Dodd-Frank Act Creates New Resolution Process for Systemically Significant Institutions

In the wake of the collapse of Lehman Brothers and the near-collapse of AIG, Bear Stearns, and Merrill Lynch, Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) creates a new resolution mechanism for institutions whose failure would jeopardize the stability of the US financial system. This new "orderly liquidation authority" (OLA), which replaces the bankruptcy process for affected entities, is vested in the Federal Deposit Insurance Corporation (FDIC) and is in many regards similar to the FDIC's existing resolution authority over insured depository institutions. While this new authority is expected to be used only under extraordinary circumstances, its provisions create new considerations and risks for counterparties to systemically significant entities and new liabilities for directors and officers of failed systemically important enterprises.

Eligible Entities. The resolution process created by Title II will apply to US "financial companies" only. In this context, a "financial company" is (i) a bank holding company; (ii) a nonbank financial company supervised by the Board of Governors of the Federal Reserve System (Federal Reserve) that has been determined under procedures established in Title I of the Act as being of systemic risk; (iii) any other company that is "predominantly engaged" in activities that the Federal Reserve has determined are financial in nature or incidental thereto for purposes of the Bank Holding Company Act (BHCA); and (iv) any subsidiary of the foregoing that is predominantly engaged in activities that the Federal Reserve has determined are financial in nature or incidental thereto for purposes of the BHCA, other than an insured depository institution or an insurance company. The FDIC, in consultation with the Secretary of the Treasury (Treasury Secretary), must promulgate regulations on how a company will be identified as "predominantly engaged" in financial activities or activities incidental thereto, but in no case can the FDIC define as "predominantly engaged," any company that has consolidated revenues from such activities of less than 85 percent of total consolidated revenues. Governmental entities, Farm Credit System institutions, and entities supervised by the Federal Housing Finance Agency (such as Fannie Mae and Freddie Mac) are specifically excluded from Title II's provisions. A company that becomes

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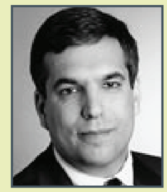

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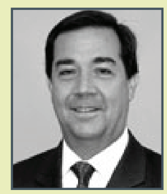

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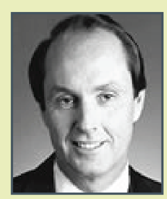

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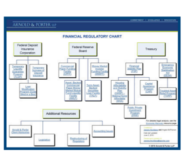

Financial Regulatory Chart

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subject to an OLA proceeding is referred to as a "Covered Financial Company."

Appointment of FDIC as Receiver. The recommendations necessary to appoint the FDIC as receiver under Title II vary depending on the type of entity involved, although in every instance the actual determination to appoint a receiver is made by the Treasury Secretary, in consultation with the President. For financial companies, the FDIC and the Federal Reserve are responsible for deciding whether to recommend to the Treasury Secretary that the appointment of the FDIC as receiver is appropriate. For broker-dealers, the Securities and Exchange Commission (SEC) and the Federal Reserve, in consultation with the FDIC, have that responsibility. For insurance companies, the Director of the new Federal Insurance Office (created by the Act) and the Federal Reserve, in consultation with the FDIC, are the relevant parties. A two-thirds vote is required of each applicable entity for a recommendation to be approved and sent to the Treasury Secretary. This approval process should result in the use of the OLA in only the most exigent of circumstances, although there can be no guarantee of such restraint.

Standards to be Applied. A recommendation to the Treasury Secretary that the FDIC be appointed receiver under the OLA must be in writing and must contain eight elements:

- An evaluation of whether the financial company is "in default or in danger of default," as that term is defined in the Act;
- A description of the effect that the default of the financial company would have on US financial stability;
- A description of the effect that the default of the financial company would have on economic conditions or financial stability for low income, minority, or underserved communities;
- A recommendation regarding the nature and the extent of actions to be taken under the OLA regarding the financial company;
- An evaluation of the likelihood of a private sector alternative to prevent the default of the financial company;
- An evaluation of why a case under the bankruptcy code is not appropriate for the financial company;
- An evaluation of the effects on creditors, counterparties, and shareholders of the financial company and other market participants; and
- An evaluation of whether the company satisfies the definition of "financial company."

