Treasury's Proposed Resolution Authority for Systemically Significant Financial Companies

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Introduction

The reorganization or liquidation of most types of companies is governed in the United States by a single federal law—the US Bankruptcy Code (the "**Bankruptcy Code**"). As a result, no matter the complexity, the type of company or the industry, the same well-defined set of avoidance powers, priorities and distribution schemes apply.

In contrast, there is no single, uniform federal law governing the restructuring or liquidation of diversified US financial groups. The restructuring or liquidation of such groups can therefore be quite complex and potentially chaotic. The parent holding company and most non-financial subsidiaries are subject to the Bankruptcy Code. FDIC-insured bank or thrift subsidiaries are subject to a specialized regime contained in the Federal Deposit Insurance Act (the "**FDIA**") and administered by the Federal Deposit Insurance Corporation (the "**FDIC**"). Broker-dealer subsidiaries that are members of the Securities Investor Protection Corporation ("**SIPC**") are subject to a combination of the Securities Investor Protection Act ("**SIPA**") and Chapter 7 of the Bankruptcy Code. The rehabilitation or liquidation of insurance company subsidiaries is governed by specialized state insurance insolvency codes, which differ from state to state. These specialized laws for "resolving" (to use FDIC terminology) troubled or insolvent financial institutions have very different avoidance powers, priorities and distribution schemes, and other rules that can significantly affect the rights of creditors and other stakeholders, as compared to the Bankruptcy Code, and to each other.

No single US government agency has any real control over this process. Reorganization proceedings under the Bankruptcy Code are usually directed by the company and overseen by a bankruptcy court with the assistance of a creditors' committee and in rare cases a trustee. The FDIC controls the process of resolving FDIC-insured US banks and thrifts. State insurance regulatory authorities generally control insolvency proceedings against insurance companies domiciled in their states. SIPC controls certain aspects of the liquidation of broker-dealers that are SIPC members, subject to SEC oversight.

In addition, many large US financial groups have a network of branches, other offices and subsidiaries outside the United States. Each of these branches, other offices and subsidiaries is generally subject to foreign bankruptcy laws, which differ from country to country. All of these foreign laws, however, have one thing in common—they all generally attempt to ring-fence the assets of the foreign offices and subsidiaries in order to maximize the assets available to satisfy the claims of domestic creditors and other stakeholders against these foreign offices or subsidiaries, without regard to the potential negative effects on other creditors and stakeholders in the group. There is no set of international agreements that provides any overarching coordination of this potentially chaotic process, nor is there any US agency with a clear mandate or authority to coordinate the process.

It can therefore be very difficult to predict the end from the beginning if the parent of a diversified US financial group is put into Chapter 11 (reorganization) or Chapter 7 (liquidation) proceedings under the Bankruptcy Code. Such proceedings are likely to trigger proceedings under the specialized US domestic insolvency regimes for US financial institution subsidiaries, as well as regulatory seizures of foreign offices, subsidiaries and assets by foreign authorities over which the US government has little or no control.

As a result of the potential for disruption under current laws if a systemically important financial group were to enter bankruptcy proceedings during the current financial crisis, Treasury recently asked for a unified federal resolution authority over all systemically significant financial companies modeled on Sections 11 and 13 of the FDIA, the specialized law that governs the resolution of US FDIC-insured banks and thrifts.

Treasury recently asked for a unified federal resolution authority over all systemically significant financial companies modeled on Sections 11 and 13 of the FDIA

Under the proposed legislation submitted by Treasury on March 25, 2009, upon a systemic risk determination by the Secretary of the Treasury (in consultation with the President) with respect to certain companies within certain financial groups, the FDIC would have the authority to provide "open" or "closed" financial assistance to the covered companies and to appoint itself as the conservator or receiver of these companies. As conservator or receiver, the

FDIC would have the power to liquidate or otherwise "resolve" any claims against the covered companies under a regime modeled on Sections 11 and 13 of the FDIA. This authority would include the important power to create and transfer to one or more "bridge financial companies" without consent any assets or liabilities from a covered company so that the healthy part of that company can continue operating on an uninterrupted basis.

