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FINANCIAL REGULATORY REFORMS UPDATE

Title II — Orderly Liquidation Authority

- **Creation of Orderly Liquidation Regime**. The Act creates a special orderly liquidation regime (the "Orderly Liquidation Regime") for the orderly dissolution of systemically important "financial companies," modeled on the currently-existing FDIA regime for the resolution of failed FDIC-insured depository institutions and administered by the FDIC as receiver.
- **Operation of the Regime**. Under the Act, a financial company can be taken out of the bankruptcy regime that would normally apply to it and placed into the Orderly Liquidation Regime upon certain determinations by the Treasury Secretary in consultation with the President. This can occur before a proceeding under the normal regime would have commenced or even after it has started.
- **Powers of the FDIC, as receiver.** The FDIC's powers as receiver under the Orderly Liquidation Regime are similar to the powers it has as receiver of an insured depository institution under the FDIA, with certain modifications intended to reduce differences between the FDIA and the Bankruptcy Code regime. Financial companies made subject to the Orderly Liquidation Regime must be liquidated. There is no option for rehabilitation or reorganization or for an FDIA-style conservatorship.
- **The Orderly Liquidation Fund.** An Orderly Liquidation Fund, which would be funded only after a financial company has been placed into the Orderly Liquidation Regime, is established to fund liquidations under such regime. The Orderly Liquidation Fund is to be funded with repayments to the FDIC with respect to the insolvent financial company, through assessments, and with borrowings from the Treasury (subject to specified limitations).

With a view to addressing "too big to fail," the Act creates a special Orderly Liquidation Regime (modeled on the FDIA regime for the resolution of FDIC-insured depository institutions) for the orderly dissolution of failing "financial companies" that pose a significant risk to the financial stability of the United States.

Relationship Between Normally Applicable Bankruptcy Regime and the Orderly Liquidation Regime

- According to the Act's legislative history, there is a presumption that most financial companies will continue to be resolved under the Bankruptcy Code or other normally applicable bankruptcy regime rather than under the Orderly Liquidation Regime. However, upon a financial company being made subject to the Orderly Liquidation Regime (which can occur before a financial company would have become subject to a proceeding under the

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Bankruptcy Code or other normal regime or even after such a proceeding has commenced), such resolution will cease to be conducted under the Bankruptcy Code or other normal regime and become subject to the Orderly Liquidation Regime instead. Consequently, in their dealings with financial companies that could become subject to the Orderly Liquidation Regime, counterparties need to consider the impact on their rights of both regimes, because either could apply. In addition, they need to take into account, as best as they can, that they may not know which of the two regimes will apply to a financial company, even after a proceeding under the normal regime has commenced with respect to such company.

Institutions Subject to the Orderly Liquidation Regime

- Only "financial companies" may be made subject to the Orderly Liquidation Regime. The Act defines a "financial company" as any company incorporated or organized under Federal or State law (*i.e.,* only U.S. institutions) that is:
  - a bank holding company, as defined in the BHCA;
  - a company that has been subjected to stricter prudential regulation by the Federal Reserve Board under the Act;
  - a company that is "predominantly engaged" in activities that are financial in nature or incidental thereto for purposes of the BHCA; or
  - any subsidiary of any of the foregoing that is "predominantly engaged" in activities that are financial in nature or incidental thereto for purposes of the BHCA (other than a subsidiary that is an insured depository institution or an insurance company).
- No company is considered "predominantly engaged" for purposes of the above tests unless at least 85% of its total consolidated revenues (including revenues derived from ownership or control of a depository institution) are derived from activities that are financial in nature or incidental thereto for purposes of the BHCA. The "predominantly engaged" requirement is intended to exclude non-financial companies from being subjected to the Orderly Liquidation Regime.
- "Government entities," Farm Credit System institutions, GSEs and Federal Home Loan Banks are also excluded from the Orderly Liquidation Regime.
- Insured depository institutions are not subject to the Orderly Liquidation Regime. Their resolution would continue to be conducted under the FDIA and other applicable law.

