

FDIC's Second Notice of Proposed Rulemaking under the Orderly Liquidation Authority

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Introduction

On March 23, 2011, the FDIC published its [second notice of proposed rulemaking](#) (the “**Second NPR**”) to implement its new Orderly Liquidation Authority (OLA) under Title II of the Dodd-Frank Act.

The Second NPR strikes a more balanced tone between how the FDIC will use its new authority to end taxpayer-funded bailouts of creditors and other stakeholders, while avoiding the sort of “disorderly” liquidation or reorganization under the Bankruptcy Code that could trigger a chain reaction of panic and failures that could result in a severe destabilization or collapse of the U.S. financial system.¹

While it is too early to tell whether the Second NPR signals a permanent change in the tone of the FDIC’s rulemakings and other public statements, it is an important first step.

Nevertheless, the Second NPR continues to focus primarily on issues that are relevant to the FDIC’s own exercise of authority, rather than those that are important to market efficiency and confidence. In particular, it does not clarify how many of the most essential rights of creditors and customers of a systemically important bank holding company or nonbank financial institution (a “**non-bank SIFI**”) will be protected, including how:

- the FDIC will use its new powers to avoid or mitigate any serious adverse effects on financial stability in the United States that could be caused by the failure of a non-bank SIFI and its “disorderly” liquidation or reorganization under the Bankruptcy Code during a financial crisis;²
- unsecured creditors will be assured adequate due process, including challenging any disputed asset valuations by the FDIC or any failure by the FDIC to comply with its duties to maximize the value of a failed SIFI for the benefit of its creditors, minimize losses to shareholders and creditors, and provide creditors with their minimum recovery entitlement;³
- customers and secured creditors will be assured adequate due process, including challenging or allowing them to take actions to protect themselves against any disputed asset or collateral valuations by the FDIC or any failure by the FDIC to segregate assets belonging to customers and secured creditors from assets available to satisfy the claims of unsecured creditors; or
- the claw-back rules in Section 210(o) of Title II would work in the case of creditors who receive additional payments from the FDIC or whose claims are assumed by a creditworthy third party or bridge financial company, if some creditors or claims of the same class do not or are not.

The Second NPR does clarify several issues that are important to both the FDIC and market efficiency, including:

- the definition of the term “financial company”;

¹ Such a destabilization or collapse of the U.S. financial system could impose severe and lasting damage on the real economy, including the labor market, by causing a severe contraction of the supply of money and credit over an extended period of time.

² Unless this standard is satisfied, the Treasury Secretary cannot lawfully appoint the FDIC as receiver of a non-bank SIFI under Title II. See Dodd-Frank Act, § 203(b)(2), (5). The FDIC has similarly not clarified how it will use its analogous powers under the Federal Deposit Insurance Act (the “**FDI Act**”) to eliminate the Hobson’s choice between a taxpayer-funded bailout of a systemically important bank and a “disorderly” liquidation or resolution of such a bank under the FDI Act.

³ We understand that the FDIC considered provisions regarding how creditors could enforce their minimum recovery entitlement, but that it stripped those proposals from the final version of the Second NPR because it needed more time to consider them. The FDIC has apparently reserved 12 C.F.R. sections 380.27-.29 for such provisions to be proposed in the future.

- how the preferential and fraudulent transfer provisions in Title II will be harmonized with the Bankruptcy Code;
- the priorities of administrative expenses and unsecured claims;
- the payment of post-insolvency interest;
- the obligations of bridge financial companies with respect to assumed claims and the use of any proceeds realized from the sale or other disposition of the bridge;
- certain details of the FDIC's administrative claims process, including the procedures for seeking *de novo* judicial review of disallowed claims; and
- special rules for secured claims.

The Second NPR, however, also includes some proposals that could undermine safety and soundness of institutions and market efficiency and even be destabilizing during a financial panic, including proposals for:

- determining whether senior executives or directors of a covered financial company were “substantially responsible” for its failure and may therefore be ordered to return up to two years of their compensation; and
- the treatment of claimants whose set-off rights are destroyed by the FDIC's exercise of its new authority under Title II, resulting in such claimants receiving less for their claims than they would have received in a liquidation under Chapter 7 of the Bankruptcy Code.

The 60-day comment period runs from the date of the Second NPR's publication in the *Federal Register*, and so ends on May 23, 2011.

The FDIC indicated that the Second NPR is only the second in a series of additional rulemakings designed to implement Title II. In particular, the FDIC has said it intends to propose additional rulemakings in the following areas, among others:

- termination of receiverships;
- eligibility requirements for purchasers of covered financial companies, their assets or bridge financial companies;
- records retention requirements; and
- the resolution of broker-dealers, including the priorities and claims process for broker-dealers.

Summary and Analysis of the Second NPR

Definition of Financial Company

The term “financial company” is defined in Title II of the Dodd-Frank Act to include any **company organized under U.S. law** that is “predominantly engaged” in activities that the Federal Reserve has determined to be “financial in nature or incidental thereto” for purposes of the Bank Holding Company Act (the “**BHC Act**”).

- **Overview.** The proposed rules clarify what it means for a company to be “predominantly engaged” in financial activities by incorporating the extensive list of activities in which a financial holding company is permitted to engage under the BHC Act. This list of activities is derived from Section 4(k) of the BHC Act and the Board's Regulation Y, which distinguishes financial activities from commercial activities, and includes activities such as securities underwriting and dealing and

insurance underwriting and brokerage, along with investment advisory activities among many other activities.

- **Excluded companies.** Title II expressly excludes from the term “financial company” Fannie Mae, Freddie Mac, any Federal Home Loan Bank and any Farm Credit System institution.
- **Insured depository institutions and insurance companies.** Title II expressly excludes from its scope insured depository institutions, which cannot be covered financial companies under Title II. An insurance company cannot be subject to Title II merely as a result of being a **subsidiary** of another financial company.
 - **Insurance companies.** An insurance company that is a standalone company or the ultimate parent of a group, or even a subsidiary, could be treated as a covered financial company for purposes of Title II provided that the Treasury Secretary were to make a specific determination that such company should be subject to Title II, upon a recommendation of two-thirds of the board of the Federal Reserve and the consent of the Director of the Federal Insurance Office, in consultation with the FDIC. If it were so treated, however, Title II would require it to be resolved under applicable state insurance insolvency laws.
- **Predominantly Engaged.** The proposed rules would define “predominantly engaged” in financial activities to mean that:
 - at least 85% of the total consolidated **revenues** of the company for **either** of its two most recently completed fiscal years were derived, directly or indirectly, from financial activities; or
 - the **FDIC** determines **at any time** that, based upon all relevant facts and circumstances, the consolidated revenues of the company from financial activities constitute 85% or more of the total consolidated revenues of the company.

Two-year look-back. Title II itself does not specify the time frame for determining whether an entity is predominantly engaged in financial activities; however, the proposed test is designed to disregard temporary declines in financial revenues by basing the test on a company’s annual revenues in **either** of the two most recent fiscal years. Therefore, a company must fail to meet the 85% test for two consecutive years in order to be excluded from the first alternative definition.

Case-by-case determination. The FDIC reserves the right based on all the facts and circumstances to determine that a company is predominantly engaged in financial activities by applying the 85% test at any point in time. This provision is designed to give the FDIC flexibility to treat a company as a financial company for purposes of Title II at any time, if changes in the activities of the company would affect whether it is subject to Title II.

Accounting standards. The accounting standards used to calculate a company’s revenues must be the standards used by the company in the ordinary course of business to prepare its consolidated financial statements, provided that the standards are U.S. GAAP, IFRS or any other accounting standard determined by the FDIC to be appropriate.

- A “**financial activity**” would be defined as follows:
 - any activity, wherever conducted, described in § 225.86 of Regulation Y or any successor regulation, including any activity that is “incidental” to a financial activity;
 - ownership or control of one or more depository institutions; or

- any other activity, wherever conducted, determined by the Federal Reserve in consultation with the Treasury Secretary, under Section 4(k)(1) of the BHC Act to be financial in nature or incidental to a financial activity.

Does not include “complementary activities”. This definition would not include activities that are complementary to a financial activity, such as trading in physical commodities like oil, natural gas and agricultural products. Another example of a complementary activity is the provision of disease management and mail-order pharmacy services by an insurance company. Such examples may prove helpful for some companies (and their creditors) in determining whether the companies could be financial companies for purposes of Title II.

No Additional Conditions. The release accompanying the proposed rules specifically indicates that the FDIC will not seek to alter the conditions that currently apply to a financial holding company under Section 4(k) of the BHC Act or Regulation Y in order for an activity to be considered financial in nature or incidental to a financial activity. Thus, the FDIC will consider the conditions in Section 4(k) of the BHC Act or Regulation Y, but will disregard any prohibitions, limitations or other conditions imposed by other laws or regulations.

- **Data processing.** For example, data processing is only financial in nature under § 225.86 of Regulation Y if it meets the conditions in § 225.28(b)(14) of Regulation Y. Thus, unless a company’s data processing satisfies those conditions, revenues from that activity will not be considered for purposes of the 85% test.
- **Proprietary trading.** Similarly, although new Section 13 of the BHC Act (the “**Volcker Rule**”) prohibits “proprietary trading” by certain financial companies, that activity will nonetheless be treated as financial in nature for purposes of the 85% test if conducted in accordance with the conditions in Section 4(k) of the BHC Act and Regulation Y. Therefore, a company cannot exclude revenues from proprietary trading on the grounds that proprietary trading is prohibited by the Volcker Rule.

No impact of other BHC Act provisions. The proposed rules state that an activity will be “financial in nature” and “incidental to a financial activity” if it is treated as such under section 4(k) of the BHC Act or Regulation Y, even though it is independently permissible under other BHC Act provisions. This means, for example, that a company cannot exclude revenues from less than 5% voting equity investments that otherwise comply with Section 4(k) and Regulation Y on the grounds that such investments are exempt under Section 4(c)(6) of the BHC Act.

- **Rules of construction for unconsolidated investments included.** The proposed rules would include two sets of rules of construction that will be of interest to private equity firms, hedge funds and other companies that make substantial unconsolidated non-controlling minority investments.
 - **Look-through to investee companies that are predominantly engaged in financial activities.** If an unconsolidated investee company is itself predominantly engaged in financial activities, determined by applying the 85% test, then all revenues derived from such investment **must** be included in the investor company’s 85% test calculation. This look-through will complicate the calculation of the test for funds and other companies that generally make non-controlling unconsolidated investments.
 - **De minimis investments.** An investor company **may** exclude from the 85% test revenues related to certain minority investments, regardless of the activity of the investee company, but **only** up to 5% of the investor company’s total annual **financial** revenues. The minority investment must meet the following criteria in order to be eligible for the exclusion:
 - the investor company must own less than 5% of any class of voting shares of the investee company;

- the investor company must own less than 25% of the total equity of the investee company;
- the investor company must not consolidate the financial statements of the investee company;
- the investor company's investment must not be held in connection with the conduct of a financial activity (such as, for example, investment advisory services or merchant banking activities conforming to Section 4(k) and Regulation Y); and
- the investee company must not be a depository institution or subsidiary of a depository institution, bank or thrift holding company, foreign bank, broker-dealer, insurance company or certain other SEC- or CFTC-regulated financial institutions as enumerated in the proposed rules.

Limited value. Because of the relative narrowness of these criteria, we believe that this exclusion will only provide limited value to most companies.

- **Similar to Proposed Definition under Title I.** The FDIC's proposed definition of "predominantly engaged in financial activities" under Title II is substantially identical to the Federal Reserve's proposed definition under Title I, subject to the following notable differences:
 - The Federal Reserve's proposed definition includes both an "assets" and a "revenues" test, whereas the FDIC's definition includes only a "revenues" test. The Federal Reserve's test considers only activities that are "financial in nature," whereas the FDIC's test considers both activities that are "financial in nature" and those that are "incidental to a financial activity." Finally, the Federal Reserve's test considers the ownership, control **and** activities of **insured** depository institutions, whereas the FDIC's test refers only to the ownership or control of depository institutions (not limited to insured). These differences reflect differences in the statutory definitions in Titles I and II, although the differences in the last item cannot be explained entirely by differences in statutory language.