This memorandum analyzes the key provisions of Treasury's proposed legislation, compares it to the specialized FDIA regime on which it is modeled and to certain provisions of the Bankruptcy Code that it would replace, and identifies some of the most important policy and technical issues raised by the proposal. The legislation was proposed as part of a larger Treasury framework for regulatory reform, which is discussed in a companion Davis Polk & Wardwell memorandum, Treasury's Rules of the Road for Regulatory Reform, dated March 30, 2009.

Davis Polk & Wardwell will continue to monitor new developments and issue newsflashes and memoranda as appropriate as the resolution authority legislation continues to take shape.

Treasury's Proposed Legislation

Modeled on Section 11 of the FDIA

Treasury's proposed legislation is basically a mark-up of Section 11 of the FDIA. It also contains some ideas borrowed from Section 13 of the FDIA and other laws, as well as a few genuinely new ideas necessary to adapt it to the very different companies to which the proposed legislation would apply.

FDIC as Conservator or Receiver. Like the FDIA, the proposed legislation would create a procedure for appointing the FDIC as conservator or receiver of any "financial company" if a systemic risk determination is made with respect to that company. As described more fully in the sidebar, the proposed legislation defines the term "financial company" to include both financial and non-financial subsidiaries of certain holding companies and to exclude many important financial institutions, such as insured banks and thrifts, SEC-

> The proposed legislation would create a procedure for appointing the FDIC as conservator or receiver of any "financial company" if a systemic risk determination is made with respect to that company

Financial Companies

- **Any of the following that are incorporated or organized under US federal law or the laws of any state:**
  - bank holding company
  - financial holding company
  - savings and loan holding company
  - holding company of an insurance company
  - holding company of an SEC-registered broker or dealer
  - any subsidiary (including any non-financial subsidiary) of any of the foregoing holding companies, except as provided below
  - holding company of a futures commission merchant or commodity pool operator
- **The following financial institutions are <u>not</u> "financial companies" under proposed legislation:**
  - insured depository institutions and their subsidiaries,
  - SEC-registered brokers or dealers that are members of SIPC
  - US domestic insurance companies
  - hedge funds, dealers in OTC derivatives, private equity funds, investment companies, investment advisers, uninsured depository institutions, securities clearing agencies, futures clearing organizations, payment system operators, commodity trading advisors or any other financial institution that are not subsidiaries of any of the first fiveholding companies listed above

The definition of "company"

» **includes:**

- corporations
- partnerships
- business trusts
- associations
- other similar organizations, and
- certain other trusts

» **does not include:**

- a corporation the majority of whose shares are owned by the US or any State, or
- a qualified family partnership

registered brokers or dealers that are members of SIPC and US domestic insurance companies.

As conservator, the FDIC would take operational control over a covered financial company, perhaps recapitalizing or restructuring it, while preserving it as a going concern, without any liquidation of the covered financial company. In contrast, as receiver, the FDIC would be the liquidator of a covered financial company. The distinction between the powers and functions of a conservator and those of a receiver under the proposed legislation is somewhat vague, as it is under Section 11 of the FDIA. The reason is that the FDIC would have the power, as receiver, to transfer all or any part of a covered financial company's assets and liabilities to a newly organized entity called a "bridge financial company" or to third parties without consent. The receiver would have the power to operate a bridge financial company for a temporary period for the purpose of maximizing the net asset value of the transferred assets and liabilities. The covered financial company left behind would be liquidated.

As conservator or receiver, the FDIC would have the power to take a variety of actions with respect to any covered financial company, including the power to:

» sell or transfer the assets or liabilities of the company;

» merge it with another company; and

» replace the board of directors and senior officers of the company.

Like the FDIA, the proposed legislation would shield the board of directors of the covered financial company from liability to the company's shareholders or creditors for acquiescing to the appointment of a conservator or receiver.

Claims Process. As conservator or receiver, the FDIC would administer the claims process, sorting out valid from invalid claims, determining priorities and administering distributions.

No Judicial Review. Like the FDIA, the proposed legislation would authorize the FDIC to conduct the claims process without court supervision. Indeed, it would even make the FDIC's decision to disallow a claim unreviewable by any court, without any exception for manifest error or any other legitimate reason.

