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Clients&FriendsMemo

U.S. Senate Bill Creates New Regime for Orderly Liquidation of Financial Companies That Present Systemic Risk

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The comprehensive financial reform bill recently passed by the Senate[1] creates a new "orderly liquidation authority" ("**OLA**") that would allow the Federal Deposit Insurance Corporation ("**FDIC**") to seize control of a financial company[2] whose imminent collapse is determined to threaten the financial system as a whole. This measure — which awaits reconciliation with a similar bill passed by the House of Representatives late last year — represents Congress' attempt to address companies considered "too big to fail." Because the measure applies to corporations that are subject to the United States Bankruptcy Code, a determination by the designated government authorities that a company poses a systemic risk would enable the FDIC to seize the entity and liquidate it under the new OLA, preempting any proceedings under the Bankruptcy Code. Thus, lenders, rating agencies, and others seeking to transact business with a company, or an affiliate of a company, that could potentially be considered to present systemic risk will have to consider the impact on creditors' rights of both the Bankruptcy Code and the OLA. Further, the OLA is solely a liquidation remedy. Rehabilitation or reorganization is not an option. And the ability of a debtor to stay in possession is eliminated. The FDIC, in nearly all cases, assumes full control.[3] Insurance companies, which remain subject to state regulation, are not covered by the OLA, but their holding companies and unregulated affiliates are covered. Insured depository institutions will continue to be subject to the FDIA. However, the ability of the FDIC to seize a bank holding company allows the FDIC to run coordinated proceedings for the bank and its affiliates.

The proposed OLA is modeled after the FDIC's existing framework for failed insured depository institutions, although there are differences. Among other things, the OLA would maintain safe

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1 S. 3217, as passed by the Senate on May 20, 2010, was substituted for the House version, original H.R. 4173, passed on December 11, 2009, and renamed H.R. 4173. *See Restoring American Financial Stability Act of 2010*, H.R. 4173, 111th Cong. (2010). All section references herein are to the Senate bill. This memorandum presents an overview only of the Orderly Resolution Authority set forth in Title II that would form part of this reform package.

2 The OLA applies to eligible financial companies other than insured depository institutions, which continue to be subject to FDIC regulation. *See* § 201(a)(7).

3 *But see* discussion, *infra* at 3-4, regarding SIPC's responsibility in covered broker or dealer liquidations under the OLA.

harbors for qualified financial contracts that mirror those of the Federal Deposit Insurance Act ("**FDIA**"), subject to certain modifications such as a 3-day stay period before counterparties can close out their contracts.[4] In addition, the legislation aims to preserve certain priorities of payment, rights to setoff and avoidance action protections that generally follow those established under the Bankruptcy Code.[5] The receiver is required to resolve claims on a fast track (within 180 days of commencement of receivership).[6] The OLA provides some degree of adequate protection to secured creditors by allowing a secured creditor faced with diminution of the value of its collateral to request expedited resolution of its claim (within 90 days).[7]

The bill provides a mechanism for recovering the cost of the OLA from other members of the financial industry.[8] It also exposes officers and directors of seized financial companies to personal liability, including by subjecting to clawback their incentive and other compensation paid during the two year period prior to the commencement of a receivership.[9] If found to have engaged in more serious misconduct (*e.g.,* personal dishonesty or willful disregard of company welfare), a senior executive is subject to being banned from serving any financial company for a minimum of two years.[10]

Executive Summary of Title II – Orderly Liquidation Authority

Certain key elements of the OLA, as proposed by the Senate, are highlighted below.[11]

Only "Financial Companies" are Eligible

The OLA potentially applies to U.S. companies that are bank holding companies, non-bank financial companies supervised by the Federal Reserve Board ("**FRB**"), companies predominantly engaged in activities that the FRB determines are financial in nature or incidental thereto, subsidiaries of such

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4 *See* § 210(c)(10)(B)(i).

5 *See* § 210(a)(11), (12); *see also* § 210(b).

