiaries in these countries to continue operations as going concerns, which in turn could have had a significant negative impact on the ability of management to maximize the value of the estate. According to the FRBNY's bankruptcy counsel, it is not uncommon for the non-U.S. subsidiaries and the U.S. parent to become adversaries in legal proceedings. Each has a duty to maximize the value of its own estate, notwithstanding the many and complex inter-company transactions and arrangements and different treatments across international jurisdictions. AIG had material intercompany accounts and transactions. Further complicating the insolvency according to experts with whom we spoke, the state-regulated insurance subsidiaries likely would not have been included in the bankruptcy.

*Fortis Bank SA/NV.* The 2008 nationalization of Fortis is an example of how differences in national interests can limit international coordination even between closely linked nations. In 2008 at the time of its crisis, Fortis was a financial institution with banking and insurance subsidiaries and significant operations in Belgium, the Netherlands, and Luxembourg, nations that had a long history of economic cooperation dating to at least the 1950s.

According to our analysis of the company's annual report to investors and a report on Fortis by the Bank of International Settlements, Fortis's problems were precipitated by a combination of factors. The first was excessive leverage, which Fortis gained as one of three partners in the large acquisition of Dutch banking group ABN AMRO Holding NV (ABN AMRO) in October 2007. In addition, Fortis held a large portfolio of structured credit spread products, asset-backed securities, and collateralized debt obligations that experienced significant drops in market value during the financial crisis in 2008.<sup>8</sup> These factors and the general

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<sup>8</sup>A collateralized debt obligation is a security backed by a pool of bonds, loans, or other assets.

deterioration in global financial conditions led to a liquidity crisis for Fortis in September 2008 as clients began to withdraw large deposits, and the overnight interbank lending market, which is essential to short-term bank financing, stopped dealing with Fortis.

The legal segregation of ABN AMRO into three parts by Fortis and the UK and Spanish banks that had joined it in the acquisition complicated an effective international regulatory resolution; the acquisition was not scheduled to be completed until the second half of 2009, and the integration of ABN AMRO into Fortis was not near completion when Fortis started experiencing problems. In September 2008, the Netherlands, Belgium, and Luxembourg (viewing the pieces of Fortis in their jurisdictions as systemically important) separately injected capital—but only into their regulated subsidiaries of the larger holding company. In October, somewhat coordinated action between the Dutch and Belgian governments led to 100 percent nationalization of the Dutch banking subsidiaries and the nationalization and subsequent sale of 75 percent of the Belgian banking subsidiary to French bank Paribas. Fortis also sold 100 percent of its Belgian insurance company to the same French bank. These moves left Fortis, the holding company, with (1) Fortis Insurance International; and (2) a 66 percent share in an entity set up to hold the problematic structured credit portfolio, with a 24 percent interest going to Paribas, and the remaining 10 percent held by the Belgian government. Fortis shareholders successfully challenged the sales agreement for the Belgian banking subsidiary in a Belgian court. They claimed Belgian law required their approval for the sale to proceed. The transaction was renegotiated to more favorably treat Fortis equity holders before being allowed to close. Fortis, the holding company, subsequently changed its name to Ageas N.V. However, Ageas continues to have ongoing legal issues related to the seizure. They include cases involving ABN AMRO Group NV and its owner, the Dutch government, as well as cases brought by Fortis shareholders.

Fortis was ultimately bailed out by the French, Belgian, and Luxembourg states, but the initial lack of coordination and inward-looking response by the respective national authorities point to the limits of current cross-border resolution mechanisms, and the reality that complexities of cross-border organizational structures and differences in national laws can impede orderly and effective resolution of systemically important financial institutions. In addition, according to European experts with whom we spoke, even in a case of two countries with strong regulatory relationships and closely aligned national interests, small divergences in these interests dominated, preventing a coordinated solution. Prior to Fortis

being split up, Belgium, the Netherlands, and Luxembourg all provided financial support but only to the parts that were in their country. This illustrates the countries' willingness to support the company in a coordinated, although national, manner. However, Dutch concern over ABN AMRO, (which was still the brand name for many Dutch retail bank branches of Fortis at the time of its nationalization) prevented a consolidated solution. A report by the Basel Committee on Banking Supervision concluded that Fortis demonstrated that the complexity of the international financial groups and national resolution systems led to fragmentation and break downs along national lines.<sup>9</sup>

*Dexia SA.* The 2008 Dexia example illustrates how aligned national interests and joint exposure by entities domiciled in more than one country can help facilitate cooperation. Dexia, a bank headquartered in Belgium, had significant operations in Belgium, France, and Luxembourg. It specialized in providing financing to local governments globally but concentrated in France and other European countries. Dexia also had a New York branch and a U.S.-based monoline bond insurance subsidiary.<sup>10</sup> Dexia faced significant liquidity stress in 2008 arising from issues with its longer-term bond investments, nonperforming loans, and as a bond insurer. In order to strengthen its capital, the Belgian, French, and Luxembourg governments coordinated in September 2008 a nearly €10 billion capital infusion and replaced the Chairman and Chief Executive of Dexia. When these actions did not result in an improvement in market sentiment about the bank, the three nations coordinated the creation of a joint guarantee mechanism whereby the governments of Belgium, France, and Luxembourg guaranteed 60.5 percent, 36.5 percent and 3 percent, respectively, of Dexia's obligations in excess of the bank's ability to fulfill them up to €150 billion. The nations' shares of the guarantee were based on the proportional share of the company's equity and debt held by institutional investors residing in the three countries. In 2008, Dexia drew only €12.3 million under this guarantee. This example of coordination in order to avoid an international insolvency was driven by the unique nature of the company's business and shareholder base. In France, Dexia was a key provider of municipal finance. In Belgium, the

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<sup>9</sup>Basel Committee on Banking Supervision, *Report and Recommendations of the Cross-border Resolution Group* (Basel, Switzerland: 2010).