Treatment of Fraudulent and Preferential Transfers

The proposed rules would effectively codify an opinion of the Acting General Counsel of the FDIC issued on December 29, 2010 to the Securities Industry and Financial Markets Association and the American Securitization Forum.⁴ It would seek to harmonize two important differences between the preferential and fraudulent transfer provisions of Title II with their counterparts in the Bankruptcy Code.

- **BFP vs. Hypothetical Lien Creditor Standard.** The first relates to the standard used in determining whether the FDIC can avoid a transfer as a fraudulent or preferential transfer under Title II. Section 210(a)(11)(H) of Title II provides that a transfer is made when the transfer is so perfected that a *bona fide* purchaser ("**BFP**") could not acquire a superior interest under applicable noninsolvency law, or if the transfer has not been so perfected before the FDIC is appointed as receiver, immediately before the date of appointment. Title II can be read to apply the BFP standard to all fraudulent or preferential transfers. By contrast, Sections 547(e) and 548(d) of the Bankruptcy Code use the BFP standard only for fraudulent transfers, and for preferential transfers of real property other than fixtures. Section 547(e) of the Bankruptcy Code

⁴ Letter dated December 29, 2010 from Michael H. Krimminger, Acting General Counsel of the FDIC, to Kenneth E. Bentsen, Jr., Executive Director of the Securities Industry and Financial Markets Association and Tom Deutsch, Executive Director of the American Securitization Forum.

provides that in the case of preferential transfers of personal property or fixtures, a transfer occurs at the time the transferee's interest is so perfected that a hypothetical creditor on a simple contract could not obtain a judicial lien (a "**hypothetical lien creditor**") that is superior to the interest of the transferee under applicable noninsolvency law.

- The proposed rules would use the hypothetical lien creditor standard to determine whether the FDIC could avoid a preferential transfer of personal property or fixtures. Because security interests in personal property or fixtures that are perfected by filing under the Uniform Commercial Code are superior to the interest of a hypothetical lien creditor, but may not be superior to the interest of a BFP, the proposed rules will provide legal certainty that security interests in such property that are perfected by filing cannot be set aside by the FDIC. This would more fully harmonize the treatment of security interests perfected by filing under Title II with their treatment under the Bankruptcy Code.
- **30-day grace period.** The second difference relates to the 30-day grace period provided in the Bankruptcy Code in which a security interest in transferred property may be perfected under applicable noninsolvency law after the transfer has taken effect between the parties. The Bankruptcy Code provides that security interests that are perfected under applicable noninsolvency law within 30 days of a transfer relate back to the date of transfer or the day before commencement of a bankruptcy proceeding if the commencement of bankruptcy occurs first. The proposed rules would more fully harmonize the perfection of security interests under Title II with the Bankruptcy Code by providing that security interests that are perfected by filing or otherwise under applicable noninsolvency law within 30 days of transfer relate back in the same way as under the Bankruptcy Code.
- **Incomplete harmonization.** The proposed rules contain an ambiguity that results in their not being entirely harmonized with the Bankruptcy Code. They appear to give the FDIC discretion to determine *whether* the transfer has been perfected such that either a BFP or a hypothetical lien creditor could not obtain a superior interest under applicable noninsolvency law. In contrast, the Bankruptcy Code contains an objective, non-discretionary standard. The FDIC's rule therefore implies that any judicial review of its determination would be subject to a deferential standard of review rather than a *de novo* determination of the issue.

Priorities of Administrative Expenses and Unsecured Claims

Subsection 210(b)(1) of the Dodd-Frank Act contains the general list of priorities among administrative expenses and unsecured claims. The statute contains certain exceptions and qualifications to this general list, but they are scattered throughout Section 210.

- **Single List of Eleven Priorities.** The proposed rules would unify these various provisions into the following list of eleven priorities.
 - (i) **Post-receivership financing obtained by the FDIC subject to certain conditions.** Repayment of debt incurred by or credit obtained by the FDIC on behalf of the covered financial company *after* the FDIC's appointment as receiver, if the FDIC has determined that it is unable to obtain unsecured debt for the covered financial company from commercial sources.
 - (ii) **Administrative expenses.** Administrative expenses of the receiver, other than those described in (i) above.
 - (iii) **Amounts owed to the U.S. or any agency, including the FDIC.** Any amounts owed to the United States, whether incurred before or after appointment of the FDIC as receiver (including amounts arising out of interests in debt, equity or other capital securities,

unless expressly subordinated to specified claims, subject to the conditions and limitations described below).

- (iv) **Wages.** Any wages, salaries or commissions earned by an individual (not a senior executive or director) within 180 days prior to the appointment of the receiver up to \$11,725 per an individual (adjusted for inflation).
 - (v) **Employee benefit plans.** Certain contributions owed to employee benefit plans up to \$11,725 (adjusted for inflation) times the number of employees.
 - (vi) **Claims of creditors with FDIC-destroyed setoff rights.** Any amounts due to creditors who have an **allowed claim** for loss of setoff rights.
 - (vii) **General claims.** Any other general or senior liability of the company (which is not described below).
 - (viii) **Subordinated debt.** Any obligation subordinated to general creditors (which is not described below).
 - (ix) **Compensation of senior executives and directors.** Any wages, salaries, or commissions owed to senior executives and directors of the company.
 - (x) **Post-insolvency interest.** Post-insolvency interest, but only on **allowed claims** in the order of their priority.
 - (xi) **Other claims.** Any amount remaining shall be distributed to equity holders, in proportion to their relative equity interests.
- **Pro-rata distribution rule for shortfalls.** The proposed rules provide that if there are insufficient funds to pay all the claims within a particular class, then distributions to the creditors in that class shall be made *pro rata*.
 - **Pro rata as to what?** The proposed rules do not specify whether pro-rata distributions are pro-rata with respect to the amount of claims, headcount or some other criteria. Presumably, the FDIC means pro-rata with respect to the amount of claims proved to the satisfaction of the FDIC or a court.
 - **Allowed claims.** The proposed rules define the term “allowed claim” as any claim “allowed by the [FDIC]” or “upon which a final non-appealable judgment has been entered in favor of a claimant against a receivership by a court with jurisdiction to adjudicate the claim.”
 - **Unsecured claims proved to the satisfaction of the FDIC.** The priority scheme expressly applies only to “unsecured claims . . . proved to the satisfaction of the [FDIC].”
 - **Treatment of judicially allowed claims unclear.** The priority scheme does not expressly apply to unsecured claims that were rejected by the FDIC, but subsequently allowed by a court pursuant to its *de novo* review of the claims. The proposed rules define the term “allowed claim” to include such judicially allowed claims, but then use the more limiting phrase “unsecured claims . . . proved to the satisfaction of the [FDIC]” in the introductory clause of the proposed priority rule, which defines the scope of the claims to which the priority scheme applies.
 - **Administrative expenses of the receiver.** The proposed rules would define administrative expenses of the receiver to include all “actual and necessary pre- and post-failure costs and expenses incurred by the [FDIC]; together with any obligations that the [FDIC] . . . determines to be necessary and appropriate to facilitate the smooth and orderly liquidation of the covered financial company,” including:

- **Obligations under rental contracts.** Contractual rent pursuant to an existing lease or rental agreement from the date of the FDIC's appointment as receiver until the later of (i) the date the FDIC sends a notice disaffirming or repudiating the lease or rental agreement and (ii) the date such disaffirmance or repudiation becomes effective, provided that the lesser of such lease is not in default or breach of contract;
- **Obligations under contracts for "accepted" services.** Amounts owed pursuant to the terms of a contract for "services" performed and accepted by the FDIC after the date of appointment up to the date the FDIC repudiates, terminates, cancels or otherwise discontinues the contract or notifies the counterparty that it no longer accepts performance of such services;
- **Obligations on other contracts made or approved in writing.** Amounts owed under the terms of a contract or agreement executed in writing and entered into by the FDIC as receiver after the date of appointment, or any contract or agreement entered into by the covered financial company before the date of appointment that has been expressly approved in writing by the FDIC after the date of appointment (rather than be implied by a course of conduct); and
- **Expenses of the inspector general.** Expenses of the Inspector General of the FDIC incurred in carrying out its responsibilities to conduct audits and investigations of receiverships every 6 months after the appointment of a receiver.

Drawdowns on pre-existing lines of credit. As confirmed by the release accompanying the proposed rules, Section 210(c)(13)(D) provides that the claims of creditors on drawdowns made by the FDIC under committed lines of credit extended to the covered financial company before the FDIC was appointed as receiver will be treated as administrative expenses. As a result, such drawdowns would be junior in priority to post-receivership financing obtained by the FDIC on behalf of the covered financial company if the FDIC has determined that it is unable to obtain unsecured debt for the covered financial company from commercial sources.

- **Amounts owed to the United States.** The proposed rules would define this term as including all amounts due to the United States or any department, agency or instrumentality of the U.S. government, without regard to whether such amount is included in debt or capital on the books and records of the company, unless the U.S. consents in writing as provided in the proposed rules. It would include obligations incurred before and after the FDIC's appointment as receiver. It would include all of the following, which would all have equal priority under the proposed rules:
 - **Secured or unsecured extensions of credit from the FDIC.** Amounts owed to the FDIC for any extension of credit by the FDIC, including amounts made available from the Orderly Liquidation Fund, whether such extensions of credit are secured or unsecured;
 - **Reimbursement for payments made under FDIC guarantees.** Unsecured amounts paid or payable by the FDIC pursuant to its guarantee of any debt issued by the company under the Temporary Liquidity Guaranty Program, any other widely available debt guarantee program authorized under the Dodd-Frank Act, or any other debt or obligation of any kind or nature that is guaranteed by the FDIC;
 - **Tax liabilities.** Amounts owed to Treasury on account of unsecured tax liabilities that directly result from the income or activities of the company; and
 - **Unsecured extensions of credit from the Federal Reserve.** The amount of any *unsecured* debt owed to a Federal Reserve Bank.

Subordination of U.S. claims. The proposed rules would treat a claim of the U.S. as subordinated to any other claim (other than a claim under regulatory capital), **only if** the following conditions are satisfied:

- the U.S. consents to such subordination in writing by the appropriate department, agency or instrumentality;
- the relevant instrument specifies the particular debt, obligation or other amount to be subordinated and the amount thereof; **and**
- the relevant instrument references the proposed rule containing these conditions or Section 210(b)(1) of the Dodd-Frank Act.

Note: These conditions go beyond what is required under the statute for an effective subordination.

Ban on certain subordination agreements. Under the proposed rule, the FDIC would not give effect to an otherwise enforceable subordination agreement entered into by the United States to the extent the agreement purports to subordinate the “unsecured claims” of the United States to any regulatory capital. This appears to be the FDIC’s interpretation of Section 210(b)(3) of the Dodd-Frank Act, which provides that “[u]nsecured claims of the United States shall, at a minimum, have a higher priority than liabilities of the covered financial company that count as regulatory capital.”

- **Retroactive vs. prospective application.** The proposed rule is not expressly limited to agreements entered into or securities acquired by the United States after the effective date of the proposed rule or the Dodd-Frank Act. Instead, it appears to have retroactive application.
 - **Potential retroactive override of outstanding TARP preferred stock.** Therefore, assuming “unsecured claims” include claims in respect of equity securities, the proposed rule would create substantial legal uncertainty, in the absence of clarification from the FDIC, as to whether it would retroactively override the subordination of any outstanding common stock or preferred stock acquired by the U.S. government under the Troubled Asset Relief Program (“TARP”) or any other government program. The proposed rule would appear to override the subordination of such common stock to regulatory capital in the form of preferred stock or subordinated debt and the subordination of such preferred stock to regulatory capital in the form of subordinated debt. Finally, the proposed rule would appear to override the subordination of such common or preferred stock to the claims of general creditors because the terms of those securities do not make express reference to the proposed rule or Section 210(b)(1) of the Dodd-Frank Act, which did not exist when the securities were issued.
 - **Retroactive effect inconsistent with Supreme Court precedent.** The proposed rule is inconsistent with Supreme Court precedent to the extent it purports to give Section 210(b)(3) retroactive application. Under current case law, the Supreme Court will give a congressional statute retroactive effect only if Congress specifies in clear and unmistakable language that it intended such retroactive application. The Dodd-Frank Act contains no such language.
- **Permanent constraint on future subordination agreements.** The proposed rules would also purport to override any future agreement by the U.S. government to subordinate its unsecured claims and equity interests to any regulatory capital or

without making express reference to the proposed rule or Section 210(b)(1) of the Dodd-Frank Act.