6 *See* § 210(a)(3). These provisions mirror those of the FDIA. *See* 12 U.S.C. § 1821(d)(5), (8).

7 *See* § 210(a)(5).

8 *See* § 210(o)(1).

9 *See* § 201(s)(1).

10 *See* § 213.

11 Note that although the House and Senate bills are substantially similar, certain provisions of the House bill that passed in December differ materially from its Senate counterpart.

companies (other than insured depository institutions or insurance companies), and brokers or dealers registered with the SEC and a member of SIPC.[12]

The liquidation of insured depository institutions will proceed under existing FDIC procedures. The liquidation or rehabilitation of insurance companies shall continue to be conducted under state law, although the FDIC has authority to commence judicial action in state court if a state regulator fails to act within 60 days after the Treasury Secretary determines that a company presents a systemic risk.[13]

OLA is Exclusive Regime for "Covered Financial Companies"

Although Title II of the Senate bill creates a new regime governing the orderly liquidation of financial companies threatening systemic risk, according to the Senate Banking Committee's report on the legislation, "there is a strong presumption that the bankruptcy process will continue to be used to close and unwind failing financial companies, including large, complex ones" under normal circumstances.[14] Nonetheless, if a Bankruptcy Code debtor is determined to threaten the national economy, it can be removed from Bankruptcy Court jurisdiction anywhere in the U.S., and placed into FDIC receivership following a summary judicial process presided over by the D.C. District Court (the "**Court**").[15]

Continuation of SIPA Protection for Customers of Covered Broker Dealers

The Securities Investor Protection Corporation ("**SIPC**") would continue to be responsible for the liquidation of a registered broker or dealer subjected to the OLA.[16] The FDIC's involvement would be limited to providing funding and exercising certain powers, including through a newly created bridge financial company.[17] In a covered broker or dealer liquidation, the FDIC would appoint SIPC (without court approval), to act as liquidation trustee under the Securities Investor Protection Act ("**SIPA**").[18] SIPC would be obligated to dispense with customer claims on the same priority basis

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[12] *See* § 201(a)(6)-(8); *see also* § 201(a)(10). For financial activity to be predominant, 85% or more of its and its affiliates' consolidated revenues must be derived from activities that are financial in nature. *See* § 201(b).

[13] *See* § 203(e).

[14] *See* S. Rep. No. 111-176, at 4 (2010).

[15] *See* § 208. Pending SIPA proceedings are also subject to termination.

[16] *See* § 205.

[17] *See* § 205(b)(2). With respect to a covered broker or dealer, the FDIC may transfer all customer accounts to a bridge financial company, unless the FDIC determines that the accounts likely will be transferred to another covered broker dealer or transfer would materially interfere with FDIC's ability to avoid systemic risk. *See* § 210(a)(1)(O)(i).

[18] *See* § 205(a).

that they now enjoy under SIPA section 8(c).[19] Non-customer claims (other than claims arising under qualified financial contracts) would be subject to the overall priority scheme of the OLA, subject to the elevation of certain administrative priority claims of SIPC.[20] Qualified financial contracts to which a covered broker or dealer is a party would be governed exclusively by the OLA's safe harbor provisions.[21]

SIPC would be entitled to exercise all of its powers under SIPA but would not have jurisdiction over assets and liabilities transferred by the FDIC to any bridge financial company, and SIPA could not otherwise adversely impact the FDIC in exercising its powers and duties.[22] Any claims against the FDIC arising from asset transfers to a bridge bank would be treated under the OLA and subject to federal district court review.[23]

U.S. Initiates the Orderly Liquidation Process

The FDIC could invoke the OLA with respect to a financial company only following a formal determination of systemic risk and a recommendation that the company be placed in receivership.[24] The process begins after either a request by the Secretary of the Treasury, or at the initiative of either the FRB or the FDIC (or, in the case of a broker or dealer, the SEC), for a formal recommendation that the FDIC be appointed as receiver.[25] To be effective, this written recommendation requires approval by a two-thirds vote of each of the FRB and the board of the FDIC (or, in the case of a registered broker or dealer, a two-thirds vote of the SEC).[26] If the "failure of the financial company would threaten U.S. financial stability" and the foregoing thresholds for recommendation are met, the FDIC will be appointed receiver, and liquidation will be "the only option for the company."[27]

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[19] *See* § 205(g)(1).

