What Contract Counterparties of Financial Companies Need to Know About the Dodd-Frank Orderly Liquidation Provisions

A recurring theme in the wake of the 2008 financial crisis was that federal authorities lacked the power to intervene to prevent Lehman's precipitous collapse into bankruptcy, and to lessen the enormous cash needs required to keep AIG from following suit. An important element of the recently passed financial reform legislation, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), which continues to evolve as the law moves into the rulemaking and study phase, is the grant of broad authority to the Treasury, Federal Reserve, and Federal Deposit Insurance Corporation ("FDIC") under Title II of the law to intervene quickly and decisively to liquidate a "systemically important" financial company, where failure of such an entity appears imminent. While the newly created powers in large part mirror the Bankruptcy Code and the Federal Deposit Insurance Act ("FDIA") regulatory framework, they also go beyond these current regimes, with implications for parties doing business with entities once considered "too big to fail."

What Types of Companies Can Be Liquidated Under Dodd-Frank?

Title II of Dodd-Frank (also called the "Orderly Liquidation Authority" or "OLA" provisions of the law), applies to a variety of "financial companies" including bank holding companies, non-bank financial companies supervised by the Federal Reserve, companies that are "predominately engaged" in activities the Federal Reserve has determined are "financial in nature" under Section 4(k) of the Bank Holding Company Act, and any of their subsidiaries, other than insured depository institutions or insurance companies. Subsidiaries of these companies are also swept within the purview of Title II to ensure that parent entities will not move riskier financial transactions into more lightly regulated subsidiaries. The "predominately engaged" test is satisfied if 85% of the total consolidated revenues of the target entity and its subsidiaries – including depository institutions – are derived from activities that are financial in nature.

In contrast to "financial companies," both insured depository institutions and insurance companies generally are not within the purview of Dodd-Frank's OLA provisions. The liquidation of insured depository institutions will proceed under existing FDIC procedures. The liquidation or rehabilitation of insurance companies will be conducted according to state law, unless a state regulator fails to act within 60 days after the Treasury Secretary determines a company presents a systemic risk. After this 60-day period, the FDIC has the authority to commence a proceeding in state court to liquidate or to rehabilitate the insurance company. Also excluded from Dodd-Frank's OLA provisions are "farm credit system" institutions, governmental entities, "federal home loan banks," and Fannie Mae and Freddie Mac.

Petition for Authority to Liquidate

To initiate an "orderly liquidation," the FDIC, the Securities and Exchange Commission ("SEC") (in the case of a broker-dealer), the Director of the Federal Insurance Office (in the case of an insurance company) or the Federal Reserve, either on their own initiatives or at the request of the Treasury Secretary, must ask the Treasury Secretary to appoint the FDIC as receiver for the company and its subsidiaries. The Treasury Secretary then must make a determination that the entities at issue are in default or in danger of default, and further that such default would have "serious adverse effects on financial stability in the United States" that outweigh the impact on creditors, counterparties, and shareholders. Furthermore, the Treasury Secretary must determine that no viable private sector restructuring alternative is available to prevent default.

If the entity at issue disputes the regulator's liquidation petition, Title II of Dodd-Frank mandates an expedited hearing process in federal court in Washington, DC. However, the regulator's petition is automatically granted if not acted upon within 24 hours. This accelerated time table effectively creates a strong presumption that the entity will be placed into receivership once the requisite findings are made.

Appointment of FDIC as Receiver

Once the FDIC is appointed as receiver of the entity (at that point called a "covered financial company"), the regulators will begin the process of liquidation. However, any subsidiaries that are insured by the FDIC as depository institutions, insurance companies, or SEC-registered broker-dealers will continue to be supervised by their respective regulatory oversight regimes.

SIPC Acts as Trustee in Broker-Dealer Liquidations

If a broker-dealer is to be liquidated as part of the broader receivership of the corporate family, the Securities Investor Protection Corporation ("SIPC") will be appointed to act as trustee for the liquidation, although the FDIC will retain the power to, among other things, determine claims and repudiate contracts. It will be important to closely track the rulemaking process embedded in Dodd-Frank, as these powers will add an element of uncertainty to the rights of customers and other counterparties of the broker-dealer.

