Analysis of the Orderly Liquidation Authority, Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Title II of the Dodd-Frank Act, titled "Orderly Liquidation Authority," creates an entirely new insolvency regime for large, interconnected financial companies, including broker-dealers, whose failure poses a significant risk to the financial stability of the United States.[1] Title II provides for federal receivership proceedings of qualifying financial companies, with the FDIC serving as receiver. Any receivership under Title II is subject to exceptionally broad input and control by the FDIC and numerous other government authorities, including the Board of Governors, the Secretary, Congress and the President. The purpose of Title II is to improve financial stability, mitigate risk, end "too big to fail," and protect taxpayers by "ending bailouts."[2] It is modeled in part on those provisions of the Federal Deposit Insurance Act (the "FDIA") regarding insolvencies of federal banks and savings and loans.[3] It also imports numerous provisions from the United States Bankruptcy Code (the "Bankruptcy Code")[4] and gives significant authority to the government, similar to that afforded to the government in connection with thrift insolvencies and the special conservatorships governing Freddie Mac and Fannie Mae.[5]

This article offers an overview and analysis of Title II and describes the types of entities that may be placed into federal receivership as well as the process for doing so. It also sets forth the basic attributes of the receivership process, including a mechanism by which the FDIC can create a "bridge financial company" — similar to the process by which the FDIC can create a "bridge bank" under the FDIA — to succeed to selected assets and liabilities of the entity in receivership and that can continue operating as a restructured, going concern for the benefit of stakeholders, pending transfer to a private acquirer. Title II contains new and highly particularized provisions governing financial responsibility for a receivership, including who may — and may not — be forced to pay the costs of a receivership. There are also several new provisions governing derivatives agreements and the potential consequences to management found to be responsible for a financial company's collapse.

As is apparent from the discussion that follows, many of the provisions of the Act and the powers delegated to the FDIC and other government authorities may be draconian when implemented. The right to decide whether to initiate receivership proceedings is vested in government authorities, not in financial companies' boards and management or financial companies' stakeholders, and is subject only to very limited judicial review that is highly deferential to such authorities. A bridge financial company can be created, with no stakeholder input, that houses a troubled financial company's "good" assets, while leaving behind the "bad" assets and liabilities. A financial company or a related bridge financial company can be sold to or merged with a private acquirer without notice, with no stakeholder input, and with limited regard for the consequences to them. The government is forbidden from "bailing out" failing financial companies and, in fact, is empowered to "assess" financial companies for the costs of

[1] Act § 204(a).

[2] See press release, United States House Committee on Financial Services, Dodd-Frank Wall Street Reform and Consumer Protection Act (June 21, 2010).

[3] 12 U.S.C. §§ 1811 *et seq.*

[4] 11 U.S.C. §§ 101 *et seq.*

[5] Federal Housing Finance Regulatory Reform Act of 2008, Pub. Law 110-289, 122 Stat. 2654 (codified in multiple sections of the United States Code) and the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C. §§ 4501 *et seq.*

Contributing Partner / Mark A. McDermott, Mark.McDermott@skadden.com, 212.735.2290

Thank you to David Turetsky, Kurt Ramlo, Adam Ravin, Glenn Walter, Raquelle Kaye, Julie Lanz, Emily Ma and Jason Putter for their contributions.

a receivership. The traditional rights of derivatives counterparties are restricted in several important respects. The Act effectively declares open season on failed financial company directors and management.

Ironically, the potential harshness of the Act ultimately may mean that its most salutary effect will be to minimize the circumstances under which it will, in fact, be used. In particular, the Act's broad provisions and the powers vested in the FDIC collectively may work best when used as a threat to compel a private solution, including private solutions that are largely consensual and that rely on a federal receivership solely for quick implementation — and even private solutions that avoid a federal receivership altogether. Indeed, the Act affirmatively requires the Board of Governors, the Secretary and the FDIC to consider private alternatives in deciding whether to recommend and implement receiverships.[6] These attributes might actually cause the prospect of liquidation to foster more thoughtful, value-additive, private solutions that avoid catastrophic collapses and massive bailouts.

Entities Subject to the Act: Financial Companies

To afford context to the following discussion regarding the entities that are subject to being placed into federal receivership under the Act, it is important to outline which entities may and may not become the subject of existing insolvency regimes. In the United States today, there are four main categories of insolvency laws: the Bankruptcy Code; the FDIA, which governs insolvency proceedings of banks and savings and loans; state laws concerning the rehabilitation and liquidation of insurance companies; and specialized laws governing the liquidation of brokers and dealers. The Bankruptcy Code is by far the most comprehensive of these four regimes. Almost any business entity can become a debtor under the Bankruptcy Code, where it can either liquidate its assets or attempt to reorganize its affairs pursuant to chapter 7 or chapter 11, respectively.[7]

However, banks, savings and loan associations, insurance companies and numerous other statutorily defined financial entities are specifically excluded from becoming debtors under the Bankruptcy Code.[8] Such entities are subject to their own particularized insolvency regimes, including, as noted above, the FDIA in the case of federally chartered banks and savings and loan associations and state laws in the case of insurance companies. Insolvent brokers and dealers typically are liquidated pursuant to the Securities Investor Protection Act ("SIPA"), although stockbrokers also can be liquidated under the Bankruptcy Code.[9]

The insolvency laws governing banks and saving and loans — more specifically, insured depository institutions and insurance companies — remain virtually unchanged by the Act.[10] Accordingly, insured depository institutions and insurance companies will continue to remain subject to existing insolvency

---

[6] Act § 203(a)(2)(E).

[7] See 11 U.S.C. §§ 101(41) (defining the word "person") & 109 (who may be a debtor).

[8] 11 U.S.C. § 109(b)(2).

[9] 11 U.S.C. §§ 741 *et seq.* "Stockbroker" is defined under section 101(53A) of the Bankruptcy Code as an individual, partnership or corporation, with respect to which there is a customer, and that is engaged in the business of effecting transactions in securities either for the account of others or with members of the general public, for such entity's own account.

[10] An insured depository institution is defined under section 3(c) of the FDIA as any bank or savings association the deposits of which are insured by the FDIC pursuant to the FDIA. 12 U.S.C. 1813(c). An insurance company is defined under section 201(a)(13) of the Act as any entity that is engaged in the business of insurance; subject to regulation by a state insurance regulator; and covered by a state law that is designed to specifically deal with the rehabilitation, liquidation or insolvency of an insurance company.

laws and, hence, are not eligible to be placed into federal receivership under the Act.[11] Additionally, federal home loan banks, farm credit institutions, government sponsored enterprises (including Fannie Mae and Freddie Mac, as well as any affiliate of either) and government entities are not eligible to be placed into receivership.[12]

However, certain other business entities that currently may become debtors under the Bankruptcy Code are now subject to being placed into federal receivership under the Act. The Act defines this class of business entities as "financial companies." The Act breaks down the definition of financial company into four categories. The first category includes "bank holding companies," as defined in section 2(a) of the BHCA.[13] Under this definition, a bank holding company includes any company that has control over any bank, or over any company that is or becomes a bank holding company by virtue of the BHCA.[14] The term "bank" includes banks, the deposits of which are insured in accordance with the terms of the FDIA, and institutions that accept demand deposits or deposits that the depositor may withdraw by check or similar means and that are engaged in the business of making commercial loans.[15]

The second category of financial company covered by the Act includes nonbank financial companies supervised by the Board of Governors, which in turn includes nonbank financial companies that the Council has determined must be supervised by the Board of Governors.[16] Nonbank financial companies are companies "predominantly engaged in financial activities."[17] A company satisfies this definition if it and all of its subsidiaries derive either 85% of their annual gross revenues or 85% of their consolidated assets from activities that are "financial in nature" or incidental to a financial activity, or from the ownership or control of one or more insured depository institutions.[18]

Section 4(k) of the BHCA includes an extensive list of activities designated as "financial in nature," including lending, exchanging or investing money or securities; insuring, guaranteeing or indemnifying against loss, harm, damage, illness and death; providing and issuing annuities; providing financial, investment or economic advisory services; issuing or selling instruments representing pools of assets permissible for a bank to hold directly; and underwriting, dealing in or making a market in securities.[19] The Act authorizes the Council, by a vote of not fewer than two-thirds of the members then serving, including an affirmative vote by the chairperson of the Council, to determine that a nonbank financial

---

[11] Act § 203(e)(1). Insurance companies technically are within the scope of the Act. However, if an insurance company or insurance company subsidiary otherwise qualifies under the Act, the liquidation or rehabilitation of such entity will be conducted as provided under state law, not the Act — provided that if the appropriate state agency fails to act within 60 days of a determination of the Secretary that an insurance company would otherwise qualify for receivership, then the FDIC may act in place of such agency and pursue relief under state law. Act §§ 202(b) & 203(e).

