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Dodd-Frank, Title II: Where the FDIC and the "Orderly Liquidation Authority" Meet the Bankruptcy Code

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The FDIC is currently responding to one of the worst financial crises in the history of the nation's banking system. Sheila Bair, Chairman of the FDIC, expects that 2010 "will be the high water mark for the banking crisis."[1] Just over the last two years, 268 banks have failed in the United States, which is nearly ten times the number of failed banks during the prior eight-year period.[2]

Against this backdrop, the FDIC hoped to find "a credible resolution mechanism that provide[d] the authority to liquidate large and complex financial institutions in an orderly way."[3] The government needed the power to address companies considered "too big to fail." Otherwise, markets would rely on future government bailouts.[4] Equally critical, according to Chairman Bair, was the enforcement of market discipline by making clear that shareholders and creditors bear their respective risks.[5]

The result, signed into law by President Obama on July 21, 2010, is Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The Act establishes an "orderly liquidation authority" (the "OLA"), a new regime—separate from federal bankruptcy and state dissolution laws—through which a covered financial company ("CFC")[6] such as a bank holding company,[7] whose failure threatens to have serious adverse effects on the financial stability of the United States,[8] can be seized and liquidated by the FDIC. The OLA is effective immediately, although it imposes various rulemaking requirements on at least five governmental agencies, in addition to several commissioned studies, as discussed below.

Given its intended purpose, it is no surprise that the broad powers granted to the FDIC as receiver parallel both the FDIC's existing powers over failed insured depository institutions under the Federal Deposit Insurance Act ("FDIA") and those granted to a trustee or debtor-in-possession under the U.S. Bankruptcy Code (the "Code"). An understanding of the

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[1] *Bank Failures to Peak in Third Quarter, Bair Says*, Alexandra Zenrian, July 30, 2010, http://www.forbes.com/2010/07/30/bair-commercial-real-estate-intelligent-investing-fdic.html?boxes=Homepagelighttop.

[2] *See* http://www.fdic.gov/bank/individual/failed/banklist.html. Only 27 banks failed during the entire period between October 1, 2000 and January 1, 2008.

[3] *Bank Failures to Peak in Third Quarter, Bair Says*, Alexandra Zenrian, July 30, 2010, http://www.forbes.com/2010/07/30/bair-commercial-real-estate-intelligent-investing-fdic.html?boxes=Homepagelighttop.

[4] *Don't Be Fooled by Idea of Bank Bailouts*, Steve Forbes, July 30, 2010, http://www.forbes.com/2010/07/30/bair-bailout-bank-intelligent-investing-fdic.html (noting explicit prohibitions on providing government assistance to an open institution)(". . . if these large institutions get into trouble, there will be two options, bankruptcy or this special resolution process.").

[5] *See id.* ("So if we do our job right, there really shouldn't be any significant losses because, again, the unsecured creditors and shareholders will be exposed for complete loss and even secured creditors will be protected only to the extent they have good collateral."); *see also* § 204(a)(1) (creditors and shareholders will bear the losses of the financial company as a result of promoting OLA's authority and purpose).

[6] § 201(a)(8).

[7] *See* § 201(a)(8)(B)(definition of "covered financial company" does not include an insured depository institution).

[8] *See* § 203(b)(noting criteria to be considered by the Secretary of the Treasury as part of its systemic risk determination).

OLA's framework as well as its similarities to the Code provides a useful means of anticipating how regulators may implement the OLA and what risks entities may assume by negotiating with a company whose failure could potentially be deemed a "systemic risk."[9]

THE OLA'S FRAMEWORK

An entity must be a "financial company" to be covered by the OLA. Under the OLA, a financial company is an entity incorporated or organized under any provision of federal or state law and is:

i. a bank holding company;[10]

ii. a nonbank financial company supervised by the Board of Governors of the Federal Reserve System (the "FRB"). These are financial companies that the new Financial Stability Oversight Council has concluded shall be supervised by the FRB and shall be subject to prudential standards;

iii. any company that is predominately engaged in activities (*i.e.,* equaling at least 85% of total consolidated revenues) that the FRB has determined are financial in nature or incidental thereto;[11] or

iv. any subsidiary of the above that is predominately engaged in activities that the FRB has determined are financial in nature or incidental thereto.