The Treasury Secretary in turn, in consultation with the President, must determine that:

- The financial company is in default or in danger of default;
- The failure of the financial company and its resolution under otherwise applicable federal or state law would have serious adverse effects on financial stability of the United States;
- No viable private sector alternative is available to prevent the default of the financial company;
- Any effect on the claims or interests of creditors, counterparties, and shareholders of the financial company and other market participants as a result of actions to be taken under the OLA is appropriate, given the impact that any action taken under the OLA would have on the financial stability of the United States;
- Any action under the OLA would avoid or mitigate such adverse effects;
- A federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to that regulatory order; and
- The company satisfies the definition of "financial company."

If these findings are made by the Treasury Secretary, the appointment of the FDIC as receiver may proceed. Immediate reports to Congress regarding the determination to invoke Title II's powers are required, as is a review by the Comptroller General of the United States. Ongoing supervision of the process by various Inspectors General is also provided for in the legislation.

Judicial Review of Appointment of a Receiver. Decisions to appoint the FDIC as receiver under the OLA are appealable to the US District Court for the District of Columbia under an expedited review process. Subsequent review by the Court of Appeals and, at its discretion, the US Supreme Court is also available. If the Covered Financial Company, acting through its board of directors, consents to the appointment of the FDIC as receiver, then no judicial review is available. Courts are otherwise enjoined from restraining or affecting the FDIC's exercise of its authority under Title II, except as specifically provided for in the legislation.

Safe Harbor for Consent to Appointment of a Receiver. If the Covered Financial Company, acting through its board of directors, consents to the appointment of the FDIC as receiver, the directors are shielded from liability for such action. However, as noted below, directors may face personal liability for their actions as directors of a Covered Financial Company taken prior to the appointment of the receiver.

Treatment of Broker-Dealers and Insurance Companies. If the FDIC is appointed receiver of a broker-dealer pursuant to Title II, the FDIC must appoint the Securities Investor Protection Corporation (SIPC) as trustee for the liquidation. The liquidation will then proceed according to regulations that the Act requires the FDIC and SEC, in consultation with the SIPC, to promulgate. An insurance company that is a Covered Financial Company must be liquidated or rehabilitated under applicable state insurance law. If the appropriate state insurance regulator fails to commence such a liquidation or rehabilitation within a specified period, the FDIC is authorized to act in its place.

Objectives of the FDIC as Receiver. As receiver, the FDIC must exercise its powers under the OLA so as to mitigate risk to US financial stability and to minimize moral hazard. In so doing, the FDIC must ensure that

- Creditors and shareholders will bear the losses of the financial company;
- Management responsible for the condition of the financial company will not be retained; and
- The FDIC and other appropriate agencies will take all steps necessary and appropriate to assure that all parties, including management, directors, and third parties, having responsibility for the condition of the financial company bear losses consistent with their responsibility, including actions for damages, restitution, and recoupment of compensation and other gains not compatible with such responsibility.

Consistent with these guidelines, Title II requires that resolutions conducted pursuant to the OLA result in no cost to the taxpayer.

In its role as receiver, the FDIC is to consult with other agencies, including relevant financial regulatory agencies, the SEC, and the SIPC, as appropriate.

Time Limit. The FDIC's appointment as receiver must end within three years after the date of the appointment, although that period may be extended for up to two additional years. The FDIC must promulgate rules on the termination of receiverships under Title II.

Funding. The cost of resolving an entity under the OLA is paid from the "Orderly Liquidation Fund" (Fund) established by Title II. The Fund remains unfunded until *after* the commencement of an OLA proceeding, at which point the FDIC is authorized to borrow from the US Treasury to obtain funding for the liquidation process. However, the FDIC may not access the Fund until it has submitted an acceptable "Orderly Liquidation Plan" to the Treasury Secretary, and even then the amount that may be accessed is limited until a repayment plan has been established between the FDIC and the Treasury Secretary. If the assets of the liquidated entity prove insufficient to repay the amounts owed to the Fund following the liquidation process, the FDIC must charge risk-based assessments to make up for the shortfall. Creditors who received more in the OLA process than they would have received under an ordinary liquidation are assessed first, followed by an assessment against bank holding companies with total consolidated assets of $50 billion or more and any nonbank financial companies supervised by the Federal Reserve.