Like the FDIA, the proposed legislation would authorize the FDIC to conduct the claims process without court supervision

The FDIC would have the following extraordinary powers:

» Unenforceability of *ipso facto* clauses

» Repudiation of "burdensome" contracts

» Avoidance of certain security interests

» Superpriority avoidance powers in bankruptcy cases

Extraordinary Powers. The FDIC would also have most of the extraordinary powers that it has under the FDIA, including:

- **Unenforceability of *ipso facto* clauses**: the power to enforce all contracts, other than "qualified financial contracts" in a receivership and director's or officer's liability insurance contracts, notwithstanding any provision that would otherwise allow counterparties to terminate, treat as a default, accelerate or exercise any other rights upon, or solely because of, the insolvency or appointment of the FDIC as conservator or receiver;

- **Repudiation of "burdensome" contracts**: the power to repudiate or disaffirm any contract, including but not limited to executory contracts, that the FDIC determines within a "reasonable period" to be "burdensome" if the FDIC determines that any repudiation or disaffirmance would promote the orderly administration of the covered financial company;

- **Avoidance of certain security interests**: the power to avoid those security interests taken "in contemplation of the company's insolvency," without the need to satisfy the traditional bankruptcy test to avoid a preference; and

- **Superpriority avoidance powers in bankruptcy cases**: the power to avoid and recover any property transferred by an insider or debtor of the covered financial company to a third party within five years of the FDIC's appointment as conservator or receiver, if the transfer was made with the intent to hinder, delay or defraud the covered financial company or the FDIC, with the FDIC's claim being superior to the claims of any trustee in bankruptcy or other person under the Bankruptcy Code, except another federal agency.

Damages for Repudiation. Like the FDIA, the proposed legislation would require the FDIC to pay damages to counterparties of repudiated or disaffirmed contracts. Also like the FDIA, the proposed legislation would limit damages payable by the FDIC to "actual direct compensatory damages." Damages are generally measured as of the date the FDIC was appointed as conservator or receiver, but they are measured as of the date of repudiation in the case of qualified financial contracts discussed below. The FDIC would not be liable for consequential damages, or even damages equal to the benefit of the counterparty's lost bargain, nor would it be liable for interest accruing during the period of time between appointment and repudiation. Thus, for instance, if the FDIC repudiated a debt obligation, the covered financial company would be required to pay the counterparty damages in the form of principal plus accrued interest through the date of appointment, but not through the date of repudiation or the termination date of the original bargain.

Qualified Financial Contracts. Like the FDIA and the Bankruptcy Code, the proposed legislation would treat qualified financial contracts ("**QFCs**") as a class of contracts that would receive special treatment. Notwithstanding the general prohibition on accelerating contracts against a covered financial company or the FDIC, counterparties to QFCs would be permitted to terminate, liquidate, accelerate, net or exercise their rights to realize on security arrangements upon the appointment of the FDIC as receiver, subject to a cooling-off period of one business day and the following exception: During that one business day period, the FDIC must decide whether to transfer all of the QFCs between the covered company and a particular counterparty and its affiliates to a third party or to transfer none of them. If the FDIC transfers all of them, the counterparty is not entitled to terminate the QFCs solely because of their transfer or the appointment of the FDIC as receiver. In the case of a conservatorship, counterparties to QFCs would never be permitted to terminate, liquidate or net QFCs solely because of the FDIC's appointment as conservator. QFCs include securities contracts, commodities contracts, forward contracts, repurchase agreements, swap agreements and master agreements for any of the foregoing.