Certain Farm Credit System institutions, governmental entities, and regulated entities are excluded from the term "financial company." The Act provides special treatment for broker-dealers and insurance companies, as discussed below.

"Systemic Risk"

There is a multi-step process for initiating the OLA. To start, the FDIC and the FRB must recommend, either on their own initiative or at the request of the Secretary of the Treasury (the "Secretary"), the appointment of the FDIC as a receiver of a financial company.[12] The recommendation to appoint a receiver must be approved by at least 2/3 of the then serving members of the FRB and 2/3 of the then serving members of the FDIC board of directors. The recommendation must address:

i. whether the financial company is in default or in danger of default;

ii. the effect the default would have on the financial stability of the United States;

iii. the effect the default would have on the financial stability and economic conditions for low income, minority, or underserved communities;

iv. recommendations for actions to be taken under the OLA;

v. the likelihood of private sector alternatives to prevent the default;

[9] *See* § 203 (describing mechanics of systemic risk determination).
[10] The term "bank holding company" as used in § 202(a)(11)(B)(i) refers to section 2(a) of the Bank Holding Company Act of 1956 (the "BHCA").
[11] The term "financial in nature" as used in this Section is defined in section 4(k) of the BHCA.
[12] § 203(a)(1)(a).

vi. why a bankruptcy filing is not appropriate;

vii. the effects of the receivership on the company's creditors, counterparties, shareholders and other market participants; and

viii. whether the company satisfies the definition of a financial company.[13]

Next, based on the written recommendation of the FRB and FDIC described above, the Secretary, in consultation with the President, must conclude whether the FDIC should be appointed as receiver for the financial company. The Secretary must determine that:

i. the financial company is in default or in danger of default;

ii. the failure of the financial company would have serious adverse effects on the financial stability of the United States;

iii. no viable private sector alternative is available to prevent the default;

iv. any effect on the claims or interests of creditors, counterparties, and shareholders of the financial company and other market participants of proceedings under the OLA is appropriate, given the impact that any action under the OLA would have on the financial stability of the United States;

v. an orderly liquidation under the OLA would avoid or mitigate such adverse effects;

vi. 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

vii. the company satisfies the definition of a "financial company."[14]

The OLA provides that a financial company is in default or in danger of default if any of the following have occurred:

i. a bankruptcy case has been, or likely will promptly be, commenced with respect to the financial company; or

ii. the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion; or

iii. the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or

iv. the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the ordinary course of business.[15]

As noted, a financial company that has commenced a bankruptcy case under the Code automatically satisfies the "default" requirement. However, a financial company in bankruptcy nevertheless remains eligible for an FDIC receivership and liquidation under the OLA.

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[13] § 203(a)(2).
[14] § 203(b).
[15] § 203(c)(4).

Appointing the FDIC as Receiver

The OLA contemplates a rapid process for the appointment of the FDIC as receiver for a CFC. Once the Secretary has made its determinations, a financial company is deemed a CFC under the OLA and the Secretary must notify the board of the CFC and the FDIC of its determination.

At that point, the board of the CFC can consent or acquiesce to the appointment of the FDIC as receiver, in which event the Secretary will appoint the FDIC as receiver. This process does not require a court filing. The CFC's board members will not be liable to shareholders or creditors for consenting or acquiescing in "good faith" to the appointment of the FDIC as receiver, although the OLA does not protect the board members from liability relating to any other actions.

If the board of the CFC does not consent to the appointment of the FDIC as receiver, the Secretary must file a petition under seal in the United States District Court for the District of Columbia (the "Court") seeking an order appointing the FDIC as receiver. The CFC will receive notice of the filing and is entitled to oppose the petition.

