

Corporate & Financial Weekly Digest

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FDIC Board Approves Proposed Rule to Set Claims Process; Puts Burden of Proof on Officers and Directors to Exonerate Themselves

The Board of Directors of the Federal Deposit Insurance Corporation (FDIC) on March 15 approved a Notice of Proposed Rulemaking (NPR) to further clarify application of the Orderly Liquidation Authority (OLA) contained in Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act. (The NPR issued an interim rule on the same subject on January 18, which "clarified certain discrete issues under the OLA." The earlier interim rule addressed discrete topics including the payment of similarly situated creditors, the honoring of personal services contracts, the recognition of contingent claims, the treatment of any remaining shareholder value in the case of a covered financial company that is a subsidiary of an insurance company, and limitations on liens that the FDIC may take on the assets of a covered financial company that is an insurance company or covered subsidiary.)

The Proposed Rule addresses the following issues: (1) the definition of a "financial company" subject to resolution under Title II by establishing criteria for determining whether a company is "predominantly engaged in activities that are financial in nature or incidental thereto;" (2) recoupment of compensation from senior executives and directors, including the placement of the burden of proof on such individuals to exonerate themselves; (3) application of the power to avoid fraudulent or preferential transfers; (4) the priorities of expenses and unsecured claims; and (5) the administrative process for initial determination of claims and the process for judicial determination of claims disallowed by the receiver.

The FDIC stated that the NPR approved today "will provide a 'roadmap' for creditors to better understand their substantive and procedural rights under Title II by defining key elements determining how their claims will be determined and in what priority they will be paid." The FDIC further explained that "these regulations implement newly enacted provisions of the Dodd-Frank Act and do not necessarily inform or interpret the provisions of the Federal Deposit Insurance Act, 12 U.S.C. Section 1811 et seq. (FDI Act), and the law governing the resolution of failed insured depository institutions. Thus, some provisions implementing the Dodd-Frank Act may expand the rights and duties of parties with an interest in the resolution, or otherwise provide rights and duties that differ from those under the FDI Act."

According to the FDIC, the NPR also "clarifies additional issues important to the implementation of the OLA, including how compensation will be recouped (i.e., clawed back) from senior executives and directors who are substantially responsible for the failure of the firm." According

to the FDIC, before seeking to recoup compensation, the receiver will consider whether the senior executive performed his or her responsibilities with the requisite degree of skill and care, and whether the individual caused a loss that materially contributed to the failure of the financial company. The FDIC is considering the use of additional qualitative and quantitative benchmarks to establish that the loss materially contributed to the failure of the covered financial company. Financial indicators under consideration as possible benchmarks are assets, net worth and capital, and the percentage or magnitude of loss associated with these benchmarks that would establish a material loss and trigger substantial responsibility.

Also noteworthy is the presumption that such officers are substantially responsible and thus subject to recoupment of up to two years of compensation. The FDIC explained:

Substantial responsibility shall be presumed when the senior executive or director is the chairman of the board of directors, chief executive officer, president, chief financial officer, or acts in any other similar role regardless of his or her title if in this role he or she had responsibility for the strategic, policymaking, or company-wide operational decisions of the covered financial company. The FDIC as receiver also will presume the substantial responsibility of a senior executive or director who has been adjudged by a court or tribunal to have breached his or her duty of loyalty to the covered financial company. Finally, in order to ensure consistency this presumption also extends to a senior executive or director who has been removed from his or her position with a covered financial company under section 206(4) or section 206(5) of the Act.

An exception is created for executives recently hired by the financial company specifically for improving its condition. The proposal may generate controversy, since the downfall of a company may not necessarily be the fault of such officers or directors, yet the presumption causes the burden of proof to fall on such officers and directors to exonerate themselves; further, even assuming that certain officers or directors are responsible for a failure, and that other executives and directors of covered companies may have little or nothing to do with the actions of those individuals who may bring about such a company's demise, such other officers and directors will also bear the burden of proof under the FDIC proposal.

The NPR also details the FDIC's treatment of preferential and fraudulent transfers, the expected priorities of expenses and unsecured claims in the receivership of a covered financial company, how creditors can file claims against the receivership estate, how the FDIC as receiver will determine those claims, and how creditors can pursue their claims in federal court.

The NPR also clarifies the meaning of "financial company" under OLA. Under the proposal, a financial company will be defined as "predominantly engaged" in financial activities if the organization derived at least 85% of its total consolidated revenue from financial activities over the two most recent fiscal years. However, the definition also allows FDIC broad flexibility to revisit such determinations on a case-by-case basis.

Finally, additional rulemaking will follow, according to the FDIC, including certain rules required by the Act, such as rules governing receivership termination, receivership purchaser

eligibility requirements, records retention requirements, as well as the orderly resolution of broker-dealers, including the priority scheme and claims process applicable to broker-dealers.

The proposed rule will be out for comment 60 days after publication in the *Federal Register*.

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