Like the FDIA and the Bankruptcy Code, the proposed legislation would treat qualified financial contracts as a class of contracts that would receive special treatment

Open or Closed Financial Assistance. Like Section 13 of the FDIA, the proposed legislation would authorize the FDIC to provide financial assistance to covered financial companies either before or after the company is placed into conservatorship or receivership, if certain determinations are made. Assistance provided under Section 13 before a bank is placed into conservatorship or receivership is generally called "open bank assistance." Assistance provided after a bank is placed into conservatorship or receivership is generally called "closed bank assistance." Open bank assistance has been extremely rare since 1991, when the FDIA was amended to prohibit such assistance unless it is either the least costly alternative for the deposit insurance fund or necessary to prevent systemic risk. Closed bank assistance, such as loss sharing

Appropriate Federal Regulatory Agency

- **FDIC, if financial company is, or is an affiliate of, a:**
  - bank holding company
  - financial holding company
  - S&L holding company
  - US domestic insurance company
- **SEC, if financial company is, or is an affiliate of, a:**
  - SEC-registered broker or dealer (other than an insured depository institution)
- **CFTC, if financial company is, or is an affiliate of, a:**
  - CFTC-registered futures commission merchant
  - CFTC-registered commodity pool operator

arrangements between the FDIC and any bank that purchases assets from a closed or bridge bank, has been far more common.

Bridge Financial Companies. Like the FDIA, the proposed legislation would authorize the FDIC, as receiver, to transfer all or any portion of a covered financial company's business to one or more bridge financial companies in order to maximize the net asset value of the business and protect the interests of customers and other stakeholders upon the liquidation of the covered financial company left behind. Certain important policy and technical issues related to these new bridge financial company provisions are discussed in more detail below.

Significant Differences from the FDIA

Grounds for Conservatorship, Receivership, Assistance or Other Action. The grounds upon which the FDIC may appoint itself as conservator or receiver of, provide open or closed assistance to or take any other action with respect to a troubled financial company, are significantly more limited under the proposed legislation than under Sections 11 and 13 of the FDIA with respect to insured depository institutions. Under the proposed legislation, the FDIC may only appoint itself as conservator or receiver of a financial company, or provide a financial company with open or closed assistance or take other action, if a systemic risk determination is made with respect to such financial company.

> Grounds for conservatorship, receivership, assistance or other action are significantly more limited under the proposed legislation than under the FDIA

Under the proposed legislation, a systemic risk determination would be made by the Secretary of the Treasury, in consultation with the President, only upon recommendation by the Board of Governors of the Federal Reserve System (the "**Federal Reserve Board**") and the appropriate federal regulatory agency. The recommendation would cover whether the FDIC should appoint itself as conservator or receiver of the financial company, provide the company with assistance or take any other action, including a recommendation regarding the extent of such assistance or other actions. The recommendation is valid only if it is made with the consent of no less than two-thirds of the Federal Reserve Board and two-thirds of the board or commission of the appropriate federal regulatory agency.

Default or Danger of Default

» **A financial company will be in default or danger of default if any one of following occurs with respect to it:**

- case commenced or likely under the Bankruptcy Code
- critically undercapitalized
- has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and no reasonable prospect to avoid depletion without assistance
- assets are, or likely to be, less than obligations to creditors
- is, or likely to be, unable to pay obligations (other than those subject to a bona fide dispute) in the normal course of business

Different Forms of Financial Assistance

» **making loans to, or purchasing any debt obligation of, the covered financial company**

» **purchasing the company's assets**

» **assuming or guaranteeing the company's obligations**

» **acquiring any type of equity interest or security of the company**

If the Federal Reserve Board and the appropriate federal regulatory agency recommend assistance or other action, then the Secretary, in consultation with the President, must determine whether:

» the financial company is "in default" or in "danger of default;"

» the failure of the financial company and its resolution under the Bankruptcy Code or other applicable law would have serious adverse effects on financial stability or economic conditions in the United States; and

» any actions or assistance under the proposed legislation would avoid or mitigate such adverse effects.

If Treasury determines that these conditions are met, then the FDIC may, with the approval of the Secretary of the Treasury, appoint itself conservator or receiver of the company, provide it with assistance or take other actions, taking into consideration the cost to the general fund of Treasury and the potential to increase moral hazard on the part of creditors and shareholders of the covered financial institution.

The proposed legislation defines a "covered financial company" as any financial company as to which the Secretary of the Treasury has made a systemic risk determination.

The proposed legislation lists a number of different forms of financial assistance the FDIC could provide either separately or in combination to the covered financial company, which are listed in the sidebar.