If a petition is filed, the Court must hold a hearing on a strictly confidential basis to determine whether certain determinations by the Secretary were arbitrary and capricious. Specifically, the Court must review the Secretary's determinations that the CFC (i) is in default or in danger of default; and (ii) satisfies the definitional requirements of a financial company under section 201 of the Act. None of the other determinations made by the Secretary are subject to review by this court process.

If the Court finds the Secretary's determinations on these two issues were not arbitrary and capricious, it must enter an order immediately authorizing the Secretary to appoint the FDIC as receiver. If the Court concludes that the Secretary's determinations were arbitrary and capricious, it must immediately issue a written statement to the Secretary setting forth its reasons, at which point the Secretary has an opportunity to amend and refile the petition. If the Court does not make a determination within 24 hours of its receipt of the petition, the petition will be granted by operation of law, the Secretary is to appoint the FDIC as receiver, and the liquidation of the CFC under the OLA will automatically commence.

Both the Secretary and the CFC have 30 days to appeal the Court's decision to the United States Court of Appeals for the District of Columbia, and then to the Supreme Court, in each case on an expedited basis. Nevertheless, the Court's decision "shall not be subject to any stay or injunction pending appeal."[16] In many cases, once the FDIC is appointed as receiver, the liquidation is likely to be well under way by the time the appellate court renders a decision. Appellate review is limited to whether the Secretary's two determinations described above were arbitrary and capricious.

The appointment of the FDIC as receiver under the OLA terminates three years after the date the appointment is made.[17] The three-year limit may be extended by the FDIC for one additional year if the Chairperson of the FDIC determines and certifies in writing that continuation of the receivership is necessary to (i) maximize the net present value return from the sale of assets and/or minimize losses in connection with the sale of assets; and (ii) protect the stability of the U.S. financial system. The receivership may be extended for one additional year upon the Chairperson of the FDIC issuing the same certification.[18] The receivership also may be extended for the sole purpose of completing ongoing litigation to which the FDIC as receiver is a party.

[16] § 202(a)(B).
[17] § 202(d)(1).
[18] *See* § 202(d).

If a financial company does not become a CFC as described above, then it will not be subject to the OLA process. Instead, the financial company is subject to bankruptcy proceedings under the Code and applicable insolvency law.

Application to Broker-Dealers

In the case of a financial company that is a broker or dealer, or if the largest U.S. subsidiary of a financial company is a broker or dealer, the SEC and the FRB (by a vote of at least 2/3 of the then-serving members of each), in consultation with the FDIC, are responsible for making the written recommendation to the Secretary regarding the appointment of the FDIC as receiver.[19] If the FDIC is appointed as receiver for any covered broker or dealer as described above, the FDIC must appoint the Securities Investor Protection Corporation (the "SIPC") as trustee for the liquidation. No court approval is necessary for this appointment. As trustee, the SIPC must promptly file an application for a protective decree under the Securities Investor Protection Act (the "SIPA"). Once the protective decree is obtained, the determination of claims and the liquidation of assets that are not transferred to a bridge financial company (discussed in more detail below) generally will be administered under SIPA by the SIPC, as trustee.[20] There are some nuances. For example, qualified financial contracts will be administered as required by Section 210 of the Act rather than the SIPA.

Application to Insurance Companies

In the case of a financial company that is an insurance company, or if the largest U.S. subsidiary of a financial company is an insurance company, the Director of the Federal Insurance Office and the FRB, in consultation with the FDIC, are responsible for making the written recommendation to the Secretary regarding an action to address the concerns regarding the insurance company.[21] The recommendation requires a 2/3 vote of the then-serving members of the FRB and the affirmative approval of the Director of the Federal Insurance Office. If an insurance company is a financial company, or a subsidiary or affiliate of a financial company, its liquidation or rehabilitation and that of its subsidiaries or affiliates must be conducted under applicable state law. If the state insurance regulatory authority does not commence an appropriate state court judicial action within 60 days of the required determination, the FDIC is authorized to stand in the place of the state insurance regulatory authority and initiate the judicial action in the appropriate state court. The state law process does not apply to any subsidiary or affiliate of an insurance company that is not itself an insurance company.[22] Accordingly, insurance holding companies are fully eligible for liquidation under the OLA.