[20] *See* § 205(g)(2).

[21] *See* § 205(b)(3).

[22] *See* § 205(b).

[23] *See* § 205(e).

[24] *See* § 203(a), (b).

[25] *See* § 203(a).

[26] *See* §§ 202(a), 203(a).

[27] *See* S. Rep. No. 111-176, at 4. To protect against adverse consequences resulting from media exposure, the bill contains criminal penalties for persons who recklessly disclose that an emergency petition has been filed with the Court. *See* § 202(a)(1)(C).

Twofold Test – Default/ Danger of Default and Systemic Risk.

Default or Danger of Default. A company must be in "default or danger of default." Alternative insolvency tests can be met to establish this condition: 1) a pending or threatened commencement of a case under the Bankruptcy Code; 2) the incursion of or likely incursion of losses that will deplete all or substantially all of a company's capital with no reasonable prospect for the company to avoid such depletion; 3) assets that are or likely will be less than the company's obligations to creditors and others, or 4) a situation in which the company is or likely will be unable to pay its obligations (other than those in bona fide dispute) in the ordinary course of business.[28]

Determination of Systemic Risk. If a company is found to be in default or in danger of default, a formal determination of systemic risk must be established by various experts. A covered financial company would implicate systemic risk if 1) the company is in default or the danger of default; 2) the failure of the company would have serious effects on the financial stability of the U.S.; 3) no viable private sector alternative is available to prevent default; 4) any effect on creditors, counterparties, shareholders and other market participants is appropriate given the impact actions would have on U.S. financial stability; 5) action taken would avoid or mitigate such adverse effects taking into account the mitigation of potential adverse effects on the financial system; 6) a federal regulatory agency has ordered the company to convert all its convertible debt instruments that are subject to regulatory order; and 7) a company satisfies the statutory definition of a financial company. The written recommendation voted on by the FRB and FDIC (or SEC in the case of a covered broker or dealer) must evaluate not only these factors but also why the Bankruptcy Code is inadequate to resolve the company's condition.[29]

Only "Arbitrary and Capricious" Petitions are Subject to Court Dismissal. Upon a recommendation of receivership, the Treasury Secretary would ask a company's board of directors to consent or "acquiesce" to FDIC receivership.[30] In the absence of consent or acquiescence, the Treasury Secretary would petition the Court for authority to appoint the FDIC as receiver and provide notice to the company.[31] The company may oppose the petition but the Court's role is limited to determining whether the company constitutes a "financial company" as defined by the statute and accurately has been found to be in default or in danger of default.[32] The Court cannot

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28 *See* § 203(c)(4).

29 *See* § 203(b).

30 *See* § 202(a)(1)(A)(i).

31 *Id.*

32 *See* § 202(a)(1)(A)(iii).

reject the petition unless it finds the government's actions to be "arbitrary and capricious".[33] If the Court disagrees with the Treasury's finding, the Treasury Secretary has the immediate opportunity to amend and refile the petition.[34] If the Court fails to rule within 24 hours, the petition is deemed granted.[35]

The company and the Treasury Secretary has the right to appeal a decision of the Court to the DC Circuit Court of Appeals within 30 days of the lower court's decision; the decision of the Court of Appeals may be appealed to the Supreme Court with 30 days of the Circuit Court decision.[36] In each case, the scope of appellate review is limited to the definition of the company as a financial company and whether the Treasury has acted arbitrarily and capriciously.[37]

Application of FDIC Receivership Powers

Both the Senate and House versions of this legislation would vest the FDIC with broad power to act as receiver by virtue of its experience in unwinding insured depository institutions. Upon the FDIC's appointment as receiver, all existing bankruptcy or other insolvency cases are dismissed and no further cases can be filed while the orderly liquidation is pending.[38] Company assets that have vested in another entity will revest in the company.[39] However, any order entered by a bankruptcy court prior to the appointment of the receiver will remain in effect.[40]

The FDIC's powers under the OLA mirror its existing receivership powers under the FDIA with certain modifications intended to address perceived differences between the mandatory liquidation of a company that implicates systemic risk, as opposed to a failed insured depository institution. The scheme reflects the legislative intent that value not be preserved for existing equity, management or unsecured creditors.[41]

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33 *See* § 202(a)(1)(A)(iv).