Triggering Process

- Liquidation proceedings are initiated when the FDIC and the Federal Reserve Board, on their own initiative or at the request of the Treasury Secretary, by two-thirds vote of their board members, make a written recommendation that such proceedings be commenced against the financial company. Where the financial company is a broker-dealer, or a financial company whose largest U.S. subsidiary (measured by assets) is a broker-dealer, the SEC and the Federal Reserve Board, on their own initiative or at the request of the Treasury Secretary, must make the recommendation by two-thirds vote. In the case of a financial company that is an insurance company, or whose largest U.S. subsidiary (measured by total assets) is an insurance company, the Director of the Federal Insurance Office and the Federal Reserve Board, on their own initiative or at the request of the Treasury Secretary, must make the determination, by two-thirds vote of the Federal Reserve Board and the affirmative approval of the Director of the Federal Insurance Office, in consultation with the FDIC.

- If such a recommendation is made for the Orderly Liquidation Regime to be triggered, the Treasury Secretary, in consultation with the President, must determine that:
  - the financial company is "in default or in danger of default"(meaning (1) a case has been, or likely will be, commenced with respect to the financial company under the Bankruptcy Code, (2) the financial company has incurred, or is likely to incur, losses that will deplete substantially all of its capital, (3) the assets of the financial company are, or are likely to be, less than its obligations to creditors or (4) the financial company is, or is likely to be, unable to pay its obligations in the normal course of its business);
  - the failure of the financial company and its resolution under applicable Federal or State law will have serious adverse effects on financial stability in the United States;
  - no viable private sector alternative is available;
  - any effects on claims or interests of creditors, counterparties and shareholders of the financial company and other market participants as a result of actions taken under the resolution authority are appropriate;
  - any action taken under the resolution authority will avoid or mitigate serious adverse effects on U.S. financial stability;
  - a Federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to the regulatory order; and
  - the company satisfies the definition of "financial company."
- The Treasury Secretary must then notify the financial company and the FDIC of such determination. If the board of directors of the financial company acquiesces or consents to the appointment of the FDIC as receiver, the Treasury Secretary must then appoint the FDIC as receiver.
- If the board of directors of the financial company does not so acquiesce or consent, the Treasury Secretary would need to petition the U.S. District Court for the District of Columbia ("DC District Court") for an order authorizing the appointment of the FDIC as a receiver. In such case, the DC District Court, on a confidential basis and without any public disclosure, must make a determination that the findings by the Treasury Secretary that the financial company (1) is "in default or in danger of default" and (2) satisfies the definition of "financial company" were not arbitrary and capricious. The financial company will be given notice of the DC District Court hearing and an opportunity to be heard. If the DC District Court makes such determination, it will issue an order authorizing the Treasury Secretary to appoint the FDIC as receiver. If the DC District Court does not make any determination within 24 hours following the Treasury Secretary's petition, the FDIC is automatically appointed receiver.
- The DC District Court's decision is appealable, on an expedited basis, to the U.S. Court of Appeals for the District of Columbia and then to the U.S. Supreme Court (which is given discretionary jurisdiction to review the Court of Appeals' decision). The issue of whether the Treasury Secretary properly determined failure of the financial company will have serious adverse effects on U.S. financial stability is not subject to review.

General Principles Applicable to Exercise of the Receivership Authority

- The FDIC is required to exercise the receivership powers in a manner that mitigates risk to the financial stability of the United States and minimizes "moral hazard" so that:
  - creditors and shareholders will bear the risk of losses of the financial company;
  - management responsible for the condition of the financial company will not be retained; and

  - all parties having responsibility for the financial condition of the financial company bear losses consistent with their responsibility.
- In addition:
  - all financial companies put into receivership under the Orderly Liquidation Regime must be liquidated and no taxpayer funds may be used to prevent the liquidation of any financial company;
  - all funds expended by the liquidation of a financial company under the Orderly Liquidation Regime are required to be recovered from the disposition of assets of such financial company or will be the responsibility of the financial sector through assessments; and
  - taxpayers must be protected from bearing any losses from the exercise of authority under the Orderly Liquidation Regime.

