

Clients & Friends Memo

FDIC Approves Rule Making With Respect to Orderly Liquidation Authority; Defers Ruling on Living Wills¹

July 28, 2011

On July 6, the FDIC approved a final rule implementing the Orderly Liquidation Authority. The FDIC had been expected to issue a final rule on the “Living Will” requirements July 6 as well. However, the FDIC tabled this matter until its August 6 meeting.

The rule on the Orderly Liquidation Authority is promulgated under Title II of the Dodd-Frank Act, which authorizes the FDIC to create an orderly liquidation mechanism for systemically important financial institutions, which are referred to in the rule as covered financial companies. The final rule defines key terms, creates a priority structure, and delineates the procedure for filing a claim. The final rule will become effective August 15, 2011. See [Federal Register/Vol. 76, No. 136/Friday, July 15, 2011](#).

Key provisions include:

- 380.24: Priority for loss of setoff rights. A claim for setoff rights lost by a transfer of contracts will be paid after administrative expenses, amounts owed to the United States, and certain employee claims, but before general unsecured claims. Qualified financial contracts are exempt from this provision.
- 380.25: Post-insolvency interest. Post-insolvency interest is calculated by the method determined under the Federal Deposit Insurance Act, rather than by methods adopted under the Bankruptcy Code
- 380.50: Determination of secured claims. The value of the collateral subject to a security interest will be determined by the FDIC at the time of disposition or use of the collateral.
- 380.52: Adequate protection. Adequate protection will be provided for secured property to the extent that the receiver’s actions are diminishing the value of the collateral, similar to the adequate protection required under section 361 of the Bankruptcy Code.

¹ The authors would like to thank Hunter A. White, for his assistance on this memo.

Below is a summary of each of the rules and additional detail with respect to key provisions.

Summary of Provisions

380.1 Definitions

The definitions section is relatively straight forward. Similar to the Bankruptcy Code, “claim” is defined broadly.

380.3 Treatment of Personal Service Agreements

Personal service agreements may be accepted or repudiated by the FDIC or a bridge financial institution. However, if the FDIC accepts performance under the contract prior to repudiation, then all payments due on that performance are governed by the pre-existing contract and are administrative expenses. This does not restrict the ability of the FDIC to negotiate different terms of employment by mutual agreement.

380.5 Treatment of covered financial companies that are subsidiaries of insurance companies

When the FDIC acts as a receiver for a subsidiary of an insurance company and the subsidiary itself is not an insured depository institution or insurance company, the value realized from the liquidation will be distributed according to the order of priorities set by the Dodd-Frank Act. Any proceeds remaining after the payment of all claims against the subsidiary will be transferred to the parent insurance company.

380.6 Limitation on liens on assets of covered financial companies that are insurance companies or covered subsidiaries of insurance companies

Under the Dodd-Frank Act, the FDIC may provide funding for the orderly liquidation of a covered financial company when the FDIC determines that this funding is necessary or appropriate. The FDIC is authorized to take liens on assets of the company to secure repayment of this funding. Section 380.6 provides that the FDIC will avoid taking a lien on the assets of a covered financial company that is an insurance company or a covered subsidiary of an insurance company, unless the FDIC determines that taking such a lien is necessary for an orderly liquidation of the entity, and the lien will not impede the liquidation or rehabilitation of the insurance company.

380.7 Recoupment of compensation from senior executives and directors

The FDIC can claw back up to two years of compensation from current and former senior executives and directors who are found “substantially responsible” for the failure of the covered financial company. In the case of fraud by a senior executive or director, there is an unlimited

recovery period. A senior executive or director is substantially responsible for the failure if the officer did not conduct his or her responsibilities with the same degree of care as an ordinary prudent person, and as a result caused a loss that materially contributed to the failure of the covered financial company.

A senior executive or director will be presumed to be substantially responsible for the failure if:

i) the senior executive or director had responsibility for the strategic, policy-making or company-wide operational decisions of the covered financial company (this includes the CEO, CFO, president, and chairman of the board of directors),

ii) the senior executive or director is found by a court to have violated his or her duty of loyalty, or

iii) the senior executive or director is removed from his or her position by the FDIC because he or she is substantially responsible for the failure of the covered financial company.

