Dodd-Frank Act Creates Significant Changes in Bankruptcy Law Affecting Derivatives and Other Trading Counterparties

September 22, 2010

After months of negotiations and conferences among key legislators, President Obama signed into law a final version of regulatory reform legislation on July 21, 2010. More than 2,000 pages long, the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the Act) provides new legal guidelines for both "financial companies" and non-financial companies and instructs federal agencies to develop a myriad of regulations to enforce the concepts provided in the Act. The Act also addresses the ability of federal regulators to step-in if state regulators fail to take action in certain liquidation and rehabilitation scenarios. Among the many areas in which companies now face a new legal and regulatory landscape, the Act makes a handful of significant changes to existing bankruptcy law. The Act creates new statutes that will arise infrequently, but that will likely have a significant effect on the rights of creditors and counterparties on the occasions when they are triggered.

The new statutes will become relevant only when insolvency threatens certain companies that could impact U.S. financial markets or the stability of such markets. Although years will likely pass with no activity under the new statutes, traders should be prepared to encounter new and different insolvency regimes in the event that a major counterparty faces financial difficulties. As discussed below, there are two general areas of change to bankruptcy law under the Act: (a) enforceability of key contractual provisions, such as termination rights and setoff found in derivatives and other trading agreements; and (b) the handling of customer accounts in the event that the affected financial company is a commodity broker. In effect, the changes mean that certain bank holding companies and nonbank financial companies supervised by the Board of Governors of the Federal Reserve System (the Board)[1] and many of their subsidiaries will be subject to an insolvency regime akin to the Federal Deposit Insurance Act's treatment of banks, including the imposition of FDIC receivership.

■ ■ ■

Title II of the Act provides for a new system of liquidating systemically important nonbank "financial companies" that are in danger of default. Section 201(a)(11) of the Act defines a financial company as a company that is incorporated or organized under any provision of State or Federal law and is (i) a bank holding company as defined under the Bank Holding Company Act of 1956, (ii) a nonbank financial company supervised by the Board, (iii) a company that is predominantly engaged in activities determined by the Board to be financial in nature or incidental thereto (which would include, among other companies, insurance companies, brokers or dealers, and investment advisers), or (iv) a subsidiary of such companies that is predominantly engaged in activities that the Board has determined are financial in

---

[1] The definition of a "nonbank financial company" under Section 102 of the Act is broad and includes a U.S. or foreign company that is "predominantly engaged in financial activities" in the U.S. and specifically excludes, among others, a company treated as a bank holding company, a Farm Credit System institution under and subject to the provisions of the Farm Credit Act of 1971, as amended, a national securities exchange, clearing agency, security-based swap, or a board of trade designated as a contract market. For a more in-depth discussion of these definitions, please click here.

nature or incidental thereto (other than a subsidiary that is an insurance company or an insured depository institution).[2]

For purposes of determining whether a company is predominantly engaged in financial activities, Section 201(b) of the Act establishes an 85% test. Under the test, no company will be deemed to be engaged in activities that the Board has determined to be financial in nature or incidental thereto unless the consolidated revenues of the company from such activities constitute 85% of the total consolidated revenues of the company, including consolidated revenues derived from the ownership or control of a depository institution. The Federal Deposit Insurance Corporation (the FDIC), in consultation with the Secretary of the Department of The Treasury (Treasury Secretary), is required to promulgate regulations to effect the calculation of consolidated revenues.

Upon a determination by the appropriate federal regulators that the financial company is in default or in danger of default, a financial company may become subject to FDIC receivership. The recommendation of FDIC receivership must contain among other findings, (1) an evaluation of whether the financial company is in default or in danger of default, (2) a description of the effect of a default on financial stability in the United States, (3) a description of the effect that the default would have on economic conditions or financial stability for low income, minority, or underserved communities, (4) a recommendation of actions to be taken, and (5) an evaluation of why a case under the Bankruptcy Code is not appropriate.

Next, the Treasury Secretary, after consultation with the President, must reach a number of conclusions, including that (1) the financial company is in default or in danger of default, (2) the financial company's failure and its resolution under otherwise applicable federal or state law would have serious adverse effects on financial stability in the United States, (3) no viable private sector alternative is available to prevent default, and (4) any action taken under the resolution authority would avoid or mitigate those adverse effects. Upon such determinations, the Treasury Secretary is required to notify the FDIC and the financial company. If the financial company acquiesces or consents to the appointment of the FDIC as receiver, the Treasury Secretary is authorized by Section 202 to so appoint the FDIC.[3] If the financial company does not acquiesce or consent to the appointment of the FDIC as receiver, the Treasury Secretary is required to file a petition under seal to the United States District Court for the District of Columbia (the District Court) for an order authorizing the appointment of the FDIC as receiver. If the District Court finds that the Treasury Secretary's ruling is not arbitrary and capricious, the District Court will issue an order authorizing the Treasury Secretary to appoint the FDIC as receiver and instruct the FDIC to proceed with the Orderly Liquidation Authority.

The Orderly Liquidation Authority operates under principles drawn from the receivership provisions of the FDI Act that govern receiverships of insured depository institutions. This receivership model varies from the model under the Bankruptcy Code in several ways, and one significant variation can be found under Section 210(b)(8)(F) of the Act.

[2] Note that the definition of "financial company" under Section 201(a)(11) specifically excludes a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971, as amended, a governmental entity, or a regulated entity, as defined under Section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.

[3] Section 207 of the Act provides that members of the board of directors of a financial company will not be liable to shareholders or creditors of the financial company if they acquiesce or consent in good faith to the appointment of the FDIC as receiver.