Pending Cases

Once the FDIC is appointed as receiver for the CFC, any pending case proceeding under the Code or the SIPA will be dismissed upon notice to the bankruptcy court or SIPC, as applicable. No such case may be filed while the OLA is under way. Any order issued by a bankruptcy court before the date of the FDIC's appointment as receiver continues with the same validity as if no OLA proceeding had been commenced.

Mandatory Terms and Conditions

The OLA requires the FDIC to ensure that (i) its actions are necessary for the financial stability of the United States, and not to preserve the CFC; (ii) the shareholders of a CFC do not receive payment until after all other claims and a fund

[19] § 203(a)(1)(B).
[20] § 205(a)(2) (B).
[21] § 203(a)(1)(C).
[22] § 203(e).

established by the Act are paid;[23] (iii) the CFC's unsecured creditors bear losses in accordance with the priority of claims provisions of Section 210 of the Act; (iv) the CFC's management and members of its board of directors are removed;[24] and (v) the FDIC does not take an equity interest in or become a shareholder of the CFC or any covered subsidiary.

FDIC RECEIVER POWERS

The Act grants the FDIC broad receivership power, utilizing many of the same concepts found in the FDIA. Among the OLA's FDIA and Code-derived powers include the FDIC's ability to:

- succeed to all rights, titles, powers, and privileges of the CFC and its assets, as well as title to the books, records, and assets of such CFC;[25]
- take over the assets of and operate the CFC;[26]
- collect and pay obligations in the name of the CFC;[27]
- appoint itself as receiver for any covered subsidiary of the CFC that itself is in default or in danger of default;
- liquidate and wind-up the affairs of the CFC, including selling its assets;[28]
- determine and resolve claims;[29]
- avoid fraudulent and preferential transfers of any interest in property of, or obligation incurred by, the CFC, as well as post-receivership transactions (collectively, "Avoidance Actions");[30]
- repudiate, disaffirm, or assign contracts entered into by the CFC prior to appointment of the FDIC as receiver;[31] and
- invalidate agreements that tend to diminish or defeat the interests of the FDIC as receiver in any asset acquired in the receivership unless the agreement meets certain standards. This is comparable to Section 13(e) of the FDIA and is derived from the *D'Oench, Duhme* doctrine.

The Act also incorporates various Code provisions addressing the priority of expenses and unsecured claims,[32] defenses to Avoidance Actions,[33] suspension of legal actions for a period not to exceed 90 days after the appointment of the FDIC as receiver,[34] and termination, liquidation, and netting rights of counterparties to qualified financial contracts ("QFC's").[35]

Under the OLA, a person who is a party to a QFC with a CFC may not exercise any right that such person has to terminate, liquidate, or net such contract solely by reason of or incidental to the appointment of the FDIC as receiver until

