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How to Catch a Falling Giant: FIBA Moves Closer to Realization

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July 15, 2016 - On July 6, 2016, the House of Representatives passed the Financial Institution Bankruptcy Act of 2016 ("FIBA") as part of a larger financial services budget bill. FIBA proposes to amend the Bankruptcy Code (the "Code") to address the specific challenges that arise when a financial institution becomes insolvent. The House Judiciary Committee's report accompanying the bill concluded that, the bankruptcy process is not optimally designed for the orderly resolution of financial institutions. The Committee noted that the interconnectedness of financial institutions creates a potential for systemic risk to the broader financial markets, and, as was evident during the 2008 financial crisis, taxpayers are often called upon to prevent such risks. FIBA, which would be located under a new subchapter V within Chapter 11 of the Code, confronts these challenges by seeking to improve the administration of financial institutions' bankruptcy proceedings.

Legislative Background

FIBA is the culmination of a bipartisan process that solicited and incorporated the recommendations of industry participants, regulators, and leading experts. Initially introduced and first passed in the House of Representatives in 2014, it failed to secure Senate approval. Its chief sponsor, Representative David Trott, reintroduced FIBA in the 2015 House session, where it was subsequently referred to the House Judiciary Committee. Following a hearing in July 2015, the House Judiciary Committee approved it by unanimous vote on February 11, 2016. FIBA was then brought to the House floor under suspension of the rules, which requires a two-thirds vote for passage and allows no floor amendments. On April 12, 2016, the House passed FIBA by voice vote. On July 6, 2016, the House passed a larger financial services budget bill, which included FIBA along with other regulatory provisions (such as congressional oversight of the Consumer Financial Protection Bureau).

Provision

a. Covered Financial Corporation

FIBA applies to Chapter 11 cases concerning “covered financial corporations”—corporations either incorporated or organized under any federal or state law as bank holding companies, or corporations that exist for the primary purpose of owning, controlling and financing their subsidiaries, that have total consolidated assets of \$50 billion or greater, and whose annual gross revenues meet specified tests.

b. Speedy Transfer of Assets

The legislation allows a debtor holding company that sits atop a financial institution’s corporate structure to transfer the operating assets of the financial institution over the course of a weekend, enabling the financial institution to “continue to operate in the normal course, which preserves the value of the enterprise for the creditors of the bankruptcy without a significant impact on the firm’s employees, suppliers, and customers.”^[1] The debt, any remaining assets, and equity of the holding company would remain in the bankruptcy process and would absorb the financial institution’s losses.

Furthermore, the financial institution’s operating subsidiaries would remain out of the bankruptcy process, which would help multinational firms that might also need to comply with multiple, and potentially conflicting, insolvency regimes in other jurisdictions.

c. Appointed Judges

FIBA recognizes that the presiding bankruptcy judge must be comfortable overseeing cases involving financial institutions. Therefore, the judicial process of a subchapter V case would be presided over by a bankruptcy judge randomly chosen from a pool of ten bankruptcy judges selected by the Chief Justice of the Supreme Court based on their experience, expertise, and specialized knowledge of financial institutions. In addition, a three-judge panel of Court of Appeals judges also appointed by the Chief Justice would preside over appeals.

d. Systemic Risks

To account for the potential for systemic risk in a subchapter V case, FIBA gives key financial regulators standing to present their views on pending motions to the presiding bankruptcy judge. The legislation also allows the bankruptcy judge, before issuing a final judgment on any motion, to consider the impact of a decision on financial stability in the United States.

e. Automatic Stay

The Code currently contains exemptions for counterparties to derivative and other structured transactions, allowing them to collect on outstanding debts from institutions in insolvency proceedings, ahead of other general creditors who must wait until a Chapter 11 plan is approved. FIBA overrides these exemptions by imposing a 48-hour automatic stay that would allow for the effective transfer of the financial institution’s operations to a bridge company.

Without this exemption override, counterparties to derivatives and similarly-structured transactions could terminate their relationships with a financial institution debtor upon the commencement of a bankruptcy case, likely endangering the successful transfer and continued operation of the bridge company and potentially threatening other entities within the broader financial system.

f. Timing

Taking into account the fact that the bankruptcy of a financial institution must be resolved expeditiously to mitigate the exposure of risk to financial markets, FIBA includes specific timeframes for the commencement of a case and court approval of the transfer of assets to the bridge company.

Conclusion

The purpose of FIBA is to establish a transparent and predictable bankruptcy process for large financial institutions. The legislation aims to prevent a situation similar to the 2008 financial crisis where, due to fears that the failure of financial firms could cause severe harm to the overall economy, the federal government provided taxpayer-funded assistance to prevent certain financial firms from failing. FIBA seeks to ensure that shareholders and creditors of a financial institution, and not taxpayers, bear the risks and losses of a failed financial institution. The legislation will proceed to the Senate for consideration.

Footnotes

[1] Diane Davis, "House Panel Approves Financial Institution Bankruptcy Act," Bankruptcy Law Report (February 16, 2016), <http://www.bna.com/house-panel-approves-n57982067374/>.

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