[12] Act § 201(a)(11).

[13] Act § 102(a)(1); 12 U.S.C. § 1841(a).

[14] A company "has control over a bank or a company," pursuant to section 2(a) of the BHCA, if (a) it directly or indirectly has the power to vote 25% or more of any class of voting securities of the bank or company; (b) it controls in any manner the election of a majority of directors or trustees of the bank or company; or (c) the Board of Governors determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company. 12 U.S.C. § 1841(a)(2).

[15] 12 U.S.C. § 1841(c)(1)(B).

[16] Act § 102(a)(4).

[17] Act §§ 102(a)(4)(A)(ii) & 102(a)(4)(B)(ii).

[18] Act § 102(a)(6).

[19] 12 U.S.C. 1843(k).

company will be supervised by the Board of Governors and subject to heightened prudential standards, if the Council determines that material financial distress at such company would pose a threat to the financial stability of the United States.[20]

The third category of financial company covered by the Act includes subsidiaries of the two foregoing categories of financial companies, other than subsidiaries that are insured depository institutions or insurance companies.[21] Finally, the Act applies to brokers and dealers registered with the SEC that are members of the SIPC. While stockbrokers are eligible to become debtors under the Bankruptcy Code as well, they may only liquidate pursuant to chapter 7; they are ineligible to attempt to reorganize under chapter 11. Moreover, as noted above, brokers and dealers are subject to being liquidated pursuant to their own, highly specialized insolvency regime under SIPA.[22]

"Systemic Risk Determination"

The mere fact that an entity is a financial company does not mean that it is eligible to be placed into federal receivership under the Act. To be eligible, the financial company must constitute a "covered financial company," a term defined with great particularity in the Act. A covered financial company is a financial company as to which a "systemic risk determination" has been made by the authorities identified in the Act.[23] The process for determining whether the insolvency of a particular financial company presents a systemic risk begins with the recommendations of the FDIC and the Board of Governors, with respect to a covered financial company other than a covered broker or dealer; the SEC and the Board of Governors, with respect to a covered broker or dealer; and the director of the Federal Insurance Office and the Board of Governors, with respect to an insurance company.[24]

On their own initiative, or at the request of the Secretary, the FDIC (or the SEC, in the case of a covered broker or dealer, or the director of the Federal Insurance Office, in the case of an insurance company) and the Board of Governors must make a written recommendation regarding whether a financial company presents systemic risk and, hence, whether the Secretary should appoint the FDIC as receiver. Such recommendation is made upon a vote of not fewer than two-thirds of the then-serving members of the Board of Governors and the board of directors of the FDIC (or in the case of a covered broker or dealer, the members of the SEC then serving, and in consultation with the FDIC, and in the case of an insurance company, the director of the Federal Insurance Office), respectively.

These written recommendations must contain, among other things, an evaluation of whether the financial company is "in default or in danger of default" (a phrase defined below); a description of the effect that the default of the financial company would have on the financial stability of the United States; an evaluation of the likelihood of a private sector alternative to prevent the default; an evaluation of why a bankruptcy case is not appropriate for the financial company; and an evaluation of the effects on creditors, counterparties and shareholders of the financial company and other market participants of a receivership under the Act.[25]

---

[20] Act § 113.

[21] Act § 201(a)(11)(iv).

[22] Act § 205.

[23] Act § 203.

[24] Act § 203(a).

[25] Act § 203(a)(2).

Upon receipt of the above-referenced recommendations, the Secretary — in consultation with the President of the United States — must seek appointment of the FDIC as receiver for the covered financial company if the Secretary determines, among other things, that:

- the financial company is in default or in danger of default;
- the default of the financial company would have a serious adverse effect on the financial stability of the United States;
- no viable private sector alternative is available to prevent the default;
- the effect on the claims or interests of creditors, counterparties and shareholders of the financial company and other market participants of proceedings under the Act is appropriate, given the impact that any action under the Act would have on the financial stability of the United States; and
- an orderly liquidation would avoid or mitigate such adverse effects.[26]

Three aspects of the foregoing standards warrant emphasis. First, the phrase "in default or in danger of default" is broadly defined and affords the Board of Governors, the FDIC, the SEC and the Secretary broad discretion. Specifically, a financial company is in default or in danger of default if:

- a bankruptcy case has been, or likely will promptly be, commenced with respect to the financial company;
- 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;
- the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or
- 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.[27]

The definition's repeated use of the forward-looking phrase "is likely to" gives the government discretion to make necessary judgments as events unfold, rather than after the fact.

Second, no financial company can be placed into receivership without an assessment of whether the Bankruptcy Code already provides an appropriate remedy. This requirement is important, as it forces consideration of alternatives under a longstanding and well-understood insolvency regime that affords a comprehensive mechanism for reorganizing a troubled entity, and that affords creditors and other stakeholders significant input into, and control over, the reorganization process — input and control that does not exist with respect to receiverships under the Act. Third, the Board of Governors, the FDIC and the SEC cannot recommend receivership without considering the viability of private sector alternatives. More

[26]Act § 203(b). In the case of covered brokers and dealers, the FDIC will serve as receiver, but the SIPC will serve as trustee. Upon appointment as trustee, the SIPC must file an application for a protective decree under SIPA. Assets retained by the broker or dealer and not transferred to a covered financial company must be administered pursuant to SIPA. Act § 205(a).

[27]Act § 203(c)(4).

importantly, the Secretary cannot commence a receivership unless the Secretary has determined that "*no* viable private sector alternative is available."[28]

These second and third requirements provide significant, common-sense checks on the federal receivership process envisioned by the Act, and undoubtedly reflect the alternatives the government considered as the country faced crisis after crisis in the fall of 2008. Indeed, most experienced members of the bankruptcy bench and bar agree that a troubled company's most likely source of rescue is its existing stakeholders — those with the greatest, and most vested, interest in a successful outcome. The Bankruptcy Code itself was designed to foster private, negotiated solutions. Restructuring professionals understand that the process works best when the toughest remedies afforded by the Bankruptcy Code are never used in litigation, but are instead used to prod stakeholders to a sensible, private solution. To its credit, the Act requires careful assessment of these considerations and alternatives.

A very recent example of how this process works well is the restructuring of The CIT Group, one of the largest bank holding companies in the country. Although the government infused capital into CIT during the depths of the crisis, it abstained from making further investments despite CIT's continued troubles. CIT, therefore, was compelled to work with its stakeholders on a series of transactions designed to shed more than $10 billion in debt. The result was a largely consensual, private solution, financed by the company's stakeholders, that was implemented via a pre-packaged chapter 11 reorganization plan that limited the company's stay in bankruptcy to only 40 days. The Act presumably was designed to foster solutions such as this — especially through the Act's prohibition on government infusions of capital into troubled financial companies (discussed below).