Time Limit on Receivership

- The maximum period of the receivership is three years, subject to two one-year extensions. Although the Orderly Liquidation Regime allows for the use of "bridge financial companies" for the purpose of liquidating a failed financial company, there is no option for rehabilitation or reorganization or for an FDIA-style conservatorship under which the FDIC can continue to run a failed financial company as a going concern.

Reducing Inconsistencies with the Bankruptcy Code

- Under the Act, the powers of a receiver of a financial company are similar to those the FDIC has under the FDIA as a receiver of an FDIC-insured depository institution. Such powers include a number of powers not accorded to a trustee-in-bankruptcy under the Bankruptcy Code, including:
  - subject to certain exceptions and limitations, the power to repudiate any contract (whether or not executory) which the FDIC determines to be burdensome (in which case, damages for repudiation are generally limited to actual direct compensatory damages determined as of the date of the appointment of the receiver);
  - the power to enforce contracts, notwithstanding *ipso facto* clauses in such contracts; and
  - the power to selectively transfer assets and liabilities of the failed institution without any approval, assignment or consent.
- In addition, as under the FDIA, there is a 90-day stay on the ability to declare a default under and accelerate most contracts.
- However, the Act attempts to reduce certain differences in the treatment of creditors under an FDIA-like receivership regime and the Bankruptcy Code:
  - *Claims Process/Maximum Liability of the Receiver to Claimants.* While the Act provides for a claims process similar to that contained in the FDIA, the maximum liability of the FDIC to claimants would generally be the amount the claimant would have received in a Chapter 7 liquidation.
  - *Preferential Transfers and Fraudulent Conveyances.* The FDIA does not provide the FDIC with the power to set aside preferential transfers as defined in the Bankruptcy Code. However, under the Act, the FDIC, as receiver of a failed financial company, is generally granted such power. The Act also adopts, with certain modifications, the Bankruptcy Code standard for fraudulent conveyances.
  - *Secured Claims.* The Act provides that legally enforceable security interests are protected to the extent of the fair market value of the collateral. Any claim in excess of such value is treated as an unsecured claim, the maximum amount of which is limited to what such creditor would have been entitled to receive if the financial

company had been liquidated under Chapter 7 of the Bankruptcy Code. The FDIC is able to prime a security interest to secure a loan to a bridge financial company, but it must provide the secured creditor with adequate protection.

- *Contingent Claims.* In contrast to the FDIC's view that contingent claims (such as those arising under guarantees or letters of credit) do not present provable claims under the FDIA, under the Act, the FDIC is authorized by rule or regulation to recognize such contingent claims in an amount equal to their estimated value as of the date of the appointment of the receiver.
- *Damages for Repudiation of a Debt Obligation.* The Act provides that damages for repudiation of a debt obligation may be no less than the amount lent, plus accrued interest, plus any accreted original issue discount. Such amount is determined as of the date of the appointment of the receiver, and, to the extent secured by property, the value of which is greater than the amount of the claim, through the date of repudiation.
- *Rights of Set-Off.* Like the Bankruptcy Code, the Act generally protects set-off rights, subject to certain exceptions and limitations, including limitations designed to allow the receiver to transfer liabilities to a bridge financial company or other third party.
- *Rule-Making.* The FDIC is required to issue rules and regulations that it considers necessary to implement the Orderly Liquidation Regime and to harmonize such rules and regulations, to the extent possible, with insolvency laws that would apply to the financial company if the Orderly Liquidation Regime did not apply.