Post-Insolvency Interest

As noted above, the priority scheme includes a class of claims for post-insolvency interest. That provision implements Section 210(a)(7)(D) of the Dodd-Frank Act, which permits but does not require the FDIC to prescribe rules for the payment of post-insolvency interest.

- **Date of accrual.** The proposed rules would specify that post-insolvency interest will be paid on the principal amount of an “allowed claim” from the later of (i) the date of the FDIC’s appointment as receiver, and (ii) in the case of a claim arising or becoming fixed and certain after the date of appointment, the date such claim arises or becomes fixed and certain.
- **Interest rate.** It also specifies that the post-insolvency interest rate will be equal to the coupon equivalent yield of the average discount rate on the three-month Treasury bill at the last auction during the preceding calendar quarter, computed quarterly using a simple interest method.
- **Principal amount.** The principal amount of an allowed claim will be the full allowed claim amount, including any accrued pre-receivership or pre-repudiation interest included in the allowed claim.

Comments solicited regarding harmonizing the post-insolvency interest provisions with those of the Bankruptcy Code. The release accompanying the proposed rules states that Title II does not include a provision analogous to Section 506(b) of the Bankruptcy Code, which allows for the payment of post-insolvency interest to over-secured creditors to the extent of the value of their collateral. The FDIC has requested comment on whether the FDIC should harmonize Title II with Section 506(b) of the Bankruptcy Code pursuant to its mandate in Section 209 to harmonize the rules implementing Title II to the Bankruptcy Code insofar as possible.

Certain Provisions Related to Bridge Financial Companies

The proposed rules would clarify two important issues related to bridge financial companies. The first would confirm the enforceability of obligations expressly assumed by a bridge financial company. The other relates to the use of any proceeds received by the FDIC from the sale or other disposition of a bridge financial company.

- **Enforceability of obligations.** The proposed rules would provide that any contract or agreement expressly entered into by a bridge financial company, including an agreement to purchase any assets or assume any liabilities from a covered financial company, will be enforceable against the bridge. Any claim arising under such a contract or agreement will be treated as an administrative expense in any receivership of the bridge under Title II. Upon the consummation of any purchase and assumption agreement with the covered financial company, the purchase of any asset or the assumption of any liability will, subject to the terms and conditions of the purchase and assumption agreement, constitute the assumption of the contract or agreement giving rise to such asset or liability.
- **Proceeds from the sale or other disposition of a bridge.** The proposed rules would confirm that any proceeds realized by the FDIC upon the merger or consolidation, sale of stock, sale of assets, or dissolution and liquidation of a bridge financial company must, after payment of all administrative expenses of the bridge and all other claims against the bridge, be distributed to the receivership of the related covered financial company. The release accompanying the proposed rules explains that these proceeds from the sale or other disposition of the bridge would be distributed to the creditors of the related covered financial company in accordance with the priorities set forth in Title II.

Does not address creditworthiness issues. Although the proposed rules would confirm that agreements expressly entered into by a bridge financial company would be enforceable against it, the proposed rules would not address how the market would become comfortable that the bridge financial company is creditworthy for purposes of entering into new transactions. Unless the bridge is sufficiently well capitalized and funded, or it receives credit and liquidity support from a creditworthy third party, the bridge may not be able to enter into new transactions, which is essential for it to continue to operate any business it may have acquired from the covered financial company and to preserve the going concern value of that business. If the bridge were properly capitalized by, for example, converting enough of the claims of creditors against the covered financial company into equity of the bridge, the bridge should be able to obtain financing from the private sector, including its new equity holders. But it may be necessary for the FDIC or some other government agency to provide temporary financing or credit support to the bridge in order to preserve the going concern value of any acquired business until the bridge is able to arrange private sector financing or credit and liquidity support.

FDIC's Administrative Claims Process

The proposed rules would include a new Subpart B, which would clarify the administrative claims process under Title II.

- **Definition of the term “claim”.** The proposed rules would define the term “claim” exactly as it is defined in the statute, except that the proposed rules would clarify that the term includes both a right of payment against the covered financial company and the FDIC as receiver.
 - **Clarification necessary for judicial review.** The release accompanying the proposed rules explains that claims against the receiver must be subject to the administrative claims process to ensure that courts can obtain jurisdiction over any claims denied by the FDIC in order to conduct a *de novo* review of the allowability of such claims.
 - **Statutory construction or constitutional issue.** The FDIC's proposed rule is useful in clarifying the scope of the term “claim,” but its reasoning that such a clarification is necessary to ensure that courts have jurisdiction is questionable as a statutory construction or even a constitutional matter. If the FDIC were correct, then a claimant's right to *de novo* judicial review of its denied claims would be dependent on the FDIC's exercise of discretion, which is inconsistent with the notion of *de novo* judicial review of the FDIC's denial of such claims.
- **Procedural rules.** The proposed rules would:
 - **Claims bar date.** Require the FDIC to establish a claims bar date for the presentation of claims.
 - **Notice of receivership and deadlines for filing claims.** Require the FDIC to provide potential claimants with certain types of notice of any receivership and the deadlines for filing claims.
 - **Procedures for filing claims.** Establish procedures for filing a claim.
 - **Determination of claims.** Establish procedures for the FDIC to determine whether a claim will be allowed or disallowed.
 - **Deadline for determining claims.** Establish deadlines for the FDIC to determine whether an asserted claim will be allowed or disallowed.
 - **Notice of determination of claims.** Establish procedures and deadlines for the FDIC to notify claimants whether any asserted claim has been allowed or disallowed.