Under the Act, however, if the Secretary determines that there are no private alternatives available for a financial company, then the Secretary must so notify the FDIC and the company. The company is then given the opportunity to consent to appointment of the FDIC as receiver. If the directors and officers of a troubled financial company decide to acquiesce to the appointment of the FDIC as receiver, the Act provides that such directors and officers are absolved of liability to stakeholders for such acquiescence.[29] If they do not consent, then the Secretary is required to petition the United States District Court for the District of Columbia for an order authorizing the Secretary to appoint the FDIC as receiver.[30] The petition must be filed under seal.

The Court is directed to hold a hearing, on a strictly confidential basis, in which the company may oppose the petition. The Court's task is limited to deciding whether the Secretary's determinations were "arbitrary and capricious," a standard that is very deferential to the Secretary and effectively presumes the validity of the Secretary's determinations.[31] If the Court answers the "arbitrary and capricious" question in the negative, the Court is required to issue an order immediately authorizing the Secretary to appoint the FDIC as receiver.[32] If the Court answers this question affirmatively, the Court is required to provide the Secretary with a written statement explaining its rationale, and must afford the Secretary an immediate opportunity to amend and refile the petition.

If the Court does not make a determination within 24 hours of receiving the petition, the petition will be granted by operation of law, the Secretary will appoint the FDIC as receiver and liquidation under the

[28] Act § 203(a)(2)(E).

[29] Act § 207.

[30] Act § 202(a)(1)(A)(i).

[31] Act § 202(a)(1)(A)(iii).

[32] As noted above, in broker-dealer liquidations, the FDIC is appointed as receiver, but SIPC also must appoint a trustee. Act § 205.

statute will automatically be commenced.[33] The Act provides a process for highly expedited appeals of these determinations. [34]

Basic Elements of the Liquidation Process

Once the FDIC is appointed receiver of a covered financial company, it assumes virtually complete control over the company and the liquidation process. The role of the courts in the core receivership process ends, and there are limited avenues for challenging the various ancillary decisions that the FDIC may make in pursuing the liquidation. The role of the FDIC in federal receiverships under the Act is akin to its role in connection with insolvency proceedings involving federal banks and savings and loans. It also is akin to the role of state insurance commissioners in connection with liquidation and rehabilitation of insurance companies. This role contrasts sharply with reorganization proceedings under chapter 11 of the Bankruptcy Code, where a debtor's board and management stay in place, the debtor remains in possession of its business, and the normal rules of corporate governance and decision making continue to apply (subject to the requirement that transactions outside the ordinary course of business require advance court approval).[35]

Accordingly, when the FDIC is appointed receiver for a covered financial company, it succeeds to all rights, titles, powers and privileges of the company and its assets, and of any stockholder, member, officer or director of the company.[36] The FDIC may operate the company with all of the powers of the company's shareholders, directors and officers, and may conduct all aspects of the company's business.[37] It may liquidate and wind up the affairs of the company in such manner as it deems appropriate, including through the sale of assets, the transfer of assets to a bridge financial company (discussed in more detail below), or the exercise of any other rights or privileges granted to the receiver.[38] For example, the FDIC may merge the financial company with another company or transfer any asset or liability of the company without obtaining any approval, assignment or consent from any stakeholder.[39]

While the Act affords the FDIC virtually unfettered control in these matters, the Act does identify several principles that guide the FDIC's conduct. For instance, in disposing of assets, the FDIC must use best efforts to maximize returns, minimize losses and mitigate the potential for serious adverse effects to the financial system.[40] In deciding upon a course of action, the FDIC also must determine that such action is necessary for the financial stability of the United States, and not for the purpose of preserving the company; ensure that the shareholders of the covered financial company do not receive payment until

---

[33] Act § 205.

[34] Appeals of the District Court's determination may be taken to the United States Court of Appeals for the District of Columbia. The appeal must be filed within 30 days of the District Court's decision and must be heard on an expedited basis. The Court's decision is not subject to any stay or injunction pending appeal. The Appellate Court's decision may be appealed to the United States Supreme Court. Any such appeal must be filed within 30 days of the Appellate Court's decision and heard on an expedited basis. Review is limited to whether the Secretary's determination that a covered financial company is in default or in danger of default and satisfies the definition of a covered financial company is arbitrary and capricious. Act §§ 202(a)(2)(A) & (B).

[35] 11 U.S.C. §§ 363(b), 1107 and 1108.

[36] Act § 210(a)(1)(A).

[37] Act § 210(a)(1)(B).

[38] Act § 210(a)(1)(D).

[39] Act § 210(a)(1)(G).

[40] Act § 210(a)(9)(E).

after all other claims are fully paid; and ensure that unsecured creditors bear losses in accordance with the priority of claim provisions. Significantly, the FDIC may not take an equity interest in or become a shareholder of the covered financial company or any covered subsidiary.[41]

The FDIC is given several other powers that are consistent with the powers afforded it in connection with insolvency proceedings of thrifts under the FDIA, the powers afforded SIPC trustees in connection with insolvency proceedings of broker-dealers under SIPA, and the powers afforded bankruptcy trustees in connection with liquidation proceedings under chapter 7 of the Bankruptcy Code. These powers can be grouped into three main categories: resolution and payment of claims; disposition of existing contracts and similar obligations; and recovery of pre-receivership fraudulent conveyances and preferential transfers.

Resolution and Payment of Claims. The FDIC is given unilateral authority to review claims and to make determinations either allowing them or disallowing them.[42] This unilateral authority, while similar to that granted the FDIC and SIPC trustees under the FDIA and SIPA, respectively, differs from that afforded chapter 7 trustees under the Bankruptcy Code. Under the Bankruptcy Code, a claim is deemed allowed unless the chapter 7 trustee files an objection to the claim with the bankruptcy court and affords the claimant an opportunity to appear and be heard on the objection. [43] The claim is disallowed only if the claimant fails to appear or the court otherwise determines that the claim should be disallowed. Under the Act, by contrast, a claimant wishing to contest a claim determination by the FDIC must file suit with the district court for the district where the principal place of business of the covered financial company is located.[44]

The Act identifies the priorities in which claims may be paid, with the costs of the receivership being afforded first priority after provision is made for secured claims.[45] Claims owed to the United States come next, followed by all other claims against the covered financial company.[46] Similar to the rules governing other insolvency regimes, the Act requires that all claimants who are similarly situated be treated in a similar manner (except that, as noted above, claims of the United States are paid first). Unlike other insolvency regimes, however, the FDIC may deviate from this principle as necessary to maximize the value of the assets of the covered financial company; to initiate and continue operations essential to implementation of the receivership or any bridge financial company; to maximize the present value return from the sale or other disposition of the assets of the company; or to minimize the amount of any loss realized upon the sale or other disposition of the assets of the company.[47]

Disposition of Existing Contracts and Related Obligations. The Act provides that the FDIC may, within a reasonable period of time, disaffirm or repudiate any contract or lease to which the financial company is a party where continued performance is too burdensome or it would otherwise promote orderly administration.[48] It can do so regardless of whether the contract or lease is "executory," *i.e.*,

[41] Act § 206.
[42] Act § 210(a)(2).
[43] 11 U.S.C. § 502(a).
[44] Act § 210(a)(4).
[45] Act § 210(b)(5).
[46] Act § 210(b)(1).
[47] Act § 210(b)(4).
[48] Act § 210(c)(1)-(c)(2).

whether there are unperformed obligations remaining by both parties. Under the Bankruptcy Code, by contrast, only contracts or leases that are executory may be rejected.[49] With few exceptions, damages for such repudiation are limited to actual, direct compensatory damages; punitive or exemplary damages and claims for lost profits or opportunities are not allowed.[50]

Alternatively, the FDIC may decide to transfer its rights and obligations under a contract or lease to an acquirer of the covered financial company's assets. It may do so notwithstanding so-called "ipso facto" clauses which excuse a counterparty from performing by reason of the company's insolvency, the appointment of a receiver, and similar circumstances.[51] These powers are largely consistent with the powers afforded the FDIC, SIPC trustees and bankruptcy trustees under the FDIA, SIPA and the Bankruptcy Code, respectively, though the process involves significant counterparty input and court supervision in the case of the Bankruptcy Code.