[23] § 206(2).
[24] § 206(4)-(5).
[25] *See* § 210(a)(1)(A)(i)-(ii); *compare with* 11 U.S.C. §§ 541, 1107.
[26] *See* § 210(a)(1)(B)(i); *compare with* 11 U.S.C. §§ 541,1108, 363.
[27] *See* § 210(a)(1)(B)(ii); *compare with* 11 U.S.C. § 704(a).
[28] *See* § 210(a)(1)(D); *compare with* 11 U.S.C. §§ 704(a), 363(a).
[29] *See* § 210(a)(2); *compare with* 11 U.S.C. §§ 704(a)(5), 502(a)-(b).
[30] *See* § 210(a)(11)(A)-(C); *compare with* 11 U.S.C. § 547, 548.
[31] *See* § 210(c)(1); 210(c)(6)(C); *compare with* 11 U.S.C. § 365(a).
[32] *See* § 210(b)(1); *compare with* 11 U.S.C. § 507.
[33] *See* § 210(a)(11)(F); *compare with* 11 U.S.C. §§ 546, 547, 548, and, 549.
[34] *See* § 210(a)(8); *compare with* 11 U.S.C. § 362(a).
[35] *See* § 210(c)(10)(B)(i)(A "qualified financial contract" includes a "securities contract," "commodity contract," "forward contract," "repurchase agreement," "swap agreement," and any similar agreement that the FDIC determines by regulation, resolution, or order."). *See id.* § 210(c)(8)(D); *compare with* 11 U.S.C. §§ 362(b)(6) and 362(b)(7) (providing an exception to the automatic stay for the exercise of certain contractual rights by certain non-debtor counterparties to a commodity contract, forward contract or securities contract, and repurchase agreement).

either one business day post-appointment, or after the person has received notice that the QFC has been transferred to another financial institution (including a bridge financial company, as described below), whichever is earlier. Under the OLA, any "ipso facto" clause (*i.e.,* a provision that purports to authorize a counterparty to terminate or accelerate performance on a contract solely by reason of the FDIC's appointment as receiver or the insolvency of the institution) contained in a QFC is deemed an unenforceable "walkaway" clause.[36] Certain other rights under QFC's are not stayed or prohibited by reason of the establishment of the FDIC's receivership.

In addition to its FDIA and Code-derived powers, the FDIC maintains subpoena powers[37] and the ability to terminate the rights and claims of creditors, all the while ensuring that shareholders and unsecured creditors bear losses, consistent with the priority of expenses provisions.[38]

Bridge Financial Companies

The FDIC has the power to create a "bridge financial company" ("BFC") to acquire the assets and liabilities of the CFC,[39] either as receiver or in anticipation of its appointment as receiver.[40] A BFC can be created without creditor consent or court approval.[41] The FDIC appoints a board of directors to manage the BFC.[42] The BFC may operate without any capital or surplus, or with such capital that the FDIC deems appropriate. The FDIC has no obligation to capitalize the BFC or issue stock on its behalf.[43] The BFC will continue to perform as such until the stock of the BFC is sold, the BFC is merged or consolidated with another company, the assets and liabilities of the BFC are transferred to another company, the BFC reaches its maximum two-year life span (which can be extended by up to three additional one-year periods), or the BFC is dissolved.

Orderly Liquidation Plan

The OLA creates the Orderly Liquidation Fund (the "OLF") as a separate fund in the Treasury, which is available to the FDIC to carry out its powers under the OLA. Amounts received by the FDIC shall be deposited into the OLF.[44] The FDIC, as receiver for a CFC, may not use any of its allotted funding unless and until it has submitted an orderly liquidation plan ("OLP") for the CFC that is acceptable to the Secretary. The FDIC and the Secretary must reach an agreement that provides for a specific plan and schedule for the repayment of borrowings from Treasury.[45] The OLF is funded, among other sources, through risk-based assessments on "eligible financial companies," which includes bank holding companies with assets of $50 billion or more and any nonbank financial company supervised by the FRB. Taxpayer funds are not to be used to prevent the liquidation of any financial company under the Act.

Effectiveness, Rulemaking, and Future Studies

The OLA is effective immediately, although it imposes various rulemaking requirements on a number of agencies, including the FDIC, FRB, SIPC, the Secretary, SEC, Administrative Office of the United States Courts, and U.S.

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36 *See* § 210(c)(8)(F).
37 § 210(a)(1)(J).
38 § 210(a)(2) and § 210(a)(1)(M).
39 § 210(a)(1)(F).
40 § 210(h).
41 § 210(h)(2)(E)(ii).
42 § 210(h)(2)(B).
43 § 210(h)(2)(G).
44 *See* §210(n)(1).
45 *See* §210(n)(9).