- **Judicial review of disallowed claims.** The proposed rules would also specify procedures by which a claimant could seek judicial review of any claim that has been disallowed by the FDIC.
 - **Exhaustion of administrative remedies.** The proposed rules would purport to deny a court jurisdiction over a claim against the covered financial company or its assets unless the claimant has exhausted its administrative remedies.
 - **Ambiguity.** The proposed rules, however, do not unambiguously specify what constitutes the exhaustion of such administrative remedies.
 - **Forum.** The proposed rules provide that an aggrieved claimant may file suit for the *de novo* review of a denied claim in the district or territorial court of the United States for the district in which the principal place of business of the covered financial company is located, or in the case of an action on a claim commenced before the appointment of the FDIC as receiver, to continue the litigation in the court in which the action was pending.
 - **Ambiguity.** The proposed rules do not say whether this is the exclusive forum in which a claimant may file suit, or whether it is merely a non-exclusive option.
 - **Deadlines.** An aggrieved claimant must file suit on its disallowed claim within 60 days after the **earlier** of (i) the date of any notice of disallowance of such claim (regardless of when actually received), (ii) the end of the normal 180-day claims determination period (unless such period has been extended), and (iii) the end of any extended claims determination period.
 - **Statute of limitations.** If any claimant fails to file suit on such claim (or to continue an action on such claim commenced before the appointment of the FDIC as receiver) prior to the end of the 60-day period described above, the claim shall be disallowed and such disallowance shall be final.

Special Rules for Secured Claims

The proposed rules include a series of rules regarding secured claims.

- **Determination of secured claims.** The proposed rules would require the FDIC to determine:
 - the amount of each secured claim;
 - whether the claimant's security interest is legally enforceable and perfected;
 - the priority of the claimant's security interest; and
 - the fair market value of the collateral.
- **Allocation of partially secured claims.** The proposed rules would require the FDIC to treat the portion of any claim that exceeds the fair market value of the collateral securing the claim as an unsecured claim.
 - **Due process issue.** The proposed rules do not contain any express procedures for a secured claimant to seek judicial review of any disputes over the FDIC's determination of the fair market value of the collateral.
- **No liquidation of collateral without FDIC's consent.** Section 210(c)(13)(C) of the Dodd-Frank Act prohibits a secured creditor, other than with respect to collateral securing a qualified financial contract ("**QFC**") and under certain other conditions, to take possession of, or exercise control over, any collateral or other property of the covered financial company without the FDIC's prior consent. The proposed rules would clarify that this prohibition extends to liquidating, foreclosing on or selling any collateral.

- **Consent for self-help.** The proposed rules would authorize a secured creditor to seek the FDIC's consent to obtain possession of or exercise control over any collateral, including for the liquidation of such collateral by commercially reasonable methods, provided no involvement of the FDIC is required.
- **Consent for foreclosure or sale.** The proposed rules would also authorize a secured creditor to seek the FDIC's consent to foreclose on or sell any collateral, provided it is done by a request in writing submitted to the FDIC by certified mail. The FDIC would be required to respond as expeditiously as possible. If the FDIC denies the request, the FDIC is required to specify the reasons for the denial.
- **No requirement to consent.** The proposed rules would appear to provide that the FDIC would be permitted in its sole discretion, but not required, to grant any requested consent, even if it would be unreasonable to deny such consent.
- **Repudiation of a secured contract.** The proposed rules would confirm that if the FDIC repudiates a contract that is secured by a legally enforceable and perfected security interest, that repudiation will not be construed to permit the FDIC to set aside the related security interest, but instead the related security interest will be deemed to secure the counterparty's claim for damages on the repudiated contract.
 - **Consent to realize on collateral.** The FDIC would be permitted (but not required) to consent to the exercise of any legal or contractual rights against the collateral, including liquidation, for the purpose of applying the value of the collateral or its proceeds up to the amount of the allowed claim for damages for repudiation.
- **Expedited relief**
 - **Request.** The proposed rules would permit a secured creditor to seek expedited relief from the FDIC outside the normal administrative claims process upon alleging that:
 - **Security interest or security entitlement.** The secured creditor has a legally valid and enforceable or perfected security interest in the property of the covered financial company or control of a legally valid and enforceable security entitlement in respect of any asset held by the covered financial company; and
 - **Irreparable injury.** Irreparable injury will occur if the normal administrative claims process is followed.
 - **Deadline for determination.** The FDIC would be required to determine whether to allow or disallow such a claim, or any portion thereof, or whether such claim should be determined under the normal administrative claims process, within 90 days after the request for expedited relief is made.
 - **Not consistent with "expedited relief".** Although this 90-day period is consistent with the statutory language in Section 210(a)(5) of the Dodd-Frank Act, it is difficult to see how a 90-day response period constitutes "expedited treatment" under the likely facts and circumstances given how quickly collateral values can drop during a financial crisis – when Title II is most likely to be invoked. Something more along the lines of 24-48 hours would appear to be more consistent with the notion of expedited treatment under such facts and circumstances.
 - **Notice of determination.** The FDIC would be required to notify the claimant of its determination and, if the claim is disallowed, the reason for such disallowance and the procedures for obtaining a judicial determination.

- **Judicial review.** A claimant may file suit (or continue a suit on the claim filed before the receivership) seeking a determination of the rights of the claimant with respect to the relevant security interest or security entitlement after the earlier of (i) the end of the 90-day determination period for expedited relief and (ii) the date on which the FDIC denies the claim or a portion thereof.
- **Statute of limitations.** If an action for judicial review is not filed, or a motion to renew a previously filed suit is not made, within 30 days after the date on which such action or motion could be filed as provided above, the claim will be deemed disallowed and such disallowance will be final.
- **Sale of collateral by the FDIC.** The proposed rules would allow the FDIC to sell any property of the covered financial institution that is subject to a security interest (other than a security interest in favor of a Federal Reserve bank or the FDIC) free and clear of such security interest, and the security interest will attach to the proceeds of the sale.
 - **Proceeds.** The FDIC would be required to remit such proceeds, up to the allowed amount of the secured claim, to the secured claimant within a reasonable time after the sale.
 - **Secured creditor may bid.** The secured creditor may purchase the property from the receiver and offset its claim against the purchase price of such property.
- **Due process issue.** The proposed rules do not contain any express procedures for a secured claimant to seek judicial review of any disputes over whether the FDIC's sale was structured to receive and did receive the full market value for the collateral.
- **Redemption of property from security interest.** The proposed rules would allow the FDIC to redeem any property from any security interest by paying the secured creditor the fair market value of the collateral up to the amount of the allowed secured claim and retain such property free and clear of such security interest.
 - **Due process issue.** The proposed rules do not contain any express procedures for a secured claimant to seek judicial review of any disputes over the FDIC's determination of the fair market value of the collateral.