Other Significant Features

- *Priority of U.S. Government and Certain Other Claims Over Unsecured General Creditors.* The Act provides a priority over unsecured general creditors (in the following order) to: certain post-receivership financings; claims for administrative expenses of the receivership; claims of the United States against the financial company; certain claims for wages, salaries and commissions; and certain contributions owed to employee benefit plans. Administrative expenses are broadly defined to include any obligation "necessary and appropriate to facilitate the smooth and orderly liquidation" of the financial company. Wages, salaries and commissions owed to senior executives and directors are expressly subordinated to amounts owed to unsecured general creditors. Creditors similarly situated are required to be treated in a similar manner, except in certain situations, such as where different treatment is necessary to maximize the value of assets of the financial company, continue operations necessary to implement a bridge financial company or maximize the present value return from, or minimize losses on, the sale of assets of the financial company (in which cases they are subject to being assessed for the cost of dissolving the financial company as described below under "Orderly Liquidation Fund").
- *Treatment of Subsidiaries of Financial Companies.* In any case in which the FDIC is appointed as receiver of a financial company under the Orderly Liquidation Regime, the FDIC may appoint itself as receiver for any subsidiary (other than an insured depository institution, an insurance company or a covered broker-dealer subsidiary) of the financial company that is organized under Federal or State law if the FDIC and the Treasury Secretary determine (1) the subsidiary is in default or in danger of default, (2) such action would mitigate serious adverse effects on financial stability or economic conditions of the United States and (3) such actions would facilitate the orderly liquidation of the financial company. In such case, the subsidiary will itself be considered a financial company subject to the Orderly Liquidation Regime and the FDIC will have all of the powers with respect to such subsidiary as it has with respect to a financial company subject to the Orderly Liquidation Regime.
- *Treatment of Covered Broker-Dealers.* If a broker-dealer that is a member of the Securities Investor Protection Corporation ("SIPC") is made subject to the Orderly Liquidation Regime, the FDIC will be appointed receiver and the SIPC will be appointed as trustee of the broker-dealer. In such case, the SIPC is generally authorized to exercise the powers provided under the Securities Investor Protection Act ("SIPA") for trustees. However,

qualified financial contracts will be handled under special provisions governing such contracts. The FDIC retains the power to create a bridge financial company and to transfer assets and liabilities of the broker-dealer to such company. All customer claims against the broker-dealer would be resolved in the same manner and amount as under the SIPA.

- *Treatment of Insurance Companies.* If an insurance company is a financial company, or a subsidiary or affiliate of a financial company, then the liquidation or rehabilitation of the insurance company, and any subsidiary or affiliate of such company that is an insurance company, is generally required to be conducted as provided under State law. However, notwithstanding this general rule, if within 60 days after a determination has been made to subject such entity to the Orderly Liquidation Regime the appropriate regulatory agency has not filed the appropriate judicial action in the appropriate State court to place such company into orderly liquidation under the laws and requirements of the State, the FDIC is given the authority to stand in the place of the appropriate regulatory agency and file the appropriate judicial action.
- *Treatment of Guaranteed Subsidiary and Affiliate Contracts.* The FDIC, as receiver of a financial company or of a subsidiary of a financial company (including an insured depository institution), is empowered to enforce contracts of subsidiaries or affiliates of the financial company, the obligations under which are guaranteed or otherwise supported by or linked to the financial company, notwithstanding any contractual right to cause the termination, liquidation or acceleration of such contracts based solely on the insolvency, financial condition or receivership of the financial company if such guarantee or other support and all related assets and liabilities are transferred to or assumed by a bridge financial company or third party within the transfer period applicable to such contract or the FDIC as receiver otherwise provides adequate protection with respect to such obligations.
- *Automatic Stay For Qualified Financial Contracts; Walk-away Clauses.* The Act includes safe harbor provisions for qualified financial contracts that are similar to those in the FDIA. Like the FDIA, the Act provides for a one business day automatic stay (reduced from three business days in the Senate Bill) on the close out netting of qualified financial contracts after the appointment of a receiver. There is no comparable stay in the Bankruptcy Code with respect to protected derivatives. Like the FDIA, the Act denies the enforceability against financial companies being resolved under the Orderly Liquidation Regime of "walk-away clauses" in qualified financial contracts. There is no analogous provision in the Bankruptcy Code. Clearing organizations are generally exempted from the stay with respect to the exercise of contractual rights that would not be unenforceable as "walk-away clauses."
- *Written Agreement Requirement.* The Act requires that for an agreement which tends to diminish or defeat the interest of the FDIC in an asset to be enforceable against the FDIC as receiver it must be:
    - in writing;
    - executed by an authorized officer or representative of the financial company or confirmed in the ordinary course of business by the financial company; and
    - an official record of the financial company since the time of its execution or the counterparty to the financial company must provide documentation, acceptable to the receiver, of such agreement and its authorized execution or confirmation by the financial company.