Fraudulent Conveyances and Preferential Transfers. Finally, the FDIC has the power under the Act to sue to avoid fraudulent transfers, preferences and improper setoffs.[52] These powers are substantially similar to the powers afforded the FDIC, SIPC trustees and chapter 7 trustees in thrift, broker-dealer and chapter 7 liquidations, respectively.[53] Indeed, the statutory definitions of fraudulent transfers (transfers made while insolvent for less than reasonably equivalent value) and preferences (payments to or for the benefit of a creditor that allow the creditor to receive more than in a liquidation) are almost identical to the statutory definitions of these terms contained in the Bankruptcy Code.[54] Moreover, the statutory defenses available to recipients of allegedly fraudulent or preferential transfers under the Act are the same as under other insolvency regimes.[55]

Expedited Process for Creation of a Restructured Successor

Although Title II of the Act is titled "Orderly Liquidation Authority," a federal receivership under the Act will not necessarily result in the termination of a covered financial company's business, including the termination of all of its employees. Of course this could be the result not only under the Act, but also in connection with the insolvency of an entity under the Bankruptcy Code or the FDIA. One of the primary purposes of the Act, the Bankruptcy Code and the FDIA, however, is to maximize value and creditor recovery, which is most frequently achieved through some form of restructuring of the troubled company's core business and balance sheet. The Act includes mechanisms for achieving this result, although those mechanisms are much more similar to the mechanisms applicable to banks and savings and loans under the FDIA than the mechanisms under the Bankruptcy Code.

---

[49] 11 U.S. § 365. If the FDIC proposes to transfer any "qualified financial contracts," discussed in greater detail below, with a particular counterparty, the FDIC must transfer all of such contracts with that counterparty; alternatively, it must repudiate all such contracts with such counterparty. Act § 210(c)(9)(a).

[50] Act § 210(c)(3).

[51] Act § 210(c)(13).

[52] Act §§ 210(a)(11)(A), 210(a)(11)(B), & 210(a)(12), respectively.

[53] *E.g.,* 12 U.S.C. § 1821(d)(17) (authorizing the FDIC to avoid fraudulent transfers); 12 C.F.R. § 313.20 (authorizing the FDIC to offset); 11 U.S.C. §§ 547, 548 & 553 (authorizing chapter 7 trustee to avoid fraudulent transfers, preferences and improper setoffs, respectively); 15 U.S.C. § 78fff-l(a) (vesting the SIPC trustee with the same powers and title with respect to the debtor and property of the debtor as a trustee in a bankruptcy case).

[54] Compare Act §§ 210(a)(11)(A) & (B) *with* 11 U.S.C. §§ 547 & 548, respectively.

[55] Compare Act § 210(a)(11)(F) *with* 11 U.S.C. §§ 547(c), 548(c) & 550; 12 U.S.C § 1821(d)(17)(C).

In particular, as noted above, the FDIC has broad power to arrange for the sale of selected assets of a covered financial company to one or more private acquirers, subject to any applicable antitrust laws and other applicable agency review. Similarly, it may arrange for an acquisition of a covered financial company by one or more private acquirers, subject to the same antitrust and other regulatory qualifications. In connection with any sale or merger, the FDIC can arrange for the acquirer to assume selected contracts and liabilities, including outstanding derivatives contracts. This is similar to the process under the FDIA and state insurance insolvency laws whereby the FDIC and state insurance commissioners can facilitate the creation of a so-called "good bank" or "good insurance company." Core assets and related liabilities necessary for a viable, go-forward enterprise are extracted from the estate of a bank or insurance company in rehabilitation, while the non-core assets and related liabilities are left behind in the so-called "bad bank" or "bad insurance company."[56]

One key aspect of the Act, however, is that the FDIC may facilitate such transactions without advance notice to, input from or consent of creditors, shareholders and contract counterparties. Moreover, no party in interest can challenge any such transaction, as a fraudulent conveyance or otherwise, because the Act divests the courts of power to entertain any challenges to, or to restrain, any such transactions.[57]

This approach contrasts sharply with proceedings under the Bankruptcy Code. Under the Bankruptcy Code, a troubled company can sell its operating business free and clear of, or subject to, selected liabilities, but only after notice to all stakeholders, an opportunity for such stakeholders to be heard, and entry of an order by a bankruptcy court approving the sale as in the best interests of the estate.[58] Also under the Bankruptcy Code, a troubled company can restructure its operations and liabilities pursuant to a plan of reorganization, but only after impaired stakeholders are provided a detailed disclosure statement describing the plan, impaired stakeholders have been afforded an opportunity to vote to accept or reject the plan or to object to it, and the bankruptcy court has found that the plan complies with numerous requirements imposed by the Bankruptcy Code designed to ensure that the plan is fair and feasible.[59]

Arguably, there is an eminently reasonable explanation for the broad authority granted the FDIC under the Act. Put simply, financial services businesses are relatively fragile enterprises. They are not comprised of "bricks and mortar" and do not sell physical goods. Instead, they are comprised of people — ideas and talent — and they sell advice, trust and confidence. These are businesses that cannot easily weather the storm and delays common to so many proceedings under the Bankruptcy Code. Accordingly, if a financial company is to have any chance at salvaging a core enterprise for the benefit of all, the sale and restructuring of that core enterprise must occur very rapidly under the supervision of an independent authority with broad power to broker transactions on very short notice.

Indeed, this is typical of how the FDIC handles many thrift insolvencies. For example, the FDIC may begin working behind the scenes with a troubled bank's board and possible suitors, then implement a transaction after hours on a Friday afternoon and before the "new" bank opens for business the ensuing Monday morning. This does not ensure that all creditors necessarily will be paid in full, but depositors and other customers necessary to the franchise are protected, at least to some extent, thereby enhancing value for creditors. This was similar to the approach taken by the government in facilitating expedited takeovers of financial firms after Lehman collapsed.

---

[56]See 12 U.S.C § 1821(d)(2)(G).

[57]Act §§ 210(a)(8)(D) & 210(e).

[58]11 U.S.C. §§ 363(b) & 363(f).

[59]11 U.S.C. §§ 1123, 1125 & 1129.

The foregoing can be contrasted with the process under the Bankruptcy Code. The Bankruptcy Code does afford bankruptcy courts significant flexibility to conduct expedited processes, but minimum standards of due process reflected in the provisions of the Code and related rules requiring some advance notice and an opportunity to be heard necessarily limit this flexibility. An example of how a bankruptcy court can attempt to strike a balance between these standards, on the one hand, and the need to move quickly, on the other hand, is afforded by the Lehman bankruptcy. Lehman filed its petitions on Sunday, September 15, 2008, followed the next day by an announcement of its intention to sell its business to Barclays. The hearing on the proposed sale occurred only four days later and the sale was promptly approved.

The bankruptcy court was persuaded to follow this virtually unprecedented timeline based upon its conclusion that Lehman's business was a "melting ice cube." Customers were rapidly withdrawing their accounts, resulting in dwindling prospects for Lehman's business. Only by effectuating a rapid sale to a financially stable counterparty could this exodus be stopped. The downside to this approach, however, is that there was considerable confusion at the time regarding the precise scope and value of the assets being sold and the liabilities that ultimately were assumed. Indeed, more than 18 months after the sale was approved, Lehman and Barclays remain embroiled in litigation over the terms of the sale.