Powers of the FDIC: Comparison to FDIA and Bankruptcy Code

In order to carry out its role as receiver, the FDIC will possess virtually all of the powers it now has under the FDIA with respect to failed insured depository institutions. Title II's fraudulent transfer and preference strong-arm powers closely track those found in the Bankruptcy Code. Creditor setoff rights mirror those of Section 553 of the Bankruptcy Code.

An important distinction between the OLA and the Bankruptcy Code exists, however, with respect to Qualified Financial Contracts ("QFCs"). Where the Bankruptcy Code creates a safe harbor that allows QFCs to be netted- and closed-out immediately, with remedies against collateral exercised notwithstanding the automatic stay, Title II mandates a one-day stay to enable the FDIC to assess potential inter-creditor risk.

Preemption of Existing Bankruptcy Proceeding

Once an orderly liquidation under Title II has been initiated, the proceeding will preempt a bankruptcy case under the Bankruptcy Code, terminating any prospect of the covered financial company's reorganization. Of particular concern to contract counterparties is that any assets of the liquidating company that were transferred, conveyed or paid to a contract counterparty during the pendency of the (now preempted) bankruptcy case would revest in the liquidating company once the bankruptcy is preempted by the orderly liquidation. This makes forcing a company into bankruptcy in order to trigger contractual remedies a less attractive option for counterparties, as a Title II liquidation would cause a reversal of any post-bankruptcy asset transfers.

Treatment of Creditor Claims

Title II preserves the priority of payment of creditor claims contained in the Bankruptcy Code, with several important distinctions. Under Title II, any administrative expenses of the FDIC, as well as sums owed to the U.S. government, come before any other unsecured claims. Additionally, claims of senior executives and directors related to wages and bonuses are placed below unsecured claims in the priority scheme.

Stay Not Automatic; Limited to Ninety Days

In contrast to the broad and automatic stay of all pre-bankruptcy judicial proceedings against the debtor mandated by the Bankruptcy Code, under Title II, a stay of such proceedings is not automatic, and does not last for the duration of the liquidation proceeding. To obtain a stay of any ongoing judicial proceeding related to the covered financial company, the FDIC as receiver may ask the court in which the action is pending for a stay of the proceeding, which the court must grant for a period of 90 days.

Repudiation of "Burdensome" Contracts

Title II grants the FDIC the power to repudiate "burdensome" contracts and leases of a covered financial company to promote an orderly liquidation. A similar standard applies under the FDIA, and is generally considered broader than the contract rejection rights granted by the Bankruptcy Code. Under the Bankruptcy Code, a contract must be executory, or have performance left on both sides, to be rejected. The "burdensome" standard, as applied by the FDIC in the past, has been interpreted to contain no such requirement.

Additionally, under Title II, a receiver will be liable only for "actual direct compensatory damages" measured as of the date the receiver is appointed. Recoveries for profits, lost opportunity, pain and suffering, and punitive damages are not allowed. The FDIC cannot reinstate a contract that was terminated before its appointment as receiver. Further, the Bankruptcy Code mandates that prior to assumption or assignment of a contract, a debtor must cure all defaults, compensate for damages, and provide adequate assurance of future performance. Title II does not contain such protections for contract counterparties.

Mandatory Studies

Another possibly troubling provision of Dodd-Frank to counterparties is a study to be performed by the Financial Stability Oversight Council to determine whether a mandatory 10% haircut for secured creditors "could improve market discipline and protect taxpayers." Title II requires parallel studies to review the bankruptcy and liquidation process for financial companies under the Bankruptcy Code.

Removal of Board and Management

Reflecting, no doubt, the political fallout of the bailouts of a number of high-profile institutions during the financial crisis, Title II provides that once a covered financial company is placed into receivership, its board and management must be removed. No taxpayer funds may be used to prevent the subsequent liquidation.

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Title II of the Dodd-Frank legislation creates areas of unpredictability as to how contract counterparties will be impacted by the new liquidation procedures. As regulators continue the rulemaking process with respect to Dodd-Frank, it will be important to closely monitor any regulatory proposals that could further impinge upon the rights of counterparties to contracts with entities that in the future could face liquidation under Title II of Dodd-Frank.

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