Depending on the circumstances, the FDIC could either put the covered financial institution into conservatorship with the aim to restore it to financial health or put it into receivership with the objective to liquidate the institution in an orderly manner. Rather than focusing only on the rights of creditors and other stakeholders, the goal of a conservatorship or receivership of a covered financial company would be to protect the financial system as a whole.

The goal of a conservatorship or receivership of a covered financial company would be to protect the financial system as a whole

In contrast, the FDIC may appoint itself as conservator or receiver of an insured bank or thrift and provide closed bank assistance under Sections 11 and 13 of

Covered Financial Company

- **Any "financial company" as to which a systemic risk determination has been made**
- **Does not include:**
  - insured depository institutions or their subsidiaries
  - SEC-registered brokers or dealers that are members of SIPC
  - US domestic insurance companies
  - any of the following financial institutions that are not subsidiaries of a bank holding company, a financial holding company, a savings and loan holding company, a holding company of a domestic US insurance company or a holding company of an SEC-registered broker or dealer:
    - hedge funds
    - dealers in OTC derivatives
    - private equity funds
    - investment companies
    - investment advisers
    - uninsured depository institutions
    - securities clearing agencies
    - futures clearing organizations
    - payment system operators
    - commodity trading advisors
    - any other financial institutions

the FDIA if any of a much longer list of conditions exists, without any involvement from the Federal Reserve Board or the Secretary of the Treasury, any supermajority vote of the appropriate federal regulatory agency or either of the systemic risk determinations in the second and third bullets in the text above. Among these other grounds not included in the proposed legislation is consent by a bank's board of directors, shareholders or members. The requirements of the proposed legislation are, however, similar to the systemic risk determination that must be made before the FDIC may provide any "open bank assistance," *i.e.*, prior to conservatorship or receivership, under Section 13(c) of the FDIA.

Funding Mechanism. Unlike the FDIA, the deposit insurance fund would not be used for any financial assistance provided by the FDIC under the proposed legislation. Instead, the proposed legislation would create the following mechanism to fund any such financial assistance:

- an automatic appropriation to the FDIC of necessary funds from the general funds of Treasury; and
- a grant of authority to the FDIC to recoup any expenditures under the proposed legislation, including the cost of any open or closed financial assistance provided to any covered financial company, by imposing special assessments on all financial companies, including those as to which a systemic risk determination has not been made.

Relaxed Documentation and Procedural Requirements. The proposed legislation substantially relaxes the documentation and procedural requirements for the enforceability of any contract that tends to "diminish or defeat" the interest of the FDIC or a bridge bank in any asset of a covered financial company. The proposed legislation only requires a contract be in writing and executed by an authorized officer or representative of the covered company. In contrast, Section 13(e) of the FDIA, which codifies and expands the holding in *D'Oench Duhme & Co. v. FDIC*, 315 U.S. 447 (1942), contains more extensive documentation and procedural requirements, some of which have proven unworkable and traps for the unwary.

Maximum Liability. Under the FDIA, the maximum liability of the FDIC to any claimant in the receivership of an insured institution is the amount the claimant would have received in a liquidation of the institution under the FDIA. Under the proposed legislation, the FDIC would benefit from a similar maximum liability provision, but the maximum liability is the amount the claimant would have received in a liquidation (not reorganization) of the covered financial company under Chapter 7 of the Bankruptcy Code, a case related to the Bankruptcy Code, including one under SIPA, or any state insolvency law.

Unequal Treatment. Under the FDIA, the FDIC is authorized to treat similarly situated claimants unequally, so long as each claimant receives at least the amount the claimant would have received in a liquidation under the FDIA, if the FDIC decides that such unequal treatment is necessary to maximize the value of the assets of the insured institution, to maximize the present value return from the sale of any such assets or to minimize the amount of any loss upon the sale of such assets. The proposed legislation contains a similar provision, but the minimum recovery is the amount that would have been received in a liquidation under Chapter 7 of the Bankruptcy Code, SIPA or applicable state insolvency laws, and the FDIC has an additional ground justifying such unequal treatment—namely, to contain or address serious adverse effects on financial stability or the US economy.