This is similar, though not identical, to the written agreement requirement in the FDIA.

Orderly Liquidation Fund

- The Act provides for the establishment of an orderly liquidation fund that would be available to the FDIC to carry out its authorities as receiver, including liquidating financial companies, paying administrative expenses and repaying the FDIC obligations described below. The Act eliminates a proposed provision in the House Bill that

called for prefunding the orderly liquidation fund with $150 billion from risk-based assessments on large financial institutions (*i.e.,* with $50 billion or more in assets) and large hedge funds (*i.e.,* with $10 billion or more in assets under management). Instead, under the Act, upon its appointment as receiver of a financial company, the FDIC is authorized to issue obligations to the Treasury Secretary to fund the orderly liquidation fund in an amount not to exceed, during the first 30 days after the receiver is appointed, 10% of the total consolidated assets of the financial company and, thereafter, 90% of the fair value of the total consolidated assets of the financial company available to repay the fund. No amounts may be provided by the Treasury Secretary to the FDIC under this authority unless a mandatory repayment plan is put into place which contains a schedule for repayment of such amounts and demonstrates that income to the FDIC from the liquidated assets of the financial company and assessments will be sufficient to repay such amounts within the period set forth in the schedule.

- To the extent needed to repay such FDIC obligations to the Treasury Secretary within 60 months (subject to extension if necessary to avoid serious adverse effects on the U.S. financial system), the FDIC must first impose assessments on any creditor that received more than it would have received in a liquidation under Chapter 7 of the Bankruptcy Code.
- If such amounts are insufficient to meet the repayment requirement specified above, the FDIC is required to impose risk-based assessments on bank holding companies with consolidated assets of $50 billion or more, nonbank financial companies supervised by the Federal Reserve Board and other financial companies with total assets of $50 billion or more. Assessments would be levied on a graduated basis, using a risk-matrix, with financial companies having greater assets and risks paying a higher assessment rate.
- The FDIC is authorized to claw back from any current or former senior executive or director substantially responsible for the failed condition of the financial company any compensation received during the two-year period prior to its appointment as receiver (with no time limit in the case of fraud).

Studies

- Although the Act does not contain a provision, similar to that contained in the House Bill, that would treat a portion of certain secured claims as unsecured claims, it provides for a study to be conducted to determine whether such treatment may be appropriate in certain cases. The Act also calls for a study by the Federal Reserve Board regarding the resolution of financial companies under the Bankruptcy Code (including the effectiveness of Chapter 7 of the Bankruptcy Code in facilitating the orderly liquidation or reorganization of systemic financial companies, whether amendments to the Bankruptcy Code should be made to enhance the ability of the Bankruptcy Code to resolve financial companies and whether amendments should be made to the Bankruptcy Code, the FDIA and other insolvency laws to address the manner in which qualified financial contracts are treated). The Federal Reserve Board is also directed to conduct a study regarding international coordination relating to the resolution of systemic financial companies under the Bankruptcy Code and applicable foreign law.

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