<sup>10</sup>Monoline insurers usually write a single type of insurance contract, such as for bond issuances.

bank was a key depository institution. Thus, the governments could reach a joint, coordinated solution that served the interests of France, which was able to ensure that municipalities were able to keep a key provider of funds, and those of Belgium, which avoided the costly and systemically risky failure of one of its key banks. This coordinated action allowed Dexia time to access financing and gave the bank time to sell certain operations and shrink others and avert bankruptcy.

*Icelandic banking crisis.* The United States was not greatly affected by the Icelandic banking crisis, but the issues it raised point to the difficulties in resolving systemically significant financial institutions with large international relationships. The three largest Icelandic banks, which accounted for 85 percent of the nation's banking system, collapsed in early October 2008 after growing exponentially over the past decade to have total assets peak at more than 1,000 percent of Iceland's gross domestic product. Part of this growth was funded by deposits raised in at least nine other European countries, of which both Great Britain and the Netherlands were large contributors. The crisis led to investors and depositors pulling assets out of Icelandic banks simultaneously with a 70 percent depreciation in the krona (Icelandic currency) in which most of the bank's assets were priced. Those assets included significant equity stakes in other Icelandic banks, which were further impaired as the local stock market lost 80 percent of its value. As the three big Icelandic banks and their European branches and subsidiaries had significant liabilities denominated in euros and British pounds, the declines in asset values overwhelmed the banks' equity and the banks were not able to meet the huge demand for deposit withdrawals in the panic. The Icelandic government then guaranteed all domestic Icelandic deposits but did not extend the same protection to depositors in other countries. The subsequent insolvencies led to losses being borne by foreign creditors and initially by British and Dutch depositors, as the Icelandic government was unable to make them whole. Both the British and Dutch governments became involved in attempts to force the Icelandic government to make depositors in their countries whole at the same time as paying depositors some portion of their guaranteed deposits. The British government later decided to pay out all retail depositors in whole, although commercial depositors only received the guaranteed portion of the account. In order to freeze Icelandic bank assets, the UK government invoked provisions of the Antiterrorism, Crime and Security Act of 2001 stating the move was done to prevent harm to the UK economy. This move was not well received in Iceland and complicated subsequent efforts to resolve the dispute about who should repay the depositors. Nevertheless, the UK was able to transfer the bulk of the deposits to a Dutch bank. Agreements

were eventually concluded between the Icelandic and both the UK and the Netherlands governments detailing Iceland's repayment to the governments for the amount of losses borne by their respective deposit schemes. These agreements were approved by the Icelandic parliament, but the President of Iceland refused to sign the bill into law unless it passed a referendum. On two occasions, most recently in April 2011, Icelandic voters have voted against ratifying these agreements to pay back the full amounts. Multilateral efforts to resolve the crisis have been slowed and complicated by differences of opinion about who bears the responsibility for the losses.

*Bernard L. Madoff Investment Securities.* The still active 2008 Bernard L. Madoff Investment Securities, LLC (BLMIS) case demonstrates the complications that can arise from the presence of fraud, especially in an international context. BLMIS, an internationally active broker-dealer, had three principal lines of business: market making, proprietary trading, and investment advisory services. BLMIS filed for bankruptcy protection on December 15, 2008, after the founder revealed that his investment management firm was in fact a Ponzi scheme through which he had stolen customer funds for years. As part of this scheme, the founder had sent fraudulent statements to clients falsely claiming that their invested assets had grown in value, as detailed in reports by the BLMIS bankruptcy and SIPA trustees. At the time of failure, BLMIS customers believed that they had an aggregate of \$65 billion in assets managed by BLMIS. BLMIS was a member of SIPC pursuant to its registration as a broker-dealer. BLMIS led to losses to investors of invested capital of at least \$17 billion. This amount excludes "gains" that investors falsely believed their investments had earned due to the fraudulent account statements. In addition to his own investment advisory business, Madoff had utilized a global network of "feeder funds" to collect "investments" from wealthy individuals around the globe.<sup>11</sup> Several of these feeder funds also were forced into liquidation with the individuals in charge of liquidating these funds filing claims against the BLMIS estate. On the same day as the bankruptcy filing, the broker-dealer was placed into liquidation under the Securities Industry Protection Act, and a SIPA

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<sup>11</sup>A feeder fund is an investment fund that conducts virtually all of its investing through another fund (called the master fund). The master-feeder fund structure is a common way that hedge funds are set up to accept assets from both foreign and domestic investors in the most tax and trading efficient manner possible. The master fund is often located offshore.

trustee was appointed to resolve claims. The bankruptcy court later combined the processes for resolving the BLMIS estate with the SIPA process, placing them under the direction of the SIPA trustee. Since his appointment, the trustee has located assets in the Bahamas, Bermuda, the British Virgin Island, Canada, the Cayman Islands, England, Gibraltar, Ireland, Italy, Luxembourg, Panama, Spain, and Switzerland.