Priority of Unsecured Claims. Under the FDIA, deposit liabilities have priority over other general or senior creditor claims. The FDIC, as receiver for an insured depository institution, steps into the shoes of the insured depositors and has the same priority with other uninsured depositors. Under the proposed legislation, "any amounts owed to the United States" would have priority over claims of any other general or senior creditor claims of the covered financial company. This means that some types of financial assistance that the FDIC may provide pursuant to the resolution authority to a covered financial company, such as loans made or obligations assumed or purchased, would have priority over other general creditors.

Chartering of Bridge Financial Companies. Unlike the FDIA, which relies on the Office of the Comptroller of the Currency to provide national charters for bridge banks, the proposed legislation would authorize the FDIC to establish a new process for granting federal charters to bridge financial companies. Certain important policy and technical issues related to this new chartering authority and the rest of the new bridge financial company provisions are discussed in more detail below.

Stay of Legal Proceedings. Under the FDIA, the FDIC can request a stay of legal proceedings for any judicial action, criminal or non-criminal. Under the proposed legislation, the type of judicial action subject to stay of litigation is limited only to non-criminal legal proceedings.

Miscellaneous Provisions. With respect to the distribution of customer property in a liquidation of any stockbroker that is not a member of SIPC, the proposed legislation would apply the specialized provisions of subchapter III of Chapter 7 of the Bankruptcy Code, except to the extent they conflict with any provision of the proposed legislation. Similarly, with respect to the distribution of customer property in a liquidation of any commodity broker, the proposed legislation would apply the specialized provisions of subchapter IV of Chapter 7 of the Bankruptcy Code, absent a conflict with any provision of the proposed legislation.

Significant Differences from the Bankruptcy Code

Unenforceability of *ipso facto* clause. Unlike the proposed legislation, and the FDIA, the Bankruptcy Code has limits to the unenforceability of *ipso facto* provisions, including when otherwise applicable law would not require the non-debtor to accept performance from an assignee, and in contracts to loan money, provide credit, or issue securities.

Repudiation of "burdensome" contracts. Unlike the proposed legislation, and the FDIA, under the Bankruptcy Code the debtor can only reject "executory contracts," and the test is whether rejection of the contract is in the best interests of the estate. A rejection of an executory contract also needs court approval.

Preference avoidance powers. Under the Bankruptcy Code, there is no requirement that the transfer be made "in contemplation of" the debtor's insolvency in order to avoid the transfer, but it is limited to transfers on account of antecedent debt while the debtor is insolvent and only when it improves the position of the person taking the transfer.

Qualified Financial Contracts. There are no analogous restrictions related to QFCs in the Bankruptcy Code. Under the Bankruptcy Code, the automatic stay does not apply to QFCs, so the Bankruptcy Code does not prevent termination and closeout.

Unequal treatment of similarly-situated creditors. Under the Bankruptcy Code, a Chapter 11 plan generally must treat similarly-situated creditors equally.

Creditors' Recoveries. Except in cramdown, a creditor's recovery under Chapter 11 of the Bankruptcy Code is not capped at what the creditor would have received in a Chapter 7 liquidation under the Bankruptcy Code.

Key Policy and Technical Issues

What Is Treasury's Goal? Does the Proposal Accomplish It? If So, At What Cost?

Treasury's proposed legislation would give the FDIC sweeping new power to control the resolution of certain financial and non-financial companies within certain systemically important US financial groups. In effect, the proposed legislation would substitute a new regime modeled on Section 11 of the FDIA for the Bankruptcy Code with respect to companies as to which a systemic risk determination is made that would otherwise be subject to the Bankruptcy Code.

> The proposed legislation would not achieve the goal of creating a single, uniform federal law to govern the restructuring or liquidation of all systemically important financial groups

But if Treasury's goal is to create a single, uniform federal law to govern the restructuring or liquidation of all systemically important financial groups, regardless of charter, or to give a federal agency control over the resolution of all systemically important financial groups, the proposed legislation will not achieve it.

