

FDIC Begins Action on Its Super-Resolution Rules for Covered Financial Companies

Title II of the Dodd-Frank Act establishes a new non-judicial receivership alternative for resolving troubled financial companies that could threaten the stability of the U.S. financial system ("Covered Financial Companies"), as described further below. The Federal Deposit Insurance Corporation ("FDIC"), on October 12, 2010, issued a notice of proposed rulemaking (the "Proposal") to begin to implement the provisions of Title II. Comments on the regulatory language contained in the Proposal and certain related questions are due no later than November 18, 2010, and comments on a broader set of issues raised in the Proposal are due no later than January 18, 2011. For a detailed analysis of Title II, see our [Analysis of Financial Regulatory Reform Legislation for the American Bankers Association](#).

The Impact of the Proposal

Title II creates some initial uncertainty for creditors (i.e., current investors) of Covered Financial Companies because they cannot know in advance whether a Covered Financial Company will be subject to the bankruptcy rules under Chapter 7 or Chapter 11, or to a receivership regime administered by the FDIC. The Proposal adds context to this difference by seeking to establish differing treatment for long-term bondholders in the resolution of a Covered Financial Company. More broadly, investors and other counterparties of Covered Financial Companies will want to carefully monitor and evaluate their assumptions and transaction structures in dealing with Covered Financial Companies, now that the possibility of a non-bankruptcy resolution exists, to see what changes if any are required in their own strategies.

Orderly Liquidation Authority

The Dodd-Frank Act established a structure under which Covered Financial Companies could, in certain limited circumstances, be placed by federal action into a non-judicial receivership, which, in

most instances, would be administered by the FDIC. Covered Financial Companies are (i) any bank holding company, (ii) any financial company that has been designated as systemically significant by the Financial Stability Oversight Council, (iii) any other company that is predominantly engaged in financial activities, and (iv) certain subsidiaries of the foregoing entities.

Title II receiverships would be conducted under rules that are substantially similar to the receivership process that applies to FDIC-insured depository institutions. That process is significantly different from the conduct of a bankruptcy case under Chapter 7 or Chapter 11, in that the receivership process does not provide a judicial forum in which all interested parties participate and have an opportunity to advocate their position. In this context, Congress intended a Title II receiver to have many of the authorities of the FDIC (in its role with respect to insured depository institutions) to maximize the value of the receivership and to minimize the disruptive effect of a failure on third parties.

At the same time, Congress was focused in the Dodd-Frank Act on negating the concept that any organization was “too big too fail” and emphasized that Title II would not result in taxpayer-funded bailouts. Accordingly, the Dodd-Frank Act expressly provides that, “All financial companies put into receivership under [Title II] shall be liquidated. No taxpayer funds shall be used to prevent the liquidation of any financial company under [Title II].”

The Dodd-Frank Act is at odds with itself in that the practical application of the statute may have a result that differs from what Congress contemplated. This will pose significant challenges for the FDIC as it interprets this new law. Accordingly, the Proposal suggests that, in some instances, a Covered Financial Company will not, in fact, be resolved through a straight liquidation. Instead, it appears to indicate that, in some cases, the FDIC may create a new bridge financial company that will acquire a significant portion of the activities and operations of the failed company, so it may realize a higher recovery from continuing the company’s operations. The FDIC would likely have to provide, at least for some period of time, financing for a bridge financial company through borrowings from the U.S. Treasury.

Differential Treatment of Similarly Situated Creditors

Congress was also focused in enacting Title II on avoiding federal government protection of the constituents of the failed institution. Under the Dodd-Frank Act, the FDIC may discriminate among similarly situated creditors if it makes certain findings that such discrimination will have a beneficial impact upon the receivership. This discretionary authority is subject to the requirement that all similarly situated claimants must receive at least the amount they would have received had the Covered Financial Company been liquidated under Chapter 7 of the Bankruptcy Code, or any similar provision of applicable State insolvency law.

In the Proposal, the FDIC provides that it would not use its discretionary authority to make additional payments or credits to three categories of potential claimants:

- Bondholders and other holders of long-term senior debt. This includes holders of long-term senior debt who have a fifth-level priority claim. Long-term senior debt means debt issued by the Covered Financial Company to bondholders or other creditors that has a term of more than 360 days. It excludes, among other things, partially funded,

revolving or other open lines of credit necessary to continue the operations of the receivership or any bridge financial company.

- Subordinated debt holders. This category applies to holders of subordinated debt who have a sixth-level priority claim.
- Shareholders and other equity holders. This category applies to equity holders who have a seventh-level priority claim (such as shareholders, members, general partners, or limited partners).

In contrast, the FDIC reserves the right to make additional payments or credits to fifth-level general creditors who are not holders of long-term senior debt. Under the Proposal, the board of directors of the FDIC could make payments to short-term debt holders or other fifth-level priority general creditors, and would publicly identify any claimant that received such favorable treatment. In addition, such additional payments would be subject to a “claw-back” right by the FDIC, if the proceeds of the sale of the Covered Financial Company’s assets were insufficient to repay any monies drawn by the FDIC from the U.S. Treasury during the liquidation.

It is not clear whether the Proposal would treat the transfer of an obligation of a Covered Financial Company to a bridge financial company as being subject to the provisions contained in the Proposal regarding additional payments to certain claimants. To the extent that an outstanding obligation to a creditor is transferred at face value to a bridge financial company, that creditor could be treated more favorably than a creditor whose claim remains behind with the receivership. In the failed bank context, the FDIC’s authority to discriminate among creditors whose claims would be transferred to a bridge bank and those that would remain with the receivership was upheld in *Texas American Bancshares Inc. v. Clarke*, 954 F.2d 329 (5th Cir. 1992) (applying the National Bank Act but noting that the same result would have applied under amendments to the Federal Deposit Insurance Act contained in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989).

Secured Creditors

The Proposal sets forth significant provisions regarding the valuation of secured creditor claims. Under the Dodd-Frank Act, the FDIC receiver may treat that portion of a secured claim which exceeds the fair market value of any collateral as an unsecured fifth-level priority claim. In the Proposal, the FDIC expressed the view that

a major factor in the recent financial crisis was over-reliance by market participants on funding through short-term secured transactions in the repurchase market using what it described as volatile, illiquid collateral, such as mortgage-backed securities. In an apparent effort to encourage the use of U.S. government securities as collateral, the Proposal provides that proven claims secured by securities that are direct obligations of, or fully guaranteed by, the United States or any agency thereof (“Government Securities”) will be valued at par. Other instruments would not receive the benefit of such treatment.

Other Proposals

The Proposal also contains regulatory language dealing with (i) the treatment of employment agreements, (ii) the circumstances under which a contingent obligation would be treated as a provable claim, and (iii) certain matters relating to insurance company-related liquidations. The deadline for comments on the proposed regulatory language is November 18, 2010.

Subjects for 30-Day Comment Period

In addition to requesting comments on the specific regulatory provisions set forth in the Proposal, the FDIC is also requesting comments by November 18, 2010 on a number of specific questions, including:

- Should there be further limits on additional payments or credit amounts that can be provided to shorter term general creditors?
- How should non-Government Securities collateral be valued in determining whether a creditor is fully or partially secured?
- What principles should apply to creditor liquidation of non-Government Securities?

Subjects for 90-Day Comment Period

The FDIC is also requesting comments by January 18, 2010 on a set of broader questions, which include:

- What other specific areas relating to the FDIC’s orderly liquidation authority under Title II would benefit from additional rulemaking?
- What are the key areas of Title II that may require additional rules or regulations in order to harmo-

nize them with otherwise applicable insolvency laws?

- What issues surrounding the chartering, operation, and termination of a bridge company would benefit from a regulation? How should those issues be addressed?
- Should the FDIC adopt regulations to define how claims against the Covered Financial Company and the receiver are determined under Title II? What specific elements of this process require clarification?
- How should “actual direct compensatory damages” for the repudiation of certain contingent obligations be calculated?
- Are there additional issues regarding the treatment of similarly situated claimants that should be clarified in a regulation?
- Do the provisions of Title II governing priority of expenses and claims require clarification? If so, what are the key issues to clarify in any regulation?

Title II and the Proposal would effect a permanent and substantial change in the rights of borrowed money creditors of a Covered Financial Company presumably without resort to court process, thereby imposing new challenges on the FDIC. Accordingly, the FDIC will need to do a careful study of the value of collateral prior to a sale in order to assure that property rights are not impaired without due process of law. Given its ability to potentially complete a sale without an effective right of appeal to a federal judge, the FDIC will have to create safeguards to assure that creditors receive appropriate value under the circumstances.

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