As of July 15, 2011, the trustee reported a total of 16,518 claims had been made to the trustee, and 2,414 of these claims for a total of \$6.9 billion had been allowed. Of these 2,414 claims, SIPC coverage of \$500,000 per account (including up to \$250,000 for cash) resulted in claims of \$795 million. Due to the nature of the fraud, over the years, certain customers had withdrawn funds from their accounts that were greater than their initial investments with the firm. The trustee in the case chose to pursue claims against at least eight such investors to recover funds that could be distributed to other victims of the fraud. As of May 2011, the trustee had made \$13.7 billion in such claims against various feeder funds, friends, and family of the founder, and other related parties. In May 2011, an agreement was reached between the largest feeder fund and the BLMIS trustee to align their interests and jointly pursue recovery of billions of dollars in claims against the owners and management of this failed feeder fund.

According to the trustee, as of May 4, 2011, the trustee had recovered more than \$7.6 billion. However, more than \$5 billion of these recoveries were not available for distribution to BLMIS customers pending the outcome of appeals by claimants of significant settlements the trustee had made with some of the customers of BLMIS, who had withdrawn funds in excess of their capital contributions, leaving \$2.6 billion available for customers. Of this amount, the trustee expects to distribute \$272 million to the defrauded holders of 1,224 customer accounts in the near term.

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## Domestic Case Studies

*Colonial BancGroup, Inc. (Colonial).* The Colonial proceeding is significant due to the issues raised regarding the holding company's financial responsibility for an insolvent insured depository institution. Colonial was a bank holding company that owned Colonial Bank. On August 14, 2009, the Alabama State Banking Department closed Colonial Bank and appointed FDIC as the bank's receiver. FDIC, in its corporate capacity and as receiver of Colonial Bank, then executed a Purchase and Assumption Agreement (P&A agreement) with Branch Banking and Trust Company (BB&T), under which BB&T purchased substantially all of

Colonial Bank's assets, and assumed all of its deposit accounts. This left Colonial (the bank holding company) with less than 1 percent of the consolidated assets. Colonial filed for Chapter 11 bankruptcy in the Bankruptcy Court for the Middle District of Alabama (Alabama Bankruptcy Court), on August 25, 2009. Colonial Bank was closed following a liquidity crisis caused by poor management of credit risk related to an over-concentration in commercial real estate, nonperforming loans, and fraudulent conduct by some of the officers in its mortgage warehouse lending unit, which provided short-term funding to mortgage originators for loans that would be sold into the secondary market.

In connection with Colonial's bankruptcy, FDIC filed a motion seeking a court order allowing FDIC's \$905 million capital maintenance claim as a priority claim and requiring Colonial to cure the claim under 11 U.S.C. § 365(o), or convert the case to a case under Chapter 7.<sup>12</sup> FDIC based its claim on the amount of capital necessary for Colonial Bank to comply with its capital requirements at the time it was closed. FDIC also based its claim on the following prepetition agreements entered into by Colonial with its regulators: a memorandum of understanding (MOU) with the Federal Reserve Bank of Atlanta and the Alabama Banking Department, an agreement with the Federal Reserve Bank of Atlanta and the Alabama Banking Department and a Cease and Desist Order with the Federal Reserve and the Alabama Banking Department. Although these agreements referred to Colonial Bank's separate agreements with its regulators, Colonial Bank was not a party to the agreements. The Bankruptcy Court denied FDIC's motion because it found that the language contained in the agreements entered into by Colonial with its regulators did not obligate Colonial to maintain the capital of Colonial Bank within the meaning of 11 U.S.C. § 365(o).<sup>13</sup>

FDIC also filed a separate motion for relief from the automatic stay to exercise its rights under the P&A agreement to exclude Colonial's deposit accounts from the definition of "Assumed Deposits" and setoff its claims against Colonial's deposit accounts, which had been transferred to BB&T under the P&A agreement. The bankruptcy court denied FDIC's motion,

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<sup>12</sup>Due to the size of the claim and Colonial not having enough assets to pay FDIC the full amount, granting FDIC's claim likely would have forced the debtor into Chapter 7 liquidation (partially) to meet FDIC's claim.

<sup>13</sup>In re The Colonial BancGroup, Inc., 436 B. R. 713 (Bankr. M.D. Ala. 2010).

holding that FDIC could not exercise its rights after Colonial filed for bankruptcy, and, therefore, FDIC did not have mutuality for setoff purposes.<sup>14</sup> FDIC has appealed the decision.