The Act provides another mechanism designed to address situations, such as that presented by Lehman, where the government simply may not have enough time to facilitate a private transaction prior to commencing receivership proceedings. In particular, the FDIC is empowered to create a "bridge financial company" to succeed to selected assets and liabilities of the covered financial company or covered broker-dealer.[60] A bridge company can be created without notice to, input from or consent of any creditors or shareholders. It can be created without the need to obtain approval from a court.[61] The bridge company need not be funded with capital or surplus[62] (though the aggregate amount of liabilities assumed by a bridge company may not exceed the aggregate amount of assets that are transferred to it).[63] Once created, the bridge company is to be managed by a board of directors appointed by the FDIC.[64] The bridge company may follow the corporate governance rules of Delaware or the state in which the applicable covered financial company is organized.[65] Upon approval of its articles of association by the FDIC, a bridge financial company created with respect to a covered broker-dealer is established and deemed registered with the SEC and a member of SIPC.[66]

Notwithstanding this broad grant of power to the FDIC, the Act does have certain restrictions with respect to the transfer of assets or liabilities of a covered financial company or broker-dealer. First, the Act requires the FDIC to treat similarly situated creditors equally when transferring the assets or liabilities of the covered financial company to a bridge company.[67] The FDIC need not comply with this principle; however, if it determines that unequal treatment is necessary to maximize the value and returns from

[60] Act § 210(h)(2).
[61] Act § 210(e).
[62] Act §§ 210(h)(2)(E), 210(h)(5) & 210(h)(2)(G).
[63] Act § 210(h)(5)(F).
[64] Act § 210(h)(2).
[65] Act § 210(h)(2)(F).
[66] Act § 210(h)(2)(H)(i).
[67] Act § 210(h)(5)(E).

the assets or minimize the amount of loss upon sale of the assets.[68] In any event, similarly situated creditors must receive at least the amount they would have received in a liquidation under chapter 7 of the Bankruptcy Code and, with respect to the property of a customer of a covered broker or dealer, the same it would have received in a liquidation initiated by SIPC.[69]

Second, the Act requires that, if the FDIC establishes a bridge company with respect to a covered broker-dealer, all customer accounts of the covered broker-dealer shall be transferred to the bridge company.[70] An exception can be made to this requirement only if the FDIC determines, after consulting with the SEC and SIPC, that the customer accounts are likely to be quickly transferred to another covered broker-dealer, or the transfer of the accounts to a bridge company would materially interfere with the FDIC's ability to avoid or mitigate serious adverse effects on the financial stability of the United States.[71]

A bridge company is not meant to have perpetual existence. Rather, as its name suggests, it is a temporary creation designed to serve as a "bridge" to a permanent transaction with a private acquirer. To ensure a reasonably prompt transaction, a bridge company established under the Act terminates two years after it is granted its charter, although the FDIC has the discretion to extend such status for up to three additional one-year periods.[72] A bridge company will terminate if it merges with or sells the majority of its assets to a company that is not another bridge company.[73] The FDIC, however, is granted the ultimate discretion under the Act to dissolve the bridge company at any time.[74] During the life of a bridge company, the FDIC is not subject to the discretion or supervision of any other governmental agency regarding the assets, liabilities and ultimate disposition of a bridge company.[75]

Provisions for Paying for the Process

The public's negative response to the recent governmental rescues of numerous financial institutions is reflected in the Act. Indeed, the Act includes several provisions that collectively serve as a statement of principles in this regard. First, the Act provides that "no taxpayer funds shall be used to prevent the liquidation of any financial company under the legislation."[76] Second, to drive home the point, the Act provides that "taxpayers shall bear no losses from the exercise of any authority under this title."[77] Third, the Act provides that creditors and shareholders must bear all losses in connection with the liquidation of a covered financial company[78] and that the FDIC shall not take an equity interest in, or become a shareholder of, any covered financial company.[79] This point is important: Many of the rescues in 2008 and 2009 took the form of government purchases of stock in the troubled companies. The Act closes off that avenue. Finally, the Act provides that "[a]ll funds expended in the liquidation of a financial company under this title shall be recovered from the disposition of assets of such financial company, or shall be the responsibility of financial companies, through assessments."[80]

---

[68] Act § 210(h)(5)(E)(i).
[69] Act § 210(h)(5)(E)(ii).
[70] Act § 210(a)(1)(O).
[71] Act § 210(a)(1)(O)(i).
[72] Act § 210(h)(12).
[73] Act § 210(h)(13).
[74] Act § 210(h)(15).
[75] Act § 210(h)(15)(B).
[76] Act § 212(a).
[77] Act § 212(c).
[78] Act § 204(a).
[79] Act § 206(5).
[80] Act § 212(b).

While the Act contemplates financial companies being ultimately responsible for the costs of a liquidation if assets are insufficient, the Act affords means by which the FDIC can incur interim debt obligations to fund a liquidation, which can later be recovered through assessments. Specifically, upon appointment as receiver, the FDIC is authorized to issue obligations to the Secretary to fund the liquidation.[81] The Secretary, in turn, may purchase such obligations and may, for such purposes, issue public debt securities.[82] However, the Act limits the amount of debt that the FDIC may incur for each financial company. During the first 30 days after the FDIC's appointment as receiver, the amount of debt is limited to a maximum amount equal to 10% of the financial company's total consolidated assets based on its most recent financial statement. Thereafter, the debt limit equals 90% of the fair value of the total consolidated assets of the financial company that are available for repayment.[83]

No debt provided pursuant to that 90% limit, however, may be incurred unless the Secretary and the FDIC agree to a "specific plan and schedule to achieve the repayment" of any such debt.[84] The plan must demonstrate that income to the FDIC from liquidated assets and assessments will be sufficient to amortize the debt within the period established in the repayment schedule. The Secretary and the FDIC must consult with the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives on the terms of any repayment schedule agreement.[85]

Moreover, the FDIC is required to charge "one or more risk-based assessments" if necessary for it to pay in full the obligations issued by the FDIC to the Secretary within 60 months of the date of issuance of the obligations, or at a later date if an extension is necessary to avoid a serious adverse effect on the financial system.[86] These assessments must first be made against any claimant that received additional payments from the FDIC pursuant to its authority to treat some creditors more favorably than others, as described above. Any assessment against a claimant must be in an amount equal to the difference between the aggregate value the claimant received from the FDIC on its claim under the Act, on the one hand, and the value the claimant was entitled to receive solely from proceeds of the liquidation of the covered financial company, on the other hand.[87]

If the funds recouped from claimants are insufficient to satisfy the obligations to the Secretary, then the FDIC may assess "eligible financial companies" and certain other financial companies.[88] "Eligible financial companies" include any bank holding company with total consolidated assets equal to or greater than $50 billion and any nonbank financial company supervised by the Board of Governors.[89] Assessments must be imposed on a "graduated basis," with financial companies having greater assets being assessed at higher rates.[90] Moreover, in imposing assessments, the FDIC must use a "risk matrix."[91]

---

[81] Act § 210(n)(5)(A).

[82] Act §§ 210(n)(5)(B) & (E) (citing chapter 31 of title 31 of the United States Code).

[83] Act § 210(n)(6).

[84] Act § 210(n)(9).

[85] *Id.*

[86] Act § 210(o)(1)(B).

[87] Act § 210(o)(1)(D)(i).

[88] Act § 210(o)(1)(D)(ii).

[89] Act § 210(o)(1)(A).

[90] Act § 210(o)(2).

[91] Act § 210(o)(4).