As a general rule (and subject to the more stringent rules below), Section 210 provides that no person will be stayed or prohibited from exercising:

1. any right that such person has to cause the termination, liquidation, or acceleration of any qualified financial contract with a covered financial company which arises upon the date of appointment of the FDIC as receiver for such covered financial company at any time after such appointment;

2. any right under any security agreement or arrangement or other credit enhancement related to one or more qualified financial contracts described in clause 1 above; or

3. any right to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with one or more contracts or agreements described in clause 1, including any master agreement for such contracts or agreements.

Section 210(b)(8)(F) provides that notwithstanding the concepts described above, no "walkaway clause" will be enforceable in a "qualified financial contract" of a "covered financial company" in default. In effect, Section 210(b)(8)(F) would invalidate one-way termination clauses or use of the First Method under an ISDA Master Agreement. A "walkaway clause" is any provision in a qualified financial contract that suspends, conditions, or extinguishes a payment obligation of a party, in whole or in part, or does not create a payment obligation of a party that would otherwise exist, solely because of the status of such party as a nondefaulting party in connection with the insolvency of a covered financial company that is a party to the contract or the appointment of or the exercise of rights or powers by the FDIC as receiver for such covered financial company, and not as a result of the exercise by a party of any right to offset, setoff, or net obligations that exist under the contract, any other contract between those parties, or applicable law. A "qualified financial contract" is any securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, and any similar agreement that the FDIC determines by regulation, resolution, or order to be a qualified financial contract. In essence, a "qualified financial contract" is the equivalent of an agreement that would likely be protected by the safe harbor provisions in the Bankruptcy Code.

In addition, for any "qualified financial contract" subject to Section 210(b)(8)(F), there will be a limited suspension of payment and delivery obligations. For any "qualified financial contract" that grants a person the right to cause the termination, liquidation, or acceleration of any "qualified financial contract," all payment and delivery obligations arising under the "qualified financial contract" will be suspended from the time at which the FDIC is appointed as receiver until the earlier of the time at which such party receives notice that such contract has been transferred to another financial institution or 5:00 p.m. (eastern time) on the business day following the date of appointment of the FDIC as receiver.

Finally, despite the general guarantee of contractual termination and setoff rights, the Act includes significant limitations on those rights. Section 210(c)(10)(B) prohibits the exercise of termination, liquidation or setoff rights triggered by the debtor's bankruptcy or financial condition (i) until after 5:00 p.m. (eastern time) on the business day following the FDIC's appointment, and (ii) after the counterparty receives notice of the transfer of its contract. As a result, the counterparty faces the prospect of severely curtailed rights of termination and setoff.

■ ■ ■

If the financial company is a commodity broker, then the FDIC will remain as receiver but will be required to apply the commodity broker provisions of Subchapter IV of Chapter 7 of the Bankruptcy Code. Generally, that subchapter generally facilitates the transfer of customer accounts to a new, solvent broker. If customer accounts are identifiable, then the FDIC must heed a customer's request to return the property or transfer the accounts to a new commodity broker. If the customer's property cannot be identified or transferred, then the contract is liquidated. If a customer is owed money after the return or transfer of property or the liquidation of the contract, then it is entitled to a ratable distribution at a higher priority than that given to non-customer claims.

Under the Act, Subchapter IV undergoes certain changes to render it consistent with other changes to the treatment of derivatives under the Act. For example, the Act requires many types of swaps to be cleared, but historically, a swap agreement was not necessarily within the scope of the commodity broker provisions. Section 724 of the Act therefore provides that a swap agreement that is cleared by a derivatives clearing organization qualifies as a "commodity contract." That change, therefore, serves to ensure that, in the event of a bankruptcy by the commodity broker, the swap customer is entitled to the protections provided in Subchapter IV of Chapter 7 – namely, the return or transfer of property or the liquidation of the contract, as discussed above.

■ ■ ■

As outlined above, the Act creates a handful of relatively significant changes to existing bankruptcy law. Market participants must understand that provisions in their trading contracts may face considerably different treatment if a counterparty becomes subject to the Orderly Liquidation Authority than if it simply becomes a debtor under the Bankruptcy Code. Because there is some lack of clarity in the intended breadth of the term "financial company" – and some discretion afforded to governmental officials – market participants are left with a disturbing level of uncertainty with regard to their contractual rights. Unfortunately, the very contractual rights that are implicated are some of the more effective risk-management tools available to traders.

On the other hand, the commodity broker provisions under the Act should serve to aid traders in their risk management efforts. By extending Subchapter IV of Chapter 7 of the Bankruptcy Code to cleared swaps, the Act simply ensures like treatment of all cleared financial products.

Nevertheless, the Act creates a powerful regulatory authority and leaves a number of key questions unanswered. With a few exceptions, the amount of judicial oversight of the Orderly Liquidation Authority is limited. Finally, as discussed above, the rights of creditors and other counterparties appear to be curtailed significantly compared to their treatment in a similar proceeding under the Bankruptcy Code. As a result, market participants may want to remain wary of the new regime created under the Act, and not to rely too heavily on their contractual safeguards.

■ ■ ■

If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

Paul B. Turner	713.470.6105	paul.turner@sutherland.com
Annette L. Tripp	713.470.6133	annette.tripp@sutherland.com

James M. Cain	202.383.0180	james.cain@sutherland.com
Warren N. Davis	202.383.0133	warren.davis@sutherland.com
B. Knox Dobbins	404.853.8053	knox.dobbins@sutherland.com
Jacob Dweck	202.383.0775	jacob.dweck@sutherland.com
William H. Hope II	404.853.8103	william.hope@sutherland.com
Richard G. Murphy, Jr.	202.383.0635	rick.murphy@sutherland.com
Mark D. Sherrill	202.383.0360	mark.sherrill@sutherland.com
Xavier D. Jordan	713.470.6186	xavier.jordan@sutherland.com