*NextBank.* The 2002 failure of NextBank, NA, and its subsequent resolution is an example of how the failure of a relatively simple bank can lead to complex legal questions that take many years to resolve even outside of the bankruptcy context. In addition, NextBank's resolution points to how the way a holding company is structured can lead to challenges for FDIC in resolution. NextBank was a Phoenix, Arizona-based, Internet only credit-card bank that failed on February 7, 2002, with total assets of approximately \$700 million and deposits of \$554 million. FDIC lost between \$300 million and \$350 million on the failure, while 2,075 depositors that held \$29.4 million in uninsured deposits were subject to losses. FDIC's seizure of the bank left NextBank's parent, NextCard, Inc., with assets on its balance sheet of only 25 percent of their pre-seizure size. Due to NextBank's unique corporate structure, the workers who supported NextBank's credit card servicing were employees of NextCard. After the failure, NextCard and FDIC agreed that NextCard would provide certain administrative services, licenses to NextCard's intellectual property, and give FDIC access to NextCard's proprietary systems while FDIC looked for a purchaser of NextBank's credit card portfolio. In addition, 465 of NextCard's 610 employees were transferred to a third-party contractor working for FDIC to service the credit card portfolio. FDIC agreed to reimburse NextCard for these services. When these services terminated with the transfer of receivables and closure of credit card accounts (discussed later), NextCard was unable to find any viable business prospects and on November 14, 2002, NextCard filed for Chapter 11 in the Delaware Bankruptcy Court.

In July 2002, FDIC sold \$190 million of NextBank's credit card receivables that had not been securitized but were held wholly on NextBank's balance sheet. They then closed credit card accounts with outstanding balances of \$1.4 billion in credit card receivables that had been securitized and were still being serviced by NextBank at the time of failure. While these securitized accounts were closed, the cardholders still were responsible for paying off their balances at the original terms. The securitizations had four classes of noteholders (A–D), with each lower

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<sup>14</sup>In re The Colonial BancGroup, Inc., 2011 Bankr. LEXIS 275 (Bankr. M.D. Ala. 2011).

level (B-D) exposed to increasing levels of risk. Before the receivership, the stream of cardholder payments (monthly principal, interest, and fee payments) were used to make interest payments on the notes first with all remaining cash divided into two accounts. One was for “collateral,” which would pay principal on the notes according to the priority schedule that had been set forth in the securitization’s prospectus, and the other was for “transferor interest,” which would pay NextBank as servicer and then, after the bankruptcy, FDIC. However, the credit performance on the closed accounts was poor. FDIC, as servicer, and Bank of New York the trustee in the securitization, applied all delinquent payments to the collateral account, thus depriving bondholders of principal payback, while all payments received from cardholders went to the transferor interest to which FDIC, now the owner of NextBank, was entitled.<sup>15</sup> But, the securitization offering documents stated that, in the event of a receivership, noteholders were entitled to accelerated payment of principal compared with the slower schedule without a receivership. While the Class A and B noteholders were paid in full, the Class C noteholders stopped receiving principal payments and the Class D noteholders never received any principal as of the start of litigation in June 2003.

The Bank of New York (now BNY), as trustee, sued FDIC in the District of Columbia federal district court (a nonbankruptcy court) on behalf of the Class C and D noteholders, claiming that FDIC was not entitled to the transferor interest because the receivership was an ipso facto trigger for the accelerated payment of principal and this took priority over the payments of the transferor interest to FDIC.<sup>16</sup> After some claims were dismissed by the court and others were dismissed pursuant to a settlement, the D.C. Court ruled against BNY on its remaining claim that FDIC had violated federal banking law and unlawfully converted funds that should have been paid to note holders. Despite this and several subsequent judicial proceedings in both D.C. and New York, not all of the claims associated with NextBank were settled. Following disposition of the D.C. Court proceedings, certain Class C and D noteholders demanded that BNY turn over transferor interest assets for principal repayment. BNY, in its capacity as a trustee, instituted a lawsuit in New

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<sup>15</sup>The Bank of New York merged with Mellon Financial Corporation on January 1, 2007, to form The Bank of New York Mellon Corporation (BNY).

<sup>16</sup>The Bank of New York v. FDIC, 453 F. Supp. 2d 82 (D.D.C. 2006), aff’d, 508 F.3d 1 (D.C. Cir. 2007), reh. denied, Bank of New York v. FDIC, 2008 U.S. App LEXIS 1582, 1586 (D.C. Cir. 2008).

York, known as an “interpleader” action, so that competing claims to assets it held in trust could be resolved by a court. Applying principles of contract law, the U.S. District Court for the Southern District of New York held that the noteholders, and not FDIC, were entitled to the money held in the transferor interest account.<sup>17</sup> FDIC appealed. In June 2010, the U.S. Court of Appeals for the Second Circuit upheld the Southern District Court ruling.<sup>18</sup>

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<sup>17</sup>Bank of New York v. First Millennium, Inc., 958 F. Supp. 2d 550 (S.D. N.Y. 2009).

<sup>18</sup>Bank of New York v. First Millennium, Inc., 607 F. 3d 905 at 910-915 (2d Cir. 2010). The decision contains a description of the NextBank receivership and subsequent lawsuits.