34 *Id.*

35 *See* § 202(a)(1)(A)(v).

36 *See* § 202(a)(2)

37 *Id.*

38 *See* § 208(a)

39 *See* § 208(b).

40 *See* § 208(c).

41 *See generally* § 204(a) and S. Rep. No. 111-176, at 4 (Upon being placed into receivership, "The financial company's business operations and assets will be sold off or liquidated, the culpable management of the company will be discharged, shareholders will have their investments wiped out, and unsecured creditors and counterparties will bear losses").

As receiver under the OLA, the FDIC succeeds to the rights, title, powers and privileges of the covered company and operates the entity in order to maximize net asset sale value.[42] Among other things, under the OLA the FDIC may engage in

- creating a bridge financial company to acquire the CFC's assets; [43]
- engaging in financing activities, including funding the liquidation and receiving priority in repayment (but excluding the power to take equity in a CFC or covered subsidiary)[44], and making additional payments to claimants that are needed to maximize value or limit losses (subject to their being recaptured if the OLF is depleted as discussed below);[45]
- appointing itself as receiver of subsidiaries (other than insured depository institutions, covered broker dealers, and insurance companies) of covered financial companies;[46]
- exercising subpoena powers;[47]
- utilizing private sector services to manage and dispose of assets;[48]
- terminating rights and claims of creditors (subject to the Act's priority of claims provisions);[49] and
- coordinating with appropriate foreign financial authorities regarding any covered financial company with assets/operations outside US.[50]

Avoidance/ Repudiation Power. The FDIC has the authority to avoid fraudulent and preferential transfers (with standards similar to those under the Bankruptcy Code; financial contracts enjoy similar carveouts), disaffirm or repudiate any burdensome contract or lease, and enforce any

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42 *See* § 210(a)(1)(A), (B).

43 *See* § 210(a)(1)(F).

44 *See* §§ 204(d), 206, 210(b).

45 *See* §§ 210(b)(3), 210(d)(4), 210(h)(5)(E).

46 *See* § 210(a)(1)(E).

47 *See* § 210(a)(1)(J).

48 *See* § 210(a)(1)(L).

49 *See* § 210(a)(1)(M). But the FDIC may fail to treat similarly situated creditors in a similar manner if such disparate treatment is deemed necessary to maximize value. *See* § 210(b)(4).

50 *See* § 210(a)(1)(N).

contract notwithstanding any provisions for termination, default , acceleration, or exercise of rights upon insolvency.[51]

Clawback of Senior Executive Compensation; Potential to be Banned from Financial Companies. Although directors are insulated from liability for consenting to the regime, the bill requires senior management to be removed[52] and causes repayment of their claims to be subordinated to the repayment of other creditors.[53] In addition, the FDIC as receiver also would have the power to recapture incentive and other compensation received two years prior to receivership from current or former senior executives or directors deemed substantially responsible for the company's failure.[54] In cases of fraud no time limit would apply.[55] Under extreme circumstances, the FDIC could seek to ban a senior executive from the industry.[56]

Stay Protection. Courts are precluded from taking action to restrain the FDIC as receiver and upon request of the FDIC courts must grant a 90-day stay of any judicial action in which the covered company is or becomes a party (45-days in the case of a bridge financial company that becomes a party to litigation as a result of its assets or assumption of liabilities of a seized company).[57]