As currently drafted, the proposed legislation would not apply to the resolution of insured depository institutions, SEC-registered brokers or dealers that are members of SIPC or US domestic insurance companies, even if a systemic risk determination is made with respect to their parent holding companies. Nor would it apply to hedge funds, dealers in OTC derivatives, private equity funds, investment companies, investment advisers, uninsured depository institutions, securities clearing agencies, futures clearing organizations, payment system operators, commodity trading advisors or any other company that might be considered to be a financial institution in the future, unless they are subsidiaries of a bank holding company, a savings and loan holding company, a holding company of a domestic US insurance company or a holding company of an SEC-registered broker or dealer.

In short, the restructuring or liquidation of systemically important financial groups would continue to be complex and potentially chaotic, without full control by the FDIC or any other federal agency.

It is not clear whether the substitution of the new regime for the Bankruptcy Code under these limited circumstances would produce any benefits or at least sufficient benefits to outweigh the potential harm that it could cause. Changing the applicable bankruptcy or resolution laws on the eve of a covered company's insolvency could disrupt the reasonable expectations of a large number of creditors and other stakeholders that would have structured their credit and other exposures to the covered companies under the assumption that their rights would be governed by the Bankruptcy Code, not some new regime modeled on Section 11 of the FDIA that has a very different set of avoidance powers, priorities and distribution schemes.

Changing the applicable bankruptcy or resolution laws on the eve of insolvency could disrupt the reasonable expectations of a large number of creditors and other stakeholders

In addition, because bankruptcies of companies subject to the Bankruptcy Code occur with much higher frequency than bank failures, which tend to occur in waves with more than a decade or two between each wave, there is an extensive body of case law, legal commentary and other guidelines that has developed to supplement the Bankruptcy Code. In contrast, there is almost no case law, legal commentary, regulations or other guidelines supplementing Section 11 of the FDIA. The FDIC has not promulgated a comprehensive body of regulations to implement the statute and has issued only a relatively small number of orders, interpretations and policy statements to supplement it. As a result, there is a substantial amount of uncertainty surrounding how various issues would be resolved in the conservatorship or receivership of an insured depository institution. Unless the FDIC were required to promulgate regulations to resolve those legal uncertainties under the proposed new law, creditors and other stakeholders of covered companies would face another disadvantage from a change of the rules in the middle of the game—a loss of relative legal certainty in favor of relative uncertainty.

Which Agency Should Exercise the New Powers?

The principal argument in favor of the FDIC exercising the proposed resolution powers is that the proposed new legislation is modeled on Section 11 of the FDIA, which the FDIC has extensive experience administering. In addition, it already has an infrastructure in place to exercise conservatorship and receivership powers, whereas any other federal agency would have to build one from scratch.

On the other hand, the FDIC has limited experience with the sort of complex, global and diversified insurance, securities, banking or other financial groups that would almost certainly be the target of the proposed legislation. Nor does it have much experience with the foreign regulatory authorities that are likely to have resolution authority over the foreign offices, subsidiaries and other assets of such groups. The core of its experience is regulating small, domestic, community banks. Even in its capacity as receiver of large failed banks and thrifts, it has little experience resolving anything other than a purely domestic bank or thrift.

In addition, as noted above, the FDIC has not developed a culture of transparency in its administration of Section 11 of the FDIA. Such a culture will be essential to create the sort of ex-ante legal certainty that will be needed in the context of resolving complex, global and diversified financial groups. Indeed, although the FDIC has long had the power to promulgate regulations to implement Sections 11 and 13 of the FDIA, it has not done so except in extremely limited ways.

The federal regulatory agency with the most experience with the sort of complex, global and diversified financial groups that are likely to be the target of the proposed legislation, as well as the foreign regulatory authorities that are likely to have resolution authority over foreign operations, is the Federal Reserve Board.

What Could Be Done to Increase Legal Certainty?

Customer Property Rights. Many systemically important financial groups have extensive global or local securities custody operations. The proposed legislation makes it clear that otherwise enforceable and perfected security interests will be respected in a conservatorship and receivership, unless taken in contemplation of the company's insolvency or with the intent to defraud. The proposed legislation could expand this protection to include customer property and property held by insurance companies in separate accounts. It could also acknowledge that these property rights arise under and are defined by applicable state or foreign non-bankruptcy laws, as determined by applicable state conflict of laws rules such as Article 8-110 of the Uniform Commercial Code.