If there is still a deficiency, then the FDIC could assess other nonbank financial companies with total consolidated assets of $50 billion or greater, even if not supervised by the Federal Reserve. The FDIC must promulgate regulations on how these risk-based assessments will be levied.

Mandatory Actions. Title II specifies certain actions that must be taken by the FDIC in the context of a Title II receivership. In particular, in exercising its authority under Title II, the FDIC must:

- Determine that any action is necessary for purposes of the financial stability of the United States, and not for the purpose of preserving the covered financial company;
- Ensure that the shareholders of a covered financial company do not receive payment until after all other claims and the Fund are fully paid;
- Ensure that unsecured creditors bear losses in accordance with the priority of claim provisions in Title II;
- Ensure that management responsible for the failed condition of the company is removed;
- Ensure that the members of the board of directors responsible for the failed condition of the company are removed; and
- Not take an equity interest in or become a shareholder of any company or its subsidiary.

These requirements are designed in large part to ensure that Covered Financial Companies and the individuals perceived to be responsible for such companies' insolvency shoulder as much of the cost of resolution as possible.

Upon appointment of the FDIC as receiver under Title II, any pending actions under the Bankruptcy Code or the Securities Investor Protection Act (SIPA) with respect to the Covered Financial Company are subject to dismissal. To the extent any assets of the company vested in another party as a result of the commencement of the bankruptcy or SIPA proceeding, such assets re-vest in the company. As such, an effort to place an institution preemptively into a bankruptcy or SIPA proceeding so as to trigger any contractual remedies prior to the commencement of an action under Title II would likely be ineffective.

Powers of the FDIC as Receiver. As receiver, the FDIC succeeds to all rights, titles, powers, and privileges of the company for which it has been appointed receiver. The FDIC may operate the company as it sees fit, subject to the goals of the OLA, including the sale or transfer of the company's assets. In disposing of the Covered Financial Company's assets, the FDIC must:

- Maximize the net present value return from the sale or disposition of assets;
- Minimize the amount of any loss realized in the resolution of cases;
- Mitigate the potential for serious adverse effects to the financial system;
- Ensure timely and adequate competition and fair and consistent treatment of offerors; and
- Prohibit discrimination on the basis of race, sex, or ethnic group in the solicitation and consideration of offers.

Resolution of Subsidiaries: Under certain circumstances, and with the consent of the Treasury Secretary, the FDIC may appoint itself receiver of a subsidiary of a company for which it has been appointed receiver pursuant to Title II, in which case the provisions of Title II will also apply to resolution of the subsidiary. Insured depository institutions, insurance companies, and broker-dealers (if the broker-dealer has been deemed a Covered Financial Company) are *not* "subsidiaries" for the purpose of OLA, as such entities are already subject to specialized resolution procedures provided for in Title II and elsewhere.

Bridge Financial Companies: The FDIC is authorized to establish bridge institutions as necessary to facilitate the orderly liquidation of a Covered Financial Company. Such institutions must be sold, merged, or liquidated within five years of their creation.

Repudiation of Contracts: The FDIC's broad powers to conduct the affairs of the institution include the power to repudiate any contract that it deems burdensome, if repudiating such a contract would promote the orderly administration of the affairs of the company. The FDIC also has the power to avoid fraudulent and preferential transfers, similar to the authority of a debtor-in-possession or trustee in bankruptcy. In fact, with respect to the definitions of fraudulent and preferential transfers, the statute largely mirrors the provisions contained in the Bankruptcy Code. As with bankruptcy proceedings, transfers involving Qualified Financial Contracts (QFCs)—generally meaning securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements, or similar agreements as determined by statute and regulation—are not avoidable by the FDIC, except in instances where there was actual intent to hinder, delay or defraud.[1] Although the Act incorporates wholesale certain provisions of the Bankruptcy Code with respect to defenses to various preference actions, it notably omits section 546(e), frequently referred to as the "settlement defense," which is a defense to the avoidance of certain settlement payments. While other language in the Act arguably accomplishes the same result as the omitted provision, it is unclear how this difference will be interpreted in practice.

Satisfaction of Claims: Similar to the Bankruptcy Code and the Federal Deposit Insurance Act, the Act provides certain statutory procedures that must be observed with respect to the determination and satisfaction of claims, including certain notice requirements. The FDIC is given the authority to review claims and make determinations in respect of the allowance and disallowance of claims. In satisfying creditor claims, the FDIC must apply the claims priorities set forth in Title II. These priorities require, among other things, that for unsecured claims against a Covered Financial Company the costs of the receivership be afforded first priority, with claims owed to the United States afforded a second priority. The FDIC typically must respect properly perfected security interests and, to the extent the FDIC repudiates existing contracts or arrangements, the affected counterparties may seek damages from the FDIC, albeit in limited scope. Creditors are also allowed, in most instances and subject to specified conditions, to offset amounts owed to the Covered Financial Company with claims that have been allowed against such company.

1 Pursuant to rulemakings mandated by the Act, financial companies will be required to maintain records of QFCs to assist the FDIC in exercising its receivership authority under Title II.

"D'Oench, Duhme" Doctrine: Significantly, Title II incorporates a simplified version of the so-called "D'Oench, Duhme" doctrine that is applied in bank receivership situations. Under the OLA version of this doctrine, any "agreement that tends to diminish or defeat" the FDIC's interest in an asset acquired by it as receiver is void unless the agreement

- Is in writing;
- Was executed by an authorized officer or representative of the company in receivership, or confirmed in the ordinary course of business by the company; and
- Has been, since the time of its execution, an official record of the company or the party claiming under the agreement provides documentation, acceptable to the FDIC, of such agreement and its authorized execution or confirmation by the covered financial company.

Companies that enter into or have existing agreements with entities that could become Covered Financial Companies should take care to observe these requirements in order to avoid difficulties in a receivership setting.

Litigation Authority: The FDIC's powers under the OLA are particularly broad with respect to litigation—both defensively and offensively. As receiver, the FDIC may request a stay of up to 90 days of any ongoing litigation to which the Covered Financial Company is a party, and courts are obliged to grant that request. Any causes of action for tort claims arising from fraud or similar intentional conduct against a Covered Financial Company may be brought by the FDIC as receiver for as long as five years after the applicable statute of limitations has expired under state law. The FDIC is also authorized to seek recovery from individuals associated with the Covered Financial Company to the extent such individuals contributed to the company's insolvency. Specifically:

- The FDIC may commence actions against directors and officers of a Covered Financial Company to recover damages on behalf of the Covered Financial Company attributable to gross negligence by such individuals.
- Subject to the FDIC rulemaking required by the Act, the FDIC may also recover up to two years' worth of

compensation (or an unlimited period in the case of fraud) from current and previous directors and senior executive officers of a Covered Financial Company to the extent such directors or officers were directly responsible for the failed condition of the company.

In particularly egregious cases, the FDIC (or the Federal Reserve, as appropriate) may prohibit directors and senior executive officers from participating in the affairs of a financial company for two years or more, similar to the power already vested in the federal banking agencies with respect to insured depository institutions. The FDIC and the Federal Reserve must jointly issue rules addressing the terms and conditions of such prohibitions.

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The new resolution process created by Title II, though similar to bankruptcy in many regards, incorporates modified elements of the existing bank-resolution process and introduces new considerations and risks for individuals and entities that deal with potential Covered Financial Companies. Counterparties to potential Covered Financial Companies will want to review existing and future agreements with such companies to ensure compliance with the modified "D'Oench, Duhme" doctrine discussed above. Directors and officers of potential Covered Financial Companies will wish to review and understand the liability they could face in the event of a liquidation under the OLA, such as the forfeiture of past compensation. And industry participants will wish to review, and possibly comment on, the various rulemakings required under Title II, which will be critical to a better understanding of how these new provisions will be applied.

Arnold & Porter, LLP has long represented large financial companies and their subsidiaries in resolving their regulatory and supervisory issues. We have been assisting such companies during the legislative process in understanding the implications of the Act and in various changes that were made or attempted to be made to the legislation during the last several months. We are available to respond to questions raised by the Act, or to help guide your business in responding to it. For further information, please contact your Arnold & Porter attorney or:

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