Recovery of Compensation from Senior Executives and Directors

Section 210(s) of the Dodd-Frank Act permits (but does not require) the FDIC to recover from any current or former senior executive or director who is “substantially responsible” for the “failed condition” of a covered financial company any “compensation” received by such person during the 2-year period preceding the date on which the FDIC was appointed as receiver (or for an unlimited period in the case of fraud).

- **Cost/benefit analysis.** The statute requires the FDIC to weigh the financial and deterrent benefits of such a recovery against the cost of executing the recovery in deciding whether to seek recovery from a particular senior executive or director.
 - **Proposed rules silent.** Nothing in the proposed rules explain whether or how the FDIC will make such a determination.
- **Method of determining substantial responsibility.** The proposed rules would create a process for determining whether a senior executive or director is “substantially responsible” for the “failed condition” of a covered financial company.
 - **Regulatory definition.** It would do so first by “**deeming**” a senior executive or director to be “substantially responsible” for the “failed condition” of a covered financial company if he or she satisfied **both** of the following two conditions:

- **Standard of care.** He or she failed to conduct his or her responsibilities with the “requisite degree of skill and care required by that position”; **and**
 - **Causation.** As a result, he or she “caused,” individually or collectively, a “loss” to the covered financial company that “materially contributed” to its failure.
- **Potentially unreasonable expansion of the statutory language.** This proposed regulatory definition is a substantial expansion of the statutory language. Indeed, its use of the word “deem” to introduce the new definition is a signal that it has created a “legal fiction” – i.e., that one thing will be assumed to be something else.
- **No specified standard of care.** The proposed regulation would establish an **exceedingly vague standard of care** – defined as the “requisite degree of skill and care required by that position.”
 - **Potential options.** It would not specify whether that standard of care is:
 - Not negligent?
 - Not grossly negligent?
 - Failure to comply with the business judgment rule?
 - **Potential constitutional due process issues.** As a result, the standard of care may be unconstitutionally vague. While courts almost never strike down statutes or regulations as being unconstitutionally vague unless they involve intolerably vague criminal laws with harsh penalties, the stigma that could attach to being held responsible for the collapse of a systemically important financial institution during a global financial crisis and the punitive nature of the proposed sanction could expose this portion of the proposed rule to a constitutional vagueness challenge unless the FDIC amends the proposed rule to specify an appropriate standard of care.
- **Diluted standard of causation.** The proposed regulation would also dilute the statutory standard of causation from being “substantially responsible” for causing the “failed condition” to having only caused a “loss” that “materially contributed” to the institution’s failure.
 - **Potential statutory interpretation issues.** This proposed regulatory standard seems inconsistent with the language of the statute, which requires proof of substantial responsibility for the failed condition, and not merely for a loss that materially contributed to the failed condition. As a result, unless the FDIC revises this standard to be closer to the statutory language, this aspect of the proposed rule may be vulnerable to judicial challenge as an unreasonable interpretation of the statute under the arbitrary and capricious and abuse of discretion standards.
 - **Potential constitutional due process issues.** While it may not be unconstitutional to require a senior executive or director who was substantially responsible for the failure of a non-bank SIFI to return the last two year’s of his or her compensation, it may be unconstitutional to do so if his or her responsibility is in substantial doubt.
- **Benchmarks for determining materiality.** The FDIC has requested comment on the use of quantitative and qualitative benchmarks, such as the percentage or magnitude of loss of assets, net worth or capital that could be used to establish that a loss caused by the senior executive or director materially contributed to the failure of the covered financial company.
- **Rebuttable presumptions based solely on title or function.** The proposed rules would also establish a rebuttable presumption of “substantial responsibility” for the failed condition of **every** covered financial company on the company’s chairman, CEO, president, CFO **and any other**

senior executive or director "in any other similar role regardless of his or her title if in this role he or she had responsibility for the strategic, policymaking, or company-wide operational decisions of the covered financial company prior to the date that it was placed into receivership."

- **Shift burden of proof to defendant.** Although this presumption would be rebuttable, it would effectively shift the burden of proof from the FDIC to the senior executive or director.
 - **Limits on the ability to rebut the presumption.** In addition, the proposed rule would limit the ability of any covered senior executive or director to rebut the presumption. The only way to rebut the presumption would be for the senior executive or director to prove "by evidence" that he or she performed his or her duties with the "requisite degree of skill and care."
 - **Any rebuttal of causation deemed irrelevant.** The proposed rule would conclusively presume causation of the failed condition based entirely on title or function. It would do so by treating as irrelevant any evidence that another person, force or circumstance was more or even entirely responsible for causing the failed condition. For example, it would treat as irrelevant evidence that the failed condition was caused by some force or circumstance outside the senior executive's or director's control, such as market forces, illegal behavior, fraud by some third party or governmental policies or actions. Instead, the senior executive or director would be conclusively deemed to have caused the failed condition, even if he or she did not.
- **No specified standard of proof of rebuttal.** The proposed rule would *not*, however, define the standard of proof for rebutting the presumption.
 - Substantial evidence?
 - Preponderance of the evidence?
 - Clear and convincing evidence?
 - Evidence beyond a reasonable doubt?
- **Aggravated statutory construction and constitutional issues.** This rebuttable presumption based on title or function raises the same statutory construction and constitutional issues discussed above, and actually aggravates them by shifting the burden of proof and imposing the proposed limits on the ability to rebut the presumption. It also aggravates the vagueness issues by failing to specify the standard of proof for rebutting the presumption.
- **Other rebuttable presumptions.** The proposed regulations would also include other presumptions based on a court finding of a breach of the duty of loyalty or the removal of the senior executive or director by the FDIC pursuant to Section 206 of the Dodd-Frank Act.
 - **Shift burden of proof to defendant.** Although these presumptions would also be rebuttable, they would similarly shift the burden of proof from the FDIC to the senior executive or director.
 - **Limits on the ability to rebut the presumption.** The proposed rules would similarly impose limits on the ability of any covered senior executive or director to rebut any of these presumptions. The only way to rebut any of these presumptions is for the senior executive or director to prove "by evidence" that he or she "did not cause a loss to the covered financial company that materially contributed to the failure of the covered financial company under the facts and circumstances."
 - **No specified standard of proof of rebuttal.** The proposed rule would similarly fail to define the standard of proof for rebutting any of these presumptions.