Expedited Procedures. The proposed legislation includes expedited procedures for secured creditors. The expedited procedures could be expanded to cover customer and separate account property as well.

Make Rulemaking Mandatory. The proposed legislation has a number of provisions granting the FDIC permissive authority to promulgate supplementary regulations. The legislation could make such rulemaking mandatory.

Maximum Period for Repudiation. The proposed legislation could impose a maximum period of time that would be considered reasonable for purposes of the repudiation of contracts, such as 180 days.

Harmonize Preference Avoidance Powers. The proposed legislation permits the FDIC to avoid those security interests taken "in contemplation of the company's insolvency." The proposed legislation could harmonize this with Section 547 of the Bankruptcy Code to limit its applicability to security interests taken in respect of antecedent debt within a fixed period of time before conservatorship or receivership.

Customer Property Provisions of SIPA. Expand the miscellaneous provisions so that the customer property provisions of SIPA would apply with respect to the distribution of customer property in a liquidation of a broker-dealer that is a member of SIPC, except to the extent they conflict with any provision of the proposed legislation.

Bridge Financial Companies

The provisions on bridge financial companies are written as if all bridge financial companies will be formed as federally chartered corporations. Thus, for example, the provisions on management, articles of association, capital stock and termination of bridge financial companies all contemplate that bridge financial companies will be organized as federally chartered corporations.

Because many of the covered financial companies will be organized as limited partnerships, limited liability companies, trusts or other forms of business organizations, the proposed legislation should give the receiver or other federal chartering authority the flexibility to organize bridge financial companies in the same form as the covered financial companies to which they relate. The proposed legislation should also give the receiver or other federal chartering authority the flexibility to organize bridge financial companies in any business form under Delaware or other state law. If this option is added, it should be coupled with a federal licensing authority that would preempt any state law limiting the activities of state-organized companies, such as insurance, lending or other financial activities, in the absence of a state license or charter. The reason for this proposed additional flexibility is that there may be a variety of reasons why bridge financial companies need to be organized in non-corporate form or under state law, including tax reasons. Although bridge financial companies will be exempt from US federal or state franchise, property and income taxation under the proposed legislation, many of them may need to operate cross-border and they will not necessarily be exempt from foreign taxation.

Finally, Treasury should consider whether the FDIC is the right federal agency to exercise this chartering authority. The FDIC does not currently exercise the authority to charter federal bridge banks in its capacity as receiver of FDIC-insured banks or thrifts under the FDIA. Instead, the Office of the Comptroller of the Currency or the Office of Thrift Supervision charters the national banks or federally chartered thrifts that operate as bridge banks.

Technical Issues

Covered Subsidiaries. The definition of financial company excludes subsidiaries of holding companies of futures commission merchants and commodity pool operators. It is not clear whether this was intentional.

Judicial Review. The proposed legislation could provide for judicial review for the disallowance of claims, at least in the case of manifest error.

Definition of "Company." Under the proposed legislation, the definition of "company" refers to the FDIA and the Banking Holding Company Act of 1956, as amended (the "**BHC Act**"). According to the definition in the BHC Act, "company" does not include any corporation the majority of whose shares are owned by the US or by any State. This definition could limit the ability of the government to provide financial assistance to a financial company in the form of equity purchases in order to remain within the coverage of the proposed legislation.

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References

» Treasury's Regulatory Reform Proposal Press Release (March 26, 2009)

» Secretary Geithner's Testimony before the House Financial Services Committee (March 26, 2009)

» Treasury's Proposed Legislation on Resolution Authority (March 25, 2009)

» Treasury's Release on Resolution Authority (March 25, 2009)

» Secretary Geithner's Testimony before the House Financial Services Committee (March 24, 2009)

For further details on Treasury's framework for regulatory reform, please see our memorandum entitled Treasury's Rules of the Road for Regulatory Reform.

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