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# Appendix VII: Safe Harbors for Contracts under the Bankruptcy Code

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On the filing of a bankruptcy petition, the Code provides for an automatic stay, or freeze, of any action by creditors to recover assets from the debtor in possession. A debtor-in-possession (DIP) or trustee, as the case may be, may, subject to the court's approval and certain provisions in the Code, assume or reject any executory contracts or unexpired leases, and may "avoid" any prepetition preferential payments given to creditors within 90 days of the filing.<sup>1</sup> However, the DIP or trustee may not use any "cash collateral," such as cash, securities, documents of title, or other cash equivalents, without the consent of secured creditors and the court. Secured creditors of the debtor receive payment from the proceeds of the collateral, and if the collateral is insufficient to pay the claim in full the balance becomes an unsecured claim.

Certain contracts, sometimes referred to as qualified financial contracts (QFC), receive "safe harbor" protections from the automatic stay by allowing counterparties to choose whether or not to terminate, or "close-out," contracts underlying QFC transactions with a debtor. If a collateralized QFC counterparty closes-out a contract, it can remove and liquidate the collateral used to secure the transaction before that collateral becomes part of the bankruptcy estate. Also, the counterparty has the option, but is not obligated, to apply the proceeds of the collateral liquidation to any amounts owed to the debtor, a process called "netting." After netting, if the counterparty is owed money by the debtor, it awaits payment under a reorganization plan with the unsecured creditors. If it owed money to the debtor after netting, the debtor would collect what it was owed and include those funds in the estate for payment to creditors according to the established order of priority.

In addition, the safe harbor for QFCs allows the QFC counterparty to keep prepetition preferential payments, which can be understood by the example of a CDS. A CDS is generally a contract between two parties where the first party promises to pay the second party if a third party experiences a credit event such as failing to pay a debt. If the third party suffers a credit event, then the first party would be required to post increased collateral to assure the second party that it could meet its contractual obligation. On a bankruptcy filing of the first party, without the

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<sup>1</sup>11 U.S.C. §§ 365, 547. In bankruptcy, an executory contract is one in which both parties to the contract have future performance obligations that, if unperformed by either party, would result in a material breach. See *Regen Capital I, Inc., v. Halperin*, 547 F. 3d 484 (2d Cir. 2008); *Olah v. Baird*, 567 F. 3d 1207 (10<sup>th</sup> Cir. 2009).

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safe harbor, the second party would normally be required to return the increased collateral to the first party's estate as a prepetition preferential payment. Instead, under the safe harbor, the second party could close-out the CDS, liquidate the collateral, and net the proceeds against its debts to the first party.

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# Appendix VIII: Some Characteristics of Insolvency Systems in Selected Countries

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As insolvency and resolution is primarily handled at the national level, different countries will have different approaches. We interviewed experts and reviewed publications regarding aspects of insolvency and resolution systems in Canada, China, the EU, France, Germany, Luxembourg, the Netherlands, Switzerland, and the UK. This appendix illustrates some of the differences across these jurisdictions' systems, but it is not a comprehensive examination of them.

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## Netting of Financial Obligations

Generally, counterparties are allowed to close out and net financial contracts when one of the parties becomes insolvent. As described earlier in this report, in the United States, netting is allowed as determined by the safe harbor provisions of the U.S. Bankruptcy Code. According to experts we interviewed, all the jurisdictions we examined allowed for netting of mutual financial obligations. However, the exact treatment may differ across countries as follows:

- Under Canadian insolvency law, derivatives generally qualify as “eligible financial contracts” and receive special treatment under the Winding-Up and Restructuring Act (WURA), the Companies’ Creditors Arrangement Act (CCCA), and the Bankruptcy and Insolvency Act (BIA).<sup>1</sup> According to a legal expert, the treatment of derivative contracts under Canadian insolvency law is similar to that in the United States. Under the CCCA and BIA, which apply to entities other than federally insured depository institutions and certain other specialized entities, and the WURA, which governs the restructuring or reorganization of federally insured depository institutions, eligible financial contracts counterparties may terminate the contracts and net amounts payable to or by the insolvent debtor.
- According to a legal expert, netting of financial obligations is allowed in China.
- Under Articles 7 and 8 of the EU Directive on Financial Collateral, the enforceability of close-out netting arrangements is explicitly protected notwithstanding the insolvency of the parties to the arrangement. Further, EU members are prohibited from applying their national insolvency rules to the arrangements. A regulatory expert told us that

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<sup>1</sup>A general description of these laws is set forth in the following discussion about special resolution regimes.

the EU is considering incorporating a temporary stay on close-outs and netting in the proposal resolution procedures in a manner similar to the provisions of the Orderly Liquidation Authority (OLA) created in the Dodd-Frank Act.<sup>2</sup> The stay would be 48 hours rather than the 24-hour stay under OLA.

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## Special Resolution Regimes for Financial Institutions

Some countries have special resolution regimes for certain financial institutions, similar to those employed by FDIC. Some countries have recently proposed or enacted such regimes as a result of the 2008 crisis. Canada, France, Germany, Japan, Luxembourg, the Netherlands, Switzerland, and the UK all have special resolution regimes. China and the EU are currently considering some type of regime for their jurisdictions.