The council shall make a recommendation to the FDIC on the risk matrix to be used. In recommending or establishing such risk matrix, the council and the corporation, respectively, must take into account a host of factors including, among others, economic conditions generally; the extent to which a particular financial company may already be subject to assessments imposed pursuant to other statutory regimes; the risks presented by the assessed financial company to the financial system and the extent to which it has benefited, or likely would benefit, from the orderly liquidation of a financial company; and any risks presented by the assessed financial company during the 10-year period immediately prior to the appointment of the FDIC as receiver for the covered financial company that contributed to the failure of the covered financial company.[92]

An alternative to recouping losses from financial institutions that was contained in the House Bill and in early versions of the Act was the creation of a pre-funded reserve — $150 billion in the House Bill and $50 billion in early versions of the Act.[93] A pre-funded reserve was strongly supported by Sheila C. Bair, Chairman of the FDIC. Chairman Bair argued that having a reserve built up in advance would prevent the need to assess financial institutions during an economic crisis and would allow firms to better manage their expenses.[94] It also would assure that the failed firm contributed to the reserve so that all costs would not be borne by surviving firms.[95] Additionally, a pre-funded reserve would reduce the likelihood of any taxpayer funding.[96]

In a system where assessments are made after the fact, however, the initial funding necessary to provide working capital must be borrowed from the Secretary.[97] Such borrowing could be politically charged because it may be seen as a government bailout.[98] Despite the practical and political reasons to establish a pre-funded reserve, it was argued successfully that the existence of a pre-funded reserve would create a moral hazard and increase imprudent risk taking. Accordingly, the Act adopted the after-the-fact assessment funding mechanism instead.[99]

Funds raised by the FDIC through borrowings from the Secretary and through assessments on the financial sector are to be deposited into the Treasury in a separate fund known as the "Orderly Liquidation Fund."[100] Amounts in the Fund are available to the FDIC to carry out its responsibilities under the Act, including the payment of principal and interest on obligations it issues to the Secretary.[101] However, the FDIC may utilize amounts in the Fund with respect to a covered financial company only after the FDIC has developed an orderly liquidation plan that is acceptable to the Secretary.[102]

---

[92] Act § 210(o)(4).

[93] The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong (2009) § 1609(n) (House bill establishing a $150 billion pre-funded reserve).

[94] Statement of Shelia C. Bair, Chairman, Federal Deposit Insurance Corporation on the Causes and Current State of the Financial Crisis before the Financial Crisis Inquiry Commission; Room 1100, Longworth House Office Building, January 14, 2010.

[95] *Id.*

[96] *Id.*

[97] *Id.*

[98] *Id.*

[99] Amendment No. SA3827 to Act, proposed by Mr. Shelby (May 5, 2010) (amending Senate bill to delete provision that would have established a pre-funded reserve).

[100] Act § 210(n)(1) & (2).

[101] Act § 210(n)(1).

[102] Act § 210(n)(9).

These detailed provisions for recouping the costs of liquidating a covered financial company through assessments on the financial sector afford the FDIC considerable leverage in attempting to broker private rescues of troubled financial companies. As noted above, private restructuring solutions almost invariably are more value additive, less expensive and less risky than those that must be implemented through a formal process. For this reason, the government frequently attempts to facilitate private, consensual solutions regarding troubled thrifts and other regulated entities. Indeed, for this same reason, stakeholders of other business entities typically try to develop out-of-court solutions among themselves as well.

But with the hammer afforded by these provisions of the Act that allow the FDIC to recoup the costs of a liquidation from other financial counterparties, the FDIC will have significantly greater ability to compel financial counterparties to a troubled entity to develop a solution — and pay for it — themselves, without the need for a receivership. Financial counterparties in such a situation should have an incentive to do so, as the potential fallout and costs of a receivership easily could be much greater than if the parties were able to develop and implement a private, non-receivership solution themselves.

The exemplar of an effective out-of-court process in the financial services industry is the restructuring of Long-Term Capital Management.[103] In 1998, Long-Term Capital was a multibillion-dollar hedge fund that was teetering on the brink of collapse. Given the size of Long-Term Capital — it was party to more than $1.4 trillion gross national amount in outstanding trades — counterparties and the government feared that the company's failure would cause a chain reaction in the markets, leading to catastrophic losses throughout the financial system.[104] To avoid a systemic failure, the Board of Governors convened an emergency session of a consortium of several major Wall Street investment houses at which it effectively "passed the hat."

All participants at the meeting (other than Bear Stearns) agreed that it was in their interests to prop up Long-Term Capital, even though it was a rival to many of them, rather than risk the potential consequences of its failure. The participants paid a total of $3.625 billion and received, in exchange, 90% of Long-Term Capital's equity as well as operational control of the company. By 2000, the participants had been repaid.[105] If a similar situation arises in the future, the FDIC can pass the hat again — while telling counterparties that they can "pay now," or they can be forced to "pay later" under circumstances that may entail significantly greater cost.

Finally, while the Act contains broad prohibitions on the use of taxpayer funds to finance a liquidation, financing of liquidations is not prohibited outright. To the contrary, the FDIC may, "in its discretion" and as "necessary or appropriate," make available to the receivership funds for the orderly liquidation of a covered financial company.[106] All such funds are afforded priority in payment.[107] Similarly, the FDIC may provide funding to facilitate transfers to or from a bridge financial company.[108] Lastly, a bridge financial

---

[103] House Committee on Banking and Financial Services, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management: Report of the President's Working Group on Capital Markets* 12-14 (April 1999).

[104] *Id.* at 11-12.

[105] Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management* 229 (Random House, 2000).

[106] Act § 204(d).

[107] *Id.*

[108] Act § 210(h)(9).

company is authorized to obtain its own financing, including financing secured by a lien that is senior to existing liens.[109] The terms governing such financing are identical to those by which debtors under the Bankruptcy Code may obtain financing.[110]

Special Provisions Regarding Derivatives

As noted above, the Act contains numerous provisions regarding the transfer and repudiation of contracts and leases and the related rights of non-debtor parties under various scenarios. The Act also contains separate provisions that afford special protections to derivatives agreements and the rights of derivatives counterparties, protections that are not available in connection with other agreements. In this regard, the Act is consistent with existing law regarding the treatment of derivatives under the Bankruptcy Code and the FDIA.

In particular, each of these statutory regimes extends special protections to several classes of derivatives contracts — which are called "qualified financial contracts" under the Act and the FDIA — including repurchase agreements, securities contracts, forward contracts, commodity contracts and swap agreements and, in each instance, specifically defined classes of counterparties.[111] The definitions of each of these categories of agreements and protected counterparties are the same in the Act, the Bankruptcy Code and the FDIA.[112] Each regime provides that selected non-debtor counterparties to such agreements are free to exercise their contractual rights to terminate, close out and liquidate their positions upon the insolvency of their counterparties.[113] This is the reverse of the general rule governing virtually all other agreements: clauses in such agreements that allow a non-debtor to terminate an agreement based upon the financial condition of, or the commencement of insolvency proceedings with respect to, a counterparty are unenforceable.[114]

The ostensible rationale behind the special protections afforded counterparties to qualified financial contracts is that the use of such contracts is so prevalent — the amounts involved are so large; the contracts trade so quickly; and such contracts have resulted in financial institutions becoming so highly interconnected — that non-debtor counterparties must be free to close out their contracts immediately upon an insolvency event, or else the fallout from the failure of one institution will have uncontrollable, cascading effects across countless trading parties and other institutions. By being able to terminate and close out qualified financial agreements immediately, the effects of one firm's financial collapse will be contained to that one institution, or so the argument goes.

While this has been the long-standing policy behind the special protections afforded qualified financial contracts — it was, in part, what motivated counterparties to support Long-Term Capital — this policy has not been without controversy.[115] Indeed, at one point during the evolution of, and debate over, the bill that ultimately became the Act, Senator Bill Nelson (D - Fla.) proposed an amendment to the bill that would have repealed the Bankruptcy Code protections altogether.[116] The amendment was not adopted,

---

[109] Act § 210(h)(16).

[110] 11 U.S.C. § 364.

[111] Act § 210(c)(8); 11 U.S.C. §§ 555, 556, 559, 560 & 561; 12 U.S.C. § 1821(e)(8).

[112] Act § 210(c)(8)(D); 11 U.S.C. § 101; 12 U.S.C. § 1821(e)(8)(D)(i), respectively.

