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# The House and Senate Debate Resolution Authority

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The legislative season for financial regulatory reform is now in full swing. In the last two weeks, the leadership of the House Financial Services Committee and Treasury have jointly proposed a revised version of the Obama Administration proposals of last summer. Thereafter, the House Financial Services Committee began to amend the proposal, titled the Financial Stability Improvement Act of 2009, and the Chairman of the Committee, Representative Barney Frank (D-MA), has made clear that further changes will be made next week. This week, Senator Christopher Dodd (D-CT), Chairman of the Senate Banking Committee, released his own competing discussion draft of regulatory reform, entitled the Restoring American Financial Stability Act of 2009.

This memorandum analyzes the resolution provisions in the House Interim Version (by which we mean the House Financial Services Committee's version as of November 6, 2009). We also identify any significant differences between the House Interim Version and the Senate Banking Committee's discussion draft. This memorandum focuses on the key issues raised by the resolution of financial companies that could, in the future, be deemed to be systemically important. While the proposed resolution authority is only one of several regulatory restructuring proposals under consideration both in the United States and abroad, we view it as the most technically challenging. It is also key to many other reforms since it will be at the core of the political compromise around the knotty problems of "too big to fail," moral hazard, and the global interconnectedness of highly leveraged institutions.

The revised resolution proposals in the House and Senate versions, like their predecessors proposed by the Administration, could have profound implications for our economy. Yet none of these proposals has been subject to sufficient discussion and debate because it requires such a high degree of technical expertise to understand their full implications. Few people have a working knowledge of the bank resolution provisions in the Federal Deposit Insurance Act on which they are modeled, and no one has any experience applying this model to non-depository institution financial companies. Those who are experts with the bank resolution model typically do not have any real experience with the bankruptcy process that the proposed new resolution authority would replace. What is needed is for a full range of bankruptcy and bank resolution experts to sit in a room and craft a resolution authority that reflects the strength and avoids the weaknesses of both the bank resolution and bankruptcy models, as applied to large, interconnected, non-depository institution financial companies.

The goals of resolution authority require a clear and detailed statutory framework. Shareholders and creditors should suffer losses if their financial institutions fail. But a federal agency should have the power to preserve systemic stability and prevent contagion by acting quickly to sell selected assets and liabilities to a third party at fair value or, if that is not possible, to

set up a temporary bridge company and transfer them to the bridge company to be held and unwound in an orderly fashion.

All claimants left behind should have a right to a minimum recovery based on what they would have received in a liquidation proceeding under the Bankruptcy Code, had the federal agency not exercised its core resolution powers. The claims process for left-behind claimants should provide an equivalent level of legal certainty, due process protections and judicial review as in a normal bankruptcy proceeding. It should be based on the rules governing creditors' rights contained in the Bankruptcy Code.

Otherwise, the proposed resolution authority will have the unintended consequence of producing inefficient credit markets, with higher credit costs and lower credit availability to Wall Street, Main Street and consumers. The reason is that there appears to be a substantially greater risk of reduced recovery for secured and unsecured creditors and counterparties if the rules governing creditors' rights in the proposed resolution authority are modeled on the rules contained in the bank resolution statute instead of those contained in the Bankruptcy Code.

We first summarize the key features of the proposed resolution authority and then identify some of the key policy issues that need to be resolved in order for the proposed resolution authority to have the potential to do good without producing immediate harm. We conclude with a brief discussion of international coordination.

## Introduction

**Core resolution powers:**

- to act quickly to sell all or any selected assets and liabilities to a third party;
- to establish one or more temporary bridge financial companies to receive such assets and liabilities if a third party buyer cannot be found, in order to hold the assets and liabilities so they can be disposed of in an orderly fashion; and
- to provide financial assistance with respect to any covered company that has been put into receivership or to any bridge financial company to facilitate any transfer of all or any assets or liabilities of the covered company to a third party or the overall process of unwinding the company in an orderly fashion.

Both the House and Senate financial regulatory reform proposals include a proposal for resolving large, interconnected financial companies. They are both modeled on the resolution authority for insured depository institutions in the Federal Deposit Insurance Act. "Resolution authority" refers to a type of insolvency law and procedure that includes both the "core resolution powers" set forth in the sidebar and an ancillary claims process for left-behind assets and liabilities. The core resolution powers are exercised by a federal administrative agency, but the ancillary claims process may be administered either by the federal agency or a bankruptcy court.

The proposed new resolution authority could potentially apply to any US financial company and its covered subsidiaries (that is, all US subsidiaries other than insured depository institutions, insurance companies or broker-dealers that are members of the Securities Investor Protection Corporation), if certain financial distress and systemic risk determinations are made. Indeed, the relevant definition of the term "financial company" in the House Interim Version is so broad that the new resolution power could potentially apply to almost any company, including commercial companies. In both the House and the Senate versions, resolution authority would displace the Bankruptcy Code, which otherwise governs the liquidation or reorganization of such financial (or commercial) companies.

The revised resolution authority is virtually identical to the Administration's original proposal for systemically important financial companies released on March 25, 2009 and its first revised proposal for large, interconnected financial companies released on July 23, 2009. We described those prior versions in the Davis Polk memoranda, Treasury's Proposed Resolution Authority for Systemically Significant Financial Companies, March 30, 2009 and The Regulatory Reform Marathon, July 28, 2009. This memorandum assumes a basic familiarity with those prior proposals.

## Key Features

### How does it work?

The proposed resolution authority would authorize the Treasury Secretary to appoint the FDIC as receiver of any financial company that has been designated as an "identified financial holding company" (House version) or as a "specified financial company" (Senate version) and all of its covered subsidiaries, if the required financial distress and systemic risk determinations are made. In the version of the proposed legislation originally released by the House Financial Services Committee, the FDIC could also have been appointed as a qualified receiver of an identified financial holding company; however, this option was deleted by a later amendment. A qualified receiver is similar to a "conservator" under the Federal Deposit Insurance Act, except that a qualified receivership would have had a limited initial term of two years, with up to three one-year extensions, for a maximum life of five years. The distinction between a

receiver and a conservator (or qualified receiver) is that a receiver is a liquidator whereas a conservator (or qualified receiver) simply takes control of the going concern to preserve its value.

The FDIC would have the power to act immediately to exercise its core resolution powers. These would include selling any or all of the assets or liabilities of a covered financial company to a third party at fair value, without the need to respect any third-party consent rights. If the FDIC could not find a buyer at an acceptable price, it would have the power to incorporate a temporary bridge financial company under federal law and transfer the selected assets and liabilities to this bridge company to hold until they could be disposed of in an orderly fashion. The assets and liabilities left behind would then be liquidated.

Creditors and counterparties whose claims were assumed by a third party or bridge financial company would ordinarily recover at par, but the FDIC would presumably have the discretion to recoup any benefits received by such transferred claimants in excess of their guaranteed minimum recovery, discussed below. Indeed, the Senate version appears to give the FDIC this very power. Creditors and counterparties left behind would suffer losses to the extent that the assets of the company were less than its liabilities, subject to their guaranteed minimum recovery. Equity holders would be wiped out completely, unless the assets of the company turned out to be more than its liabilities.

## Authority to cherry pick

In exercising its core resolution power to sell or otherwise transfer assets and liabilities, the FDIC would have the flexibility to cherry-pick among creditors and counterparties within the same class, as long as the left-behind creditors and counterparties receive their guaranteed minimum recovery. More generally, the FDIC would have the power to treat similarly situated creditors differently, as long as all creditors receive their guaranteed minimum recovery.

## Minimum recovery

The provisions of both the House and Senate versions of the resolution authority, like their predecessors proposed by the Administration, that give the FDIC its cherry-picking authority also include the guaranteed minimum recovery provisions.[1] These provisions state that all creditors, including those whose claims are left behind for liquidation, are entitled to receive what they would have received in a liquidation proceeding under the Bankruptcy Code, as if the transfer of selected assets and liabilities or other differential treatment had not occurred.

[1] Financial Stability Improvement Act of 2009, §§ 1609(b)(4) and 1609(h)(5); Restoring American Financial Stability Act of 2009, §§ 208(b)(4) and 208(h)(5).

**Financial assistance permitted only if:**

- the Treasury Secretary and the FDIC determine that the action is necessary for the purpose of financial stability and not for the purpose of preserving the covered financial company;
- the FDIC ensures that the shareholders do not receive payment until after all other claims are fully paid;
- the FDIC ensures that unsecured creditors bear losses; and
- the FDIC ensures that management responsible for failed condition is removed.

## Financial assistance powers

The FDIC would have the power to provide financial assistance to any covered financial company to facilitate its resolution, provided that certain conditions set forth in the sidebar are satisfied. It is not clear whether the requirement in the House Interim Version that unsecured creditors bear losses would be satisfied if only some of the unsecured creditors suffer losses, or whether the provision that all unsecured creditors, including those whose claims are assumed by a third party or bridge financial company, must suffer losses. Nor is it clear whether these creditors must suffer the same amount of losses that they would have suffered in a liquidation proceeding under the Bankruptcy Code, or some different amount. The Senate version attempts to address these issues by rewording the requirement to say that the assistance does "not prevent unsecured creditors from bearing losses."

The permitted assistance would include making loans, purchasing debt obligations, purchasing assets, assuming or guaranteeing obligations, acquiring any equity interest or security, taking a lien on any or all assets, including taking a first priority lien on all unencumbered assets, or selling or transferring any or all such acquired assets, liabilities, obligations, equity interests or securities.

## Why financial assistance?

The reason the proposed resolution process—unlike a liquidation under the Bankruptcy Code—requires at least some financial assistance to work is that giving the FDIC the core resolution power to transfer selected assets and liabilities to a third party or bridge financial company would typically result in some creditors and counterparties receiving more than they would have received in a liquidation. This, in turn, means that there will not be sufficient assets left behind for left-behind creditors and counterparties to receive what they would have received in a liquidation proceeding under the Bankruptcy Code. The financial assistance powers are required so that enough assets are available to left-behind claimants to ensure that they receive the same amount they would have received in a liquidation proceeding under the Bankruptcy Code as if the FDIC had not exercised its authority to transfer selected assets and liabilities to protect the system.

## Recovery fund

The FDIC would have the right to recoup the cost of ensuring that left-behind claimants receive their guaranteed minimum recovