

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.