Safe Harbor for Qualified Financial Contracts. With respect to qualified financial contracts ("**QFCs**"), counterparties are stayed from exercising termination, close out and netting rights for three business days (during which the FDIC may transfer its obligations to a bridge financial company).[58] "Walkaway" clauses (*i.e.,* clauses that cause the contract to be void following a termination due to insolvency) continue to be invalid.[59] With respect to financial contracts that are guaranteed by or otherwise receiving credit support from a seized company, the FDIC, as receiver, can enforce obligations of a primary obligor that ordinarily would be subject to termination upon the insolvency of its credit support provider under certain conditions.[60]These conditions include that the

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[51] *See* §§ 210(a)(11)-(12), 210(c). Other notable powers of the FDIC would include the ability to prevent enforcement of provisions in standstill and confidentiality agreements that limit any person's ability to acquire all or any part of the seized company, *see* § 210(p), and to prohibit the sale of CFC assets to certain malfeasors. *See* § 210(r).

[52] *See* §§ 204(a)(2), 206, 207.

[53] *See* § 210(b)(1).

[54] *See* § 210(s)(1).

[55] *Id.*

[56] *See* § 213.

[57] *See* §§ 210(a)(8), 210(e), 210(h)(6).

[58] *See* § 210(c)(10)(B)(i).

[59] *See* § 210(c)(8)(F).

[60] FDIC can take this action as a receiver of a seized company or its subsidiary (including a subsidiary insured depository institution). *See* § 210(c)(16).

guaranty and related assets and liabilities are transferred to a bridge financial company or other third party, within the same period of time as the FDIC is entitled to transfer the qualified financial contracts of the CFC, or the FDIC otherwise provides adequate protection with respect to the obligations.[61]

Proceedings Have Limited Duration. The term of the FDIC's receivership of a CFC would be limited to an initial period of 3 years that is subject to two 1-year extensions, to the extent necessary to continue pending litigation to resolve complex claims.[62]

Orderly Liquidation Fund

In an effort to fund the OLA, the Senate bill would create a segregated fund ("**OLF**") to be held at the Treasury.[63] The FDIC has authority to issue obligations to the Treasury to fund the OLA.[64] Monies may be borrowed only once the FDIC submits a plan for a CFC's orderly liquidation that is approved by the Treasury Secretary.[65] The Senate bill restricts the FDIC from incurring any obligation during the first 30 days of liquidation that would result in total obligations outstanding exceeding the sum of 10% of the total consolidated assets of the covered financial company.[66] Thereafter, the FDIC may become obligated for 90% of the fair value of the total consolidated assets of each covered financial company that are available for repayment.[67]

The Senate bill obligates the FDIC to charge risk-based assessments if necessary to repay obligations to Treasury within 5 years of issuance (absent an extension from Treasury in order to avoid serious adverse effect on the US financial system).[68] First, assessments must be imposed on those claimants who received excess payments from the FDIC (*i.e.,* the difference between (1) the aggregate value the claimant received from the FDIC and (2) the value the claimant was entitled to receive from FDIC solely from proceeds of liquidation of the covered financial company).[69] If amounts recovered from such claimants are insufficient to repay outstanding obligations to Treasury within 5 years, the FDIC can impose special assessments on financial companies with total

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61 *See* § 210(c)(16).

62 *See* § 202(d) (need for further extension must be certified by FDIC chairperson).

63 *See* § 210(n)(1).

64 *See* § 210(n)(5).

65 *See* § 210(n)(9).

66 *See* § 210(n)(6).

67 *Id.*

68 *See* § 210(o)(1)(B).

69 *See* § 210(o)(1)(D).

consolidated assets equal to at least $50 billion.[70] In imposing these special assessments, the FDIC must take into account various macro and microeconomic risk factors to avoid further jeopardizing US financial stability.[71]

The Senate bill expressly prohibits the use of taxpayer monies to prevent the liquidation of a financial company under the Act, and mandates that all expenses of liquidation be borne by the financial sector.[72]

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[70] *Id.*

[71] *See* § 210(o)(4).

[72] *See* § 214.