A senior executive or director can rebut this presumption by showing that he or she acted with the degree of skill or care that an ordinarily prudent person would in like circumstances, or that his or her actions did not cause a loss that materially contributed to the failure of the covered financial company. This presumption does not apply to senior executives and directors hired during the two-year period prior to the FDIC's appointment as receiver to prevent further deterioration of the financial condition of the company.

380.9 Treatment of fraudulent and preferential transfers

This provision articulates the method that the FDIC will use to determine whether a transfer has been made. A transfer is made when the transfer is perfected such that a *bona fide* purchaser could not acquire an interest in the property that is superior to the initial transferee's interest. This is consistent with the provisions of the Bankruptcy Code and other insolvency laws, providing transferees with the same treatment in a liquidation under the Orderly Liquidation Authority as under the Bankruptcy Code.

On January 14, 2011, the American Securitization Forum (ASF) sent a letter to the FDIC requesting clarification about the FDIC's powers to avoid transfers under the Dodd-Frank Act. Specifically, the ASF wanted clarification on the principles that the FDIC would use to distinguish true sales from secured loans. The ASF wanted the FDIC to use the principles established under the Bankruptcy Code and other insolvency laws to determine whether to characterize a transfer as secured loans versus sales, because market participants are familiar with these principles. In response the FDIC's General Council issued a letter stating that it would utilize its powers in a manner that was consistent with the Bankruptcy Code and other insolvency laws at least until the Board of Directors of the FDIC adopted a regulation addressing the matter.

380.21 Priorities

There are eleven classes of claims. The provisions that follow this one serve to further clarify and define these classes. Each class will be paid in full before a class of lower priority will be paid. If there are insufficient funds to pay a class in its entirety, then the claims of that class will be paid *pro rata*.

The classes are as follows:

- 1) repayment of debt incurred or credit obtained by FDIC as receiver for a covered financial company, provided the FDIC was unable to secure commercial sources of funding,
- 2) administrative expenses of the receiver,
- 3) any amounts owed to the United States,
- 4) wages earned by employees up to \$11,725 per person earned within 180 days of the filing,
- 5) contributions to employee benefit plans up to \$11,725 per person earned within 180 days of filing,
- 6) allowed claims for loss of setoff rights,
- 7) any other general or senior liability of the covered financial company,
- 8) any obligation subordinated to general creditors,
- 9) wages of senior executives,
- 10) post-insolvency interest, and
- 11) any amount remaining will be distributed to shareholders or others holding equity interests.

This reflects the classes detailed in the Dodd-Frank Act.

380.22 Administrative expenses of the receiver

This section makes clear that administrative expenses of the receiver can include expenses incurred by the FDIC prior to its appointment as receiver that are in anticipation of assuming this role. Post-appointment expenses related to the liquidation are also administrative expenses.

380.23 Amounts owed to the United States

“Amounts owed to the United States” is broadly defined to include all amounts advanced before and after the appointment of the receiver by any department, agency or instrumentality of the United States. These amounts fall immediately after administrative expenses in priority. Importantly, this does not include unsecured amounts due to government agencies and instrumentalities that are incurred in the ordinary course of business of the covered financial institution.

380.24 Priority for loss of setoff rights

Under the Dodd-Frank Act, the FDIC can transfer assets that are subject to setoff rights free and clear of those setoff rights. This transfer creates a claim for loss of setoff rights. Importantly, qualified financial contracts are exempt from this provision, allowing for less restrictive netting of such contracts.

Under this provision, claims for loss of setoff rights are given priority above general unsecured claims, but lower than administrative expenses, amounts owed to the United States and certain employee claims.

Under the Bankruptcy Code setoff rights are equivalent to a secured claim. By contrast, under this rule loss of setoff rights claimants receive, in essence, a claim entitled to payment in cash ahead of only general unsecured claims. This distinction between the Orderly Liquidation Authority and the Bankruptcy Code creates a potential loss of recovery for setoff claimants as compared with their typical expectations.

380.25 Post insolvency interest

Post-insolvency interest has a lower priority than general unsecured creditors. The post-insolvency interest rate is based upon the coupon equivalent yield of the average discount rate set on the three-month T-bill. This is consistent with the rate applied under the FDI Act.

The FDIC determined that because there was no clear rule for treatment of post-insolvency interest under the Bankruptcy Code, the method under the FDI Act would be used. Alternatives to this method include using the contract rate, but the FDIC declined to adopt this method. Additionally, the FDIC suggests that because post-insolvency interest will only be paid after all allowed claims have been paid in full, this provision will not frequently be encountered, as a practical matter.

380.26 Effect of transfer of assets and obligations to a bridge financial company

Any contract or agreement assumed or entered into by a bridge financial company becomes the obligation of the bridge financial company. Additionally, any remaining assets of the

bridge financial company after all allowed claims have been paid will be distributed to the receiver of the covered financial institution for the benefit of the creditors of that covered financial institution. Additional rulemaking concerning bridge financial companies is expected.

380.27 Treatment of similarly situated claims

Certain categories of creditors, including creditors holding unsecured debt with a term of greater than 360 days, will not be given additional payments compared to other general creditors, including trade creditors. There will be no exceptions made to allow favorable treatment of holders of subordinated debt, shareholders or other equity holders. This provision makes it explicit that the FDIC does not have the authority to make these exceptions.

380.30 Receivership administrative claims process

This provision details the authority of the FDIC to act as receiver of a covered financial company.

380.31 Scope

This provision clarifies that the claims process does not apply to a bridge financial company, nor does it apply to extensions of credit from a Federal reserve bank or the FDIC to a covered financial company. Claims by these entities are exempt from this process.

380.32 Claims bar date

This provision authorizes the receiver to establish a claims bar date by which all creditors must file their claims with the receiver.

380.33 Notice requirements

Upon appointment as receiver, the FDIC must publish a first notice informing creditors to present their claims prior to the claims bar date. The FDIC must publish additional notices after the first notice. This rule describes the location and content of these notices. It also provides a procedure for settling claims that are discovered after the claims bar date.

380.34 Procedures for filing claim

This section describes the procedures for claimants to file a claim. The claim must be filed by the claimant who legally owns it, prohibiting filings on behalf of a class of litigants.

380.35 Determination of Claims

The receiver is authorized to disallow claims. The receiver may disallow claims filed after the claims bar date, subject to an exception for claimants who did not have notice of the appointment of a receiver and can file the claim in time to allow for payment by the receiver. A late filed claim may also be considered if the claim is based on an act or omission by the receiver that occurs after the claims bar date.

380.36 Decision Period

The receiver must notify the claimant of its decision to allow or disallow a claim within 180 days of the filing of the claim.

380.37 Notification of Determination

The notification of determination will be mailed, unless the claim was filed electronically in which case electronic media may be used for notification.

380.38 Procedures for seeking judicial review of disallowed claim

A claimant may obtain judicial review of a claim disallowance by filing a suit in the district court where the covered financial institution's principal place of business is located. Suits that were filed before the appointment of a receiver may also be continued.

380.39 Contingent claims

Claims based on a contingent obligation of the covered financial institution will be estimated. The receiver will estimate the value of the claim by the end of the 180 day claim determination period, unless both parties agree to an extension.

380.50 Determination of Secured claims

Similar to the Bankruptcy Code, a claim is secured to the extent of the value of the collateral securing the claim. Claims will be bifurcated to the extent they are undersecured, and oversecured claims will be allowed to accrue interest. The value of the collateral will be determined at the time of the proposed disposition or use, allowing the receiver flexibility.

Unlike the Bankruptcy Code, there is no judicial review of the valuation process until after the claims process is complete. The Orderly Liquidation Authority process is an administrative proceeding and is only subject to judicial review after the exhaustion of the receivership claims process. This adds uncertainty because it delays the point in time at which a valuation will be finalized.

380.51 Consent to certain actions

A secured claimant may request the receiver for relief to take possession of the collateral. The receiver may grant the requested relief if it determines that it will not use the subject property.

380.52 Adequate protection

If the receiver determines that it will use, sell or lease property that is subject to a security interest, then it must provide adequate protection. This can be provided by making cash payments to the secured claimant, by providing replacement liens, or by providing any other relief that will result in the secured claimant realizing equivalent value. Each of these is predicated upon the receiver's actions diminishing the value of the property. Adequate protection is assumed to be provided if the property is not depreciating in value or it exceeds the value of the secured debt. This rule matches closely the language of section 361 of the Bankruptcy Code.

380.53 Repudiation of secured contract

The authority of the receiver to repudiate a contract of the covered financial company will not have the effect of avoiding perfected security interests in the property. After repudiation, the security interest secures a claim for repudiation damages.

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If you have any questions about this memorandum, please feel free to contact any of the following attorneys:

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