Government Accountability Office. The OLA also commissions various studies on selected topics, including: (i) "secured creditor haircuts" (*i.e.,* evaluating whether a haircut on secured creditors "could improve market discipline and protect taxpayers," including recommendations for implementation);[46] (ii) the bankruptcy process for the resolution of financial companies under the Code;[47] (iii) international coordination relating to the orderly resolution of systemic financial companies under the Code and applicable foreign law;[48] (iv) separate studies regarding the bankruptcy and orderly liquidation process for financial companies under the Code; (v) a separate study regarding international cooperation relating to the orderly liquidation of financial companies under the Code; and (vi) a study of the implementation of prompt corrective action by the appropriate federal banking agencies. Among the issues to be studied under (ii) include the effectiveness of chapter 7 and chapter 11 of the Code in facilitating the orderly resolution or reorganization of systemic financial companies, and whether amendments to the Code should be adopted to enhance the ability of the Code to resolve financial companies in a manner that minimizes adverse impacts on financial markets without creating "moral hazard."[49]

THE OLA'S UNANSWERED QUESTIONS

The OLA was enacted to restore public confidence, discourage bailouts, ensure the appropriate apportionment of risk to shareholders and creditors, provide for a swift, cost-efficient liquidation mechanism for CFC's, and establish a funding mechanism for the OLF. In keeping with these goals, the OLA was also designed to preserve many of the debtor-in-possession/trustee powers and creditors' rights contained in the Code. But despite the OLA's incorporation of time-tested Code provisions, there are still many unanswered questions regarding when and how the OLA will be used (particularly for nonbank financial companies), and to what extent creditors may enjoy the same protections as they would under the Code.

As a general matter, a financial company's creditors or business counterparties should be mindful that the OLA, once initiated, will preempt a bankruptcy case under the Code, terminating any prospect of the financial company's reorganization.[50] Based on the OLA's limited and expedited judicial review mechanism, parties transacting business with a financial company should assume that any FDIC receivership appointment will stand, despite the due process protections provided to the affected company to oppose such an appointment. Subject to the exceptions for broker dealers and insurance companies discussed above, creditors should also expect that the OLA will supplant the Code.

But will the application of the OLA's Code-similar provisions result in similar treatment to unsecured creditors? For example, under the OLA's priority of expenses provision, any administrative expenses of the FDIC come before any other unsecured claims. This is unlike the priority scheme under the Code, which has been applied in certain circumstances to treat claims by the FDIC as ninth priority claims, well below the status of an administrative claim.[51] Similar to the Code, however, the OLA includes a priority for amounts owed to the United States (after administrative claims of the FDIC) over the claims of general creditors, unless the United States otherwise agrees or consents.

Until July 21, 2011 when the OLA's commissioned studies are due, it will remain unclear to what extent secured creditors'

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[46] *See* § 215(a).
[47] *See* § 216(a).
[48] *See* § 217(a).
[49] *See* § 216(a)(2).
[50] Financial companies that are insurance companies may be able to reorganize under State law. *See* § 203(e).
[51] *See, e.g., Wolfkowitz v. FDIC (In re Imperial Credit Indus., Inc.)*, 527 F.3d 959 (9th Cir. 2008) (holding that any allowable claim by the FDIC would be an unsecured priority claim under Code section 507(a)(9) and would not be treated as an administrative expense claim under claim Code section 507(a)(2)).

rights may be affected based on the results of the "secured creditors haircut" study, or how the bankruptcy process study may inform the FDIC's application of the OLA. Based on the similarities between the OLA and the Code, it seems possible that amendments to the Code may be proposed as a means of addressing CFC's without the need to utilize all the provisions of the OLA, so long as those amendments are deemed to minimize adverse impacts on financial markets without creating "moral hazard." If such amendments are ultimately adopted, how will this affect the future implementation of the OLA?

It will be critical for creditors and debtors alike to monitor these, and other related developments.

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