- In Canada, several laws can apply to the resolution of insolvent financial institutions. Similar to the United States, Canadian resolution laws differentiate between banks, insurance companies and other specialized financial institutions on the one hand, and other types of entities, which include the holding companies of those specialized institutions. Generally, most business entities are subject to the Bankruptcy and Insolvency Act (BIA) and, if the aggregate amount of claims is large enough, the Companies' Creditors Arrangement Act (CCAA). Depository institutions insured by Canada's federal government are subject to restructuring and/or reorganization by the Canada Deposit Insurance Corporation (CDIC) under the Canada Deposit Insurance Corporation Act (CDIC Act). Provincial loan and trust corporations whose deposits are CDIC-insured also may be subject to the act if the relevant province has entered an agreement with the federal government. WURA applies to federal and provincial banks, loan companies, and insurance corporations. The WURA in effect provides a liquidation regime for these financial institutions. According to a paper written by a Canadian law professor, WURA allows the Canadian court to appoint a liquidator, who can take control

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<sup>2</sup>Dodd-Frank Act. Pub. L. No. 111-203 § 210(c)(8)(F)(II) (suspending QFC counterparty's payment or delivery obligations during the time from when FDIC is appointed receiver until the earlier of the party's receiving notice that the contract has been transferred to another entity or 5:00 p.m. (eastern standard time or eastern daylight time) on the business day following the appointment).

of the firm.<sup>3</sup> This liquidator has broad powers to resolve the company and distribute proceeds to the creditors.

- According to a legal expert, China is considering an FDIC-like regime for its banks. Under the Enterprise Bankruptcy Law, the Chinese bankruptcy regime allows creditors, debtors, and the regulatory body of financial institutions to file a bankruptcy application. The regulatory body may also require reorganization proceedings. The Enterprise Bankruptcy Law also allows the state flexibility to implement more detailed regulations, if necessary. According to a legal expert, the regulatory body generally places a problematic financial institution in a trusteeship and monitors the institution.<sup>4</sup> If the regulatory body determines that an institution can be saved, the body may petition the court to suspend bankruptcy proceedings. However, the expert said that, since the government already owns the banks, it has a wide range of options available in case of insolvency.
- The EU is working on a new resolution regime for financial institutions, including developing a European Supervisory Authority.<sup>5</sup> A legal expert told us that the first stage would be to establish a general resolution and recovery framework. The EU may consider a uniform set of liquidation policies in the future.
- According to a foreign court official, until recently in Germany financial institutions were resolved under standard insolvency law. Following the 2008 crisis, the German government approved the German Act on the Orderly Restructuring and Liquidation of Banks (“Bank Reorganization Act”), the German Act on the Establishment of a Bank Restructuring Fund, and the German Act for the Extension of Time Limitations Barring Management Liability (collectively, the “Bank Restructuring Act”). The laws provide for two types of reorganization procedures and a conservatorship procedure, both through BaFin, the

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<sup>3</sup>*Bank Bankruptcy in Canada: A Comparative Perspective*, *supra* note, at 66-67.

<sup>4</sup>Jingxia Shi, Twelve Years to Sharpen One Sword: The 2006 Enterprise Bankruptcy Law and China's Transition to a Market Economy, 16 J. Bankr. L. & Prac. 5 (October 2007).

<sup>5</sup>See European Parliament and Council, 2010, Regulation on Establishing a European Supervisory Authority (European Banking Authority) Reg. No. 1093/2010.

German supervisory body.<sup>6</sup> The conservatorship allows the government to transfer the systemically important parts of the firm to a bridge institution.<sup>7</sup>

- According to an academic expert, the Netherlands recently enacted a new resolution regime in the wake of the financial crisis. The new regime includes liquidation and reorganization procedures, as well as an “emergency plan” provision for financial institutions to be used prior to liquidation. The regime allows for the appointment of a formal trustee, who can transfer assets and clients’ accounts to a bridge institution.<sup>8</sup>
- The UK made changes to its insolvency system following the failure of Northern Rock. The Banking Act of 2009 provides for a special resolution regime. According to a regulatory expert, in the case of a financial institution failure, authorities now can transfer assets, establish a bridge bank, and, as a last resort, assume “temporary public ownership” of an institution. The special resolution regime only will apply to institutions with “eligible” or insured deposits. A firm that does not have any insured deposits will continue to be resolved under the regular insolvency system.

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## Liability for Corporate Managers

Some countries can impose liabilities on corporate officers if their firm becomes insolvent, as follows:

- According to French legal practitioners, in France, a court may determine that the corporate officers have committed an “actionable fault,” which leads to an insolvency. In this case, the officers may be liable for the amount of liabilities in excess of the amount of assets.
- According to a foreign court official, in Germany, corporate officers must file for insolvency promptly. Otherwise, the officers face civil and

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<sup>6</sup>Jan D. Bayer, German Bank Restructuring Act: Impact on Investors in Debt, Hybrid and Equity Securities Issued by German Banks, available at <http://www.binghamcom/Media.aspx?MediaID=11986> (Feb. 9, 2011).

<sup>7</sup>A bridge institution is an institution established to facilitate the transfer of assets and liabilities from one institution to another.

<sup>8</sup>*The International Comparative Legal Guide to Corporate Recovery and Insolvency 2010: Netherlands*, page 147.

possibly criminal liability. The officers also may be liable for any payments made to creditors while insolvent.