[113] Act § 210(c)(8); 12 U.S.C. § 1821(e)(8); 11 U.S.C. §§ 555, 556, 559, 560 & 561.

[114] Act § 210(c)(13)(C)(i); 11 U.S.C. §§ 365(e)(1) and § 541(c); 12 U.S.C. § 1821(e)(10)(B).

[115] See, *e.g.*, Stephen J. Lubben, Derivatives and Bankruptcy: The Flawed Case for Special Treatment, 12 U. PA. J. Bus. L. 61 (2009).

[116] Proposed Amendment to the Act, available at http://www.creditslips.org/files/ayo10790.pdf.

but the fact that it was proposed — along with the numerous other provisions of the Act that provide for significant regulation of, and that require far greater transparency with respect to, derivatives trades[117] — clearly indicates that the longstanding policy regarding favorable treatment of qualified financial contracts is not universally shared and has been, at least in part, scaled back.[118]

Indeed, the recent failures of many businesses that rely on derivatives has demonstrated that when the financial condition of a derivatives counterparty begins to decline, events tend to move with alarming speed. This is partly because, under many derivatives contracts, counterparties mark the values of their positions daily, margin calls must be met within one or two days, and counterparties frequently have considerable discretion determining market values and, hence, the amounts of their margin calls. As a result, when a company experiences financial trouble — or even a market rumor of trouble — confidence vanishes; the rate of margin calls can spike, and the company therefore can find itself in a liquidity crisis overnight.

This was the fate of the roughly 150 mortgage lenders who have filed bankruptcy since early 2007. When their counterparties lost confidence, liquidity vanished. Virtually all of these lenders collapsed into bankruptcy court. None of them reorganized in the traditional sense. Their only option was rapid sales of their servicing platforms. Some entities in the mortgage securities business did not even have that option. When markets experienced major dislocations and counterparties of funds sponsored by Bear Stearns and Carlyle Capital marked down the value of their securities and made margin calls, the funds were unable to meet the margin calls, counterparties closed out their positions and liquidated tens of billions of dollars in total asset positions in a matter of days, and each fund was left to dissolve pursuant to offshore liquidation regimes, as there simply was nothing to achieve in a proceeding under the Bankruptcy Code. Finally, in September 2008, one of the largest derivatives counterparties of all — Lehman Brothers Holdings — filed for bankruptcy. Since then, its stakeholders have been left to unwind an estimated one million derivatives trades — a process that will take years.

It is perhaps in part because of the fallout from these recent experiences that the Act contains three important limitations on typical contractual rights of derivatives counterparties. First, the Act prohibits a protected party from terminating, liquidating or netting out its position solely by reason of the appointment of the FDIC as receiver or the financial condition of the financial company in receivership until 5:00 p.m. Eastern Time on the next business day following the date of appointment of the FDIC.[119] A protected party also is precluded from exercising any such contractual rights after it has received notice that its qualified financial contract has been transferred to another financial institution[120] — including a bridge financial company.[121] The Act requires the FDIC to notify a protected party of any such transfer by 5:00 p.m. Eastern Time on the next business day following the date of appointment of the FDIC.[122]

---

[117] See "Regulation of Over-the-Counter Derivatives Under the Dodd-Frank Wall Street Reform and Consumer Protection Act."

[118] Ironically, however, only a few short years ago, insolvency laws relating to derivatives actually were expanded. In particular, the Bankruptcy Code and the FDIA were amended in 2005, and again in 2006, to significantly expand the protections afforded derivatives and the rights of non-debtor counterparties. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, 119 Stat. 23 (codified in multiple sections of the United States Code). The changes included much more comprehensive definitions of the categories of protected contracts designed to reflect the dramatic growth in the diversity of sophisticated financial products that occurred in the 1990s and early 2000s. Of particular significance, the definition of qualifying repurchase agreements was expanded to cover mortgage loans and mortgage-related securities.

[119] Act § 210(c)(10)(B)(i)(I).

[120] Act § 210(c)(10)(B)(i)(II).

[121] Act § 210(c)(9)(D).

[122] Act § 210(c)(10)(A).

These provisions have no parallel in the Bankruptcy Code or SIPA, although there are provisions under the FDIA that also provide for a one-day moratorium.[123] Their collective effect is to afford the FDIC one day after its appointment, either to consummate a transfer of a qualified financial contract to a private acquirer, or to transfer it to a newly created bridge company. Absent one of these two types of transfers within the allotted time frame, counterparties may exercise their contractual rights. While this period of time is brief, and while the Act does not afford the FDIC any power to attack pre-receivership terminations and closeouts of qualified financial contracts (except in the case of intentional fraud), this limited moratorium could afford considerable stability in the early days of a receivership, thereby avoiding the type of firestorm that engulfed Lehman Brothers when it filed for bankruptcy as thousands of counterparties terminated their contracts and liquidated their positions.

The second and third limitations on the rights of derivatives counterparties relate to so-called "walkaway" clauses. In the typical derivatives contract, when the contract is terminated, the party who is "out of the money" must pay the party who is "in the money." A walkaway clause overrides this provision by affording the nondefaulting party the right to walk away from a termination payment it otherwise would owe the defaulting party. It also may give the nondefaulting party the right to suspend periodic payments it otherwise may owe to the defaulting party under the contract, an option the defaulting party may exercise in lieu of termination in the hope that favorable market movements will reduce any amount owed to the defaulting party.

The Act defines a walkaway clause, in part, as follows: "any provision in a qualified financial contract that suspends, conditions, or extinguishes a payment obligation of a party … solely because of the status of such party as a nondefaulting party in connection with the … appointment of [the FDIC] as receiver for [a] covered financial company…."[124] The Act provides that no walkaway clause shall be enforceable in a qualified financial contract of a covered financial company in default.[125] It further states that a counterparty may suspend a payment or delivery obligation only for a limited period of time: one day following appointment of the FDIC as receiver.[126] Thereafter, the counterparty must perform.

There are no provisions parallel to these limitations in the Bankruptcy Code or SIPA, although there are similar provisions under the FDIA that provide for a one-day moratorium on payment suspensions.[127] However, these limitations are consistent with two recent rulings by the bankruptcy court presiding over the Lehman liquidation that involved interpretations of broad provisions of the Bankruptcy Code that, by their terms, do not specifically contemplate walkaway clauses. In one case, the bankruptcy court addressed the enforceability of a clause contained in a synthetic collateralized debt obligation transaction.[128] The structure included a swap agreement, along with an agreement between the swap counterparty and the holders of securities that established priorities with respect to collateral for both sets of obligations. Lehman's rights, as swap counterparty, were senior to those of the securities holders — except that, in the event of a default by Lehman, that priority was to be inverted.

---

[123] 12 U.S.C. § 1821(e)(10)(B).

[124] Act § 210(c)(8)(F)(iii).

[125] Act § 210(c)(8)(F)(i).

[126] Act § 210(c)(8)(F)(ii).

[127] 12 U.S.C. § 1821(e)(8)(G)(ii).

[128] *In re Lehman Bros. Holdings Inc.* (*Lehman Bros. Special Fin. Inc. v. BNY Corp. Trustee Servs. Ltd.*), 422 B.R. 407 (Bankr. S.D.N.Y. 2010).

The *Lehman* bankruptcy court ruled that this priority inversion was unenforceable because the practical effect, given the value of the collateral, would have been that Lehman would be out of the money if the provision was enforced. The *Lehman* court relied, among other things, on a provision of the Bankruptcy Code that renders unenforceable contractual provisions that effect a forfeiture or modification of debtor's rights solely by virtue of the debtor's financial condition or the commencement of a bankruptcy case.[129] The *Lehman* court adopted a similar stance towards a counterparty who suspended payments to Lehman that otherwise would have been due absent Lehman's bankruptcy.[130] The court viewed the counterparty's conduct as inequitable and contrary to a debtor's general right under the Bankruptcy Code to compel a counterparty to continue performing pending the debtor's determination whether to assume or reject.