- **Aggravated statutory construction and constitutional issues.** These rebuttable presumptions raise the same aggravated statutory construction and constitutional issues discussed above by shifting the burden of proof and imposing the proposed limits on the ability to rebut any of the presumptions. It also aggravates the vagueness of the proposed rule by failing to specify the standard of proof for rebutting any of the presumptions.
- **Safe harbors.** The proposed rules include what appears at first blush to be a sort of safe harbor for senior executives or directors who are brought in to turn around a troubled financial company. But the safe harbor is **limited to the presumptions** discussed above, and does not otherwise protect a senior executive or director who is brought in to turn around a troubled company and tries to do so in good faith in full compliance with the business judgment rule.
 - Specifically, under this "safe harbor," the **presumptions** would **not** apply to:
 - any **senior executive** hired during the two years prior to the receivership to assist in preventing further deterioration of the financial condition of the institution that ultimately failed; or
 - any **director** who joined the board during the two years prior to the receivership **under an agreement or resolution** to assist in preventing further deterioration of the financial condition of the institution that ultimately failed.
- **Could undermine safety and soundness, market efficiency and financial stability.** Far from encouraging safety and soundness, market efficiency or financial stability, the proposed rules on recovering compensation from senior executives and directors could seriously undermine safety and soundness, market efficiency and financial stability, especially under adverse financial conditions. The proposed rules could make it difficult for non-bank SIFIs to retain or attract the best talent when general financial conditions deteriorate. Indeed, their vague and arguably unfair provisions would create powerful incentives for senior executives and directors with the best options to head for the exits at the first sign of trouble, lest a substantial portion of their compensation be at risk despite carrying out their responsibilities in good faith and in accordance with the business judgment rule and any reasonable standard of skill and care. Such a rule could encourage a revolving door of senior executives and directors seeking to avoid recoupment, which would undermine, rather than promote, stability. For the same reason, the proposed rule could make it difficult for non-bank SIFIs to attract senior executives or directors who specialize in preserving healthy or turning around troubled financial companies. In short, rather than minimize moral hazard and maximize market discipline, the proposed rule could weaken the quality of senior management and directors just when non-bank SIFIs (and the government) need the best talent most.

Treatment of Claimants Whose Setoff Rights are Destroyed by the FDIC

Section 210(a)(12)(F) of the Dodd-Frank Act provides that the FDIC may sell or transfer any assets of a covered financial company free and clear of any setoff rights, provided that any claimant whose setoff rights were so destroyed by the FDIC's actions has a claim against the receivership that is senior to general creditors but junior to all other more senior claims. By transferring either one of a pair of offsetting claims, the FDIC will destroy the mutuality of claims, an essential element of a valid setoff claim.

- **Valuation date.** In addition to restating these statutory provisions, the proposed rules provide that the value of the setoff rights will be determined as of the date of the sale or transfer of the assets that destroyed the setoff rights.
- **Allocation of setoff rights.** The proposed rules would require the FDIC to pay the portion of any claim that exceeds the fair market value of the setoff claim at the otherwise applicable level of priority for such category of claim.

- **Minimum recovery entitlement.** The release accompanying the proposed rules recognizes that the FDIC's permissible actions have the potential to result in a lower recovery for a setoff claimant than would have been received in a liquidation under Chapter 7 of the Bankruptcy Code because "in bankruptcy setoff claims are functionally treated similar to a security interest." As partial compensation for their lost setoff rights, Section 210(a)(12)(F) of the Dodd-Frank Act provides setoff claimants with a priority over general unsecured creditors if the FDIC's permissible actions result in destroying their setoff rights. The release describes this preferential treatment as "adequate protection" that "should normally provide value to setoff claimants equivalent to the value of setoff under the Bankruptcy Code."
 - **But what if it doesn't?** What if this special priority status does not provide equivalent value under certain circumstances?
 - **Minimum recovery entitlement is the absolute baseline.** Section 210(b)(4)(B) of the Dodd-Frank Act permits the FDIC to deviate from the fundamental rule of equal treatment for similarly situated creditors, **but only** if every claimant receives its minimum recovery entitlement – i.e., what it would have received in a liquidation under Chapter 7 of the Bankruptcy Code. A claimant's minimum recovery entitlement does not appear to be subject to or qualified by the FDIC's power to transfer assets free and clear of any setoff rights under Section 210(a)(12). Nor does it appear to be overridden or necessarily satisfied if the claimant receives "adequate protection" or priority over general creditors. Section 210(b)(4)(B) is crystal clear: "all claimants that are similarly situated" must "receive not less than the amount provided in paragraphs (2) and (3) of subsection (d)." The amount provided in Section 210(d)(2) is "the amount that such claimant would have received if . . . (A) the [FDIC] had not been appointed receiver with respect to the covered financial company; and (B) the covered financial company had been liquidated under chapter 7 of the Bankruptcy Code" This minimum recovery entitlement appears to be an unqualified, absolute baseline of recovery.
 - **Treatment under Chapter 7.** Since a setoff claimant would have received the full value of its setoff rights in a liquidation under Chapter 7 of the Bankruptcy Code, it should have a deficiency claim against the FDIC for any shortfall between what the setoff claimant actually received under Title II and what it would have received under Chapter 7. Sections 210(a)(12) and (b)(4)(B) permit the FDIC to transfer any assets free and clear of any setoff rights if necessary to maximize the value of the failed institution for the benefit of all creditors as a group, even if it deviates from the equal treatment rule. But if the FDIC chooses to do so, and the partial compensation for this action in the form of priority over general creditors does not provide value equivalent to the value of setoff in a Chapter 7 liquidation, Section 210(b)(4)(B) would appear to require the FDIC to pay the difference, subject to its power to recover any losses from other creditors or the financial industry generally under Section 210(o).

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