- According to a legal analysis, in Luxembourg, the court can order the officers liable for the company's debts if the insolvency is due to "gross negligence."
- According to a report by a group of international insolvency experts, in the Netherlands, corporate officers can face liability if their actions were "severely reproachable."
- According to a report by a group of international insolvency experts, in the UK, corporate officers can face liability for transactions made prior to an imminent insolvency filing.

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## Insolvency Definitions and Triggers

Countries can have different definitions of "insolvency" and thus different triggers to commence insolvency proceedings. Some countries use a "cash-flow" test, in which insolvency would mean an inability to pay debts as they come due. Others use a "balance-sheet" test, in which insolvency would mean that liabilities exceed assets. Countries can use either or both to trigger resolution or insolvency proceedings. The U.S. Bankruptcy Code defines "insolvent" as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation."

- According to Canadian practitioners, under Canadian insolvency law, a company is insolvent if it has acknowledged its inability to pay its debts. Once a company is insolvent, a court also can commence a proceeding if the shareholders passed a resolution requiring the company to be resolved or if the court opined that it is "just and equitable" that the company be resolved. As discussed previously, insolvency proceedings for financial institutions are governed by the WURA.
- In China, a debtor must be both balance-sheet insolvent and cash-flow insolvent before it can file for insolvency.
- In France, cessation of payment, meaning the inability to make payments with available assets as they become due, triggers court-supervised procedures for companies in financial difficulty.

- In Germany, the law defines three types of insolvency, “over-debtedness,” inability to pay debts, and “imminent illiquidity.” If one of the two first types is met, the directors must file for insolvency. In the third situation, management may file for insolvency, but it is not required.
- In Japan, insolvency is defined as an excess of liabilities over assets. However, insolvency proceedings are triggered by the inability to pay debts.
- In Luxembourg, insolvency proceedings begin when a debtor is both unable to pay its debts as they come due and unable to raise credit.
- In the Netherlands, a debtor can apply for insolvency protection when it determines it cannot pay its debts as they come due. The Netherlands District Court can also declare the debtor bankrupt if it has ceased to pay debts. The Netherlands does not have a balance-sheet test.
- In Switzerland, a company may file for insolvency protection if (1) it cannot pay its debts, (2) it has ceased to pay its debts, or (3) its liabilities exceed its assets.
- In the UK, both the cash-flow and balance-sheet tests are used to determine insolvency.

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## Payment Priorities

The order in which creditors are repaid from an insolvent estate varies among various countries. These repayment rankings can represent the social and political priorities of the jurisdiction.<sup>9</sup> The rankings in table 6 are general rankings and may not apply in all bankruptcy cases.

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<sup>9</sup>These rankings are based on information from secondary sources and, in some cases, the laws themselves. The priorities for unsecured creditors under U.S. law are set forth at 11 U.S.C. § 507.

**Appendix VIII: Some Characteristics of  
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**Table 6: Repayment Rankings of Selected Countries**

<b>United States</b>	1. Secured claims
	2. Claims for debts to spouse or children for court-ordered support
	3. Administrative expenses of the bankruptcy
	4. Unsecured, postpetition claims in an involuntary case
	5. Wage claims of employees and independent salespersons up to \$10,000 per claim
	6. Unpaid contributions to employee benefit plans up to \$10,000 per employee
	7. Claims of grain farmers and fishermen against debtors operating storage or processing facilities
	8. Layaway claims of consumers who did not get the item on which the deposit was made
	9. Taxes outside of bankruptcy
	10. Debtor's commitment to maintain capital of a federally insured depository institution
	11. Claims for death or personal injury from a motor vehicle that occurred while the debtor was driving it and was intoxicated
<b>Canada</b>	1. Secured creditors
	2. Funeral and testamentary expenses
	3. Administrative expenses
	4. Superintendent expenses
	5. Unpaid wages for services rendered during bankruptcy
	6. Municipal taxes owed
	7. Rent owed
	8. Fees and costs associated with process against the bankrupt's property
	9. Workers' compensation, unemployment insurance, or taxes
	10. Claims resulting from injuries to employees of the bankrupt not covered by workers' compensation
	11. Claims of the Crown not mentioned above
<b>China</b>	1. The creditor's right with guaranty on the debtor's particular assets
	2. The wages, subsidies for medical treatment and disability and comfort and compensatory funds as defaulted by the debtor, fundamental old-age insurance premiums, fundamental medical insurance premiums that shall have been transferred into the individual accounts of employers, as well as the compensation for the employees as prescribed by the relevant laws and administrative regulations
	3. Social insurance premiums and taxes as defaulted by the debtor
	4. The common creditor's right
<b>France</b>	1. Employee wage claims
	2. Legal costs including court appointees
	3. Priority for "new money," in which a party brings in money or provides goods or services without demanding cash payment after the commencement order
	4. Secured creditors
	5. Wage claims of employees arising after the commencement order
	6. Claims arising from current contracts, in which the party has agreed to defer receipt of payment for its services

**Appendix VIII: Some Characteristics of  
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	7. Amounts advanced by the wage guarantee fund
	8. Claims arising after the commencement order
	9. Claims arising prior to the commencement order and secured by general liens
	10. Claims arising before the commencement order
	11. Unsecured creditors
Germany	<ol style="list-style-type: none"> <li>1. Estate obligations <ul style="list-style-type: none"> <li>• the costs of the proceedings,</li> <li>• those obligations created by activities of the administrator or the temporary administrator to whom the debtor's right to transfer was vested,</li> <li>• obligations under mutual contracts, if their performance either is claimed by the administrator or has to take place after the opening of the proceedings, and</li> <li>• obligations due to unjust enrichment of the estate</li> </ul> </li> <li>2. Normal insolvency claims</li> <li>3. Lower-ranking claims <ul style="list-style-type: none"> <li>• the interest accruing on the insolvency claims from the opening of the proceedings,</li> <li>• costs incurred by creditors due to their participation in the proceedings,</li> <li>• fines and similar claims, and</li> <li>• claims to the debtor's gratuitous performance</li> </ul> </li> </ol>
Luxembourg	<ol style="list-style-type: none"> <li>1. Receiver's fee</li> <li>2. Liquidation expenses</li> <li>3. Employee wage claims</li> <li>4. Social security contributions</li> <li>5. Outstanding taxes</li> <li>6. Lower-ranking privileges</li> <li>7. Secured creditors</li> <li>8. Unsecured creditors</li> </ol>
Netherlands	<p>General principle: paritas creditorum, by which all creditors have an equal right to payment and proceeds of the estate shall be distributed in proportion to the size of their claims, applies to all creditors except secured creditors and creditors who have a preference under the Dutch Civil Code or other relevant act.</p> <ol style="list-style-type: none"> <li>1. Secured creditors (paritas creditorum does not apply) <ul style="list-style-type: none"> <li>• creditors who hold a mortgage</li> <li>• creditors who hold a right of pledge</li> </ul> </li> <li>2. Preferred creditors (paritas creditorum does not apply) <ul style="list-style-type: none"> <li>• creditors who have a statutory priority</li> <li>• creditors who have a nonstatutory priority</li> </ul> </li> <li>3. Unsecured creditors (paritas creditorum applies)</li> </ol>
Switzerland	<ol style="list-style-type: none"> <li>1. Secured creditors</li> <li>2. Class 1 <ul style="list-style-type: none"> <li>• salary claims of employees before the bankruptcy ruling</li> </ul> </li> </ol>

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	<ul style="list-style-type: none"> <li>• claims resulting out of obligatory accident insurance</li> <li>• claims resulting out of nonobligatory pension plans</li> <li>• claims of pension funds for premiums against employers</li> <li>• alimony claims of dependants and partners</li> </ul>
	3. Class 2
	<ul style="list-style-type: none"> <li>• certain claims of marital partners</li> <li>• premiums for social security insurance</li> <li>• premiums for accident insurance</li> <li>• premiums for unemployment benefits insurance</li> <li>• premiums and contributions to health insurance</li> <li>• contributions to family burdens equalization fund</li> </ul>
	4. Class 3
	<ul style="list-style-type: none"> <li>• all other debts</li> </ul>
UK	1. Return of deposit on petition
	2. Payment of petition costs
	3. Distribution to preferential creditors
	4. Dividend to ordinary unsecured creditors
	5. Payment of statutory interest to ordinary unsecured creditors
	6. Deferred creditors; for example, payment of any spouse's or civil partner's claim in respect of "credit provided"

Sources: GAO analysis of country bankruptcy laws and analysis provided by legal experts we interviewed.

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# Appendix IX: Organizational Affiliations of Experts

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During the course of our work, we interviewed experts from the following organizations:

Administrative Office of the U.S. Courts  
Allen & Overy LLP  
Alvarez & Marsal  
American Bankruptcy Institute  
American Bar Association  
American Council of Life Insurers  
American Insurance Association  
American International Group  
Cleary Gottlieb Stein & Hamilton LLP  
Commodity Futures Trading Commission  
Congressional Research Service  
Davis Polk & Wardwell LLP  
Department of the Treasury  
Department of State  
Duisenberg School of Finance  
European Commission  
Federal Deposit Insurance Corporation  
Federal Judicial Center  
Federal Reserve Board  
Financial Services Roundtable  
Financial Stability Board  
HM Treasury (UK)  
Hoover Institution, Stanford University  
Hughes Hubbard & Reed LLP  
Institute of International Bankers  
Institute of International Finance  
International Insolvency Institute  
International Monetary Fund  
International Swaps and Derivatives Association  
Jenner & Block LLP  
Nabarro LLP  
PricewaterhouseCoopers  
National Association of Insurance Commissioners  
New York University  
Reinsurance Association of America  
Securities and Exchange Commission  
Securities Industry and Financial Markets Association  
Securities Investor Protection Corporation  
University of California, Los Angeles  
University of Pennsylvania

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**Appendix IX: Organizational Affiliations of  
Experts**

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University of Texas  
U.S. Bankruptcy Court  
Wake Forest University  
Weil, Gotshal & Manges LLP

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# Appendix X: GAO Contact and Staff Acknowledgments

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## GAO Contact

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## Staff Acknowledgments

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*Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System.* [GAO-09-216](#). Washington, D.C.: January 8, 2009.

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