Possible Consequences to Directors and Management

Underlying much of the public's dissatisfaction with government bailouts is the sentiment that taxpayers have been made to pay for the perceived misfeasance of the rescued financial companies' management. These sentiments are not new. In 2005, Congress amended the Bankruptcy Code to curtail perceived abuses in the process by which management of companies in bankruptcy historically were compensated: "the executives of giant companies [in bankruptcy] … lined their own pockets, but left thousands of employees and retirees out in the cold."[131] Prior to the 2005 amendments, it had become standard in bankruptcies to afford management executives periodic payments to induce them to stay with the company and assist it in restructuring its affairs (so-called "pay to stay" compensation). They were often ensured significant severance and incentive compensation packages as well.

These forms of compensation continue in bankruptcy cases today — albeit subject to significant limits imposed by the 2005 amendments. The Bankruptcy Code now effectively prohibits retention payments to insiders of a debtor by limiting such payments to circumstances that are unlikely to ever occur.[132] Similarly, the Code strictly limits severance that may be provided to insiders of a debtor[133] and prohibits the payment of other obligations outside of the ordinary course of business, including incentive compensation, that is "not justified by the facts and circumstances of the case."[134]

---

[129] 11 U.S.C. § 541(c).

[130] *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555 (JMP) (Bankr. S.D.N.Y.) (Transcript of Sept. 15, 2009 Hearing at 99-113) (Docket No. 5261), and *Order Pursuant to Sections 105(a), 362 and 365 of the Bankruptcy Code to Compel Performance of Contract and to Enforce the Automatic Stay* (Docket No. 5209).

[131] *In re Dana Corp.*, 358 B.R. 567, 575 (Bankr. S.D.N.Y. 2006) (*quoting* Statement of Senator Edward Kennedy on the Bankruptcy Bill (Mar. 1, 2005)).

[132] In this regard, a debtor may only make retention payments to an insider if the bankruptcy court finds that (a) the payment is essential to the retention of the insider because such insider has a bona fide job offer at the same or greater rate of compensation; (b) the insider's services are essential to the company; and (c) either (i) the amount of the payment is not greater than 10 times the amount of the mean payment of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the payment was made, or (ii) if no similar payments were made to such nonmanagement employees during such calendar year, the payment is not greater than 25% of the amount of the mean payment of a similar kind given to nonmanagement employees for any purpose during the calendar year before the year in which the payment was made. 11 U.S.C. § 503(c)(1).

[133] Section 503(c)(2) prohibits the payment of severance to insiders of a debtor unless (a) such severance payment is part of a program that is generally applicable to all full-time employees; and (b) the amount of the payment is not greater than 10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made. 11 U.S.C. § 503(c)(2).

[134] 11 U.S.C. § 503(c)(3).

Despite these limitations, the Bankruptcy Code continues a presumption that the board and management of a company should remain in place while the company reorganizes.[135] Inherent in this presumption is the premise that, absent exceptional circumstances, existing management is best positioned to maximize the value of a debtor's estate[136] — with the further qualification that the board and management of a company in chapter 11 are subject to the supervision of a bankruptcy court and, hence, cannot implement decisions outside the ordinary course of business without advance court permission.

However, more recent expressions of public outrage over bonuses paid to management of rescued companies has resulted in a significant shift in this presumption: The Act provides, in several sections, that management responsible for the condition of the financial company will be severed from its employment.[137] Additionally, those responsible for the financial condition of the financial company may be made to bear economic consequences consistent with their responsibility.[138]

Like the Bankruptcy Code, the Act also provides that any payment made to, or for the benefit of, an insider, or any obligation incurred to or for the benefit of an insider, under an employment contract and not in the ordinary course of business, may be avoided as a fraudulent transfer if the covered financial company received less than reasonably equivalent value in exchange for such payment or transfer.[139] The target of this provision is overly rich severance and buyout payments given to separated executives. Moreover, the Act, like the Bankruptcy Code, provides a limited priority for unpaid claims of employees for wages, salaries, commissions and other benefits. However, unlike the Bankruptcy Code, the Act expressly subordinates any such claims held by senior executives and directors to general unsecured claims.[140]

Even more significantly, the Act outlines the circumstances under which culpable management may be banned from the financial services industry for a term of at least two years.[141] Specifically, the Act provides that management may be banned if the FDIC determines that:

- management directly or indirectly (a) violated any (i) law or regulation, (ii) final cease-and-desist order, (iii) condition imposed in writing by a federal agency in connection with any action, application, notice

[135] 11 U.S.C. §§ 1107 and 1108. Similarly, Bankruptcy Code section 1121 grants the debtor the exclusive right to propose a plan of reorganization during the first 120 days of a chapter 11 case. 11 U.S.C. § 1121(b).

[136] H.R. Rep. No. 95-595, at 233 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6192. ("[V]ery often the creditors will be benefited by continuation of the debtor in possession, both because the expense of a trustee will not be required, and the debtor, who is familiar with his business, will be better able to operate it during the reorganization case. A trustee frequently has to take time to familiarize himself with the business before the reorganization can get under way. Thus, a debtor continued in possession may lead to a greater likelihood of success in the reorganization.").

[137] Act § 206(4) (FDIC shall ensure that management responsible for the financial condition of the covered financial company is removed); Act § 210(a)(1)(C)(ii) (although FDIC may provide for exercise of any function by any member, stockholder, director or officer of any covered financial company, Act requires a "strong presumption" that the FDIC will remove management responsible for such company's failed condition).

[138] Act § 204(a)(3) (FDIC will take all steps necessary to ensure that all parties "having responsibility for the condition of the financial company [will] bear losses consistent with their responsibility"); § 210(f) (provides for liability of directors and officers for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct); § 210(s) (recoupment of compensation from senior executives and directors for the two-year period prior to the beginning of the receivership, except that, in the case of fraud, no time limit will apply).

[139] Compare 11 U.S.C. § 548(a)(1)(B) *with* Act § 210(a)(11) .

[140] Act § 210(b)(1).

[141] Act § 213(c)(1).

or request by the company or such senior executive, or (iv) written agreement with such agency; (b) engaged or participated in any unsafe or unsound practice in connection with any financial company; or (c) committed or engaged in any act, omission or practice which constitutes a breach of fiduciary duty;

- by reason of such violation, practice or breach, management has received financial gain or other benefit and such violation, practice or breach contributed to the failure of the company; and
- such violation, practice or breach (a) involves management's personal dishonesty; or (b) demonstrates willful or continuing disregard for the safety and soundness of the company.[142]

These strong measures may motivate boards and management to remove culpable actors and/or otherwise cooperate in connection with pre-receivership negotiations designed to reorganize a troubled financial company without receivership. But they could go too far. Through the "strong presumption" of removal, they have the potential to deprive financial companies of the services of management that might be best positioned to maximize value. Indeed, financial companies in distress may have difficulty retaining or attracting competent management who may be wary of the prospect of being subjected to a presumption of removal notwithstanding their best efforts to avoid liquidation.

[142] Act § 213(b). Upon a finding of the foregoing, the FDIC or the Board of Governors, as appropriate, may serve upon management a written notice of the intention of the agency to prohibit any further participation by management in the affairs of any financial company for a period of time that such agency determines is commensurate with such violation, practice or breach. The due process requirements and other procedures under FDIA section 8(e) apply to actions taken under this section of the Act. Such requirements include that the notice contain a statement of the facts constituting the grounds for the ban and the time and place at which a hearing will be held thereon. Generally, the hearing must be set for a date not earlier than 30 days nor later than 60 days after the date of service of the notice. Act § 213(c); 12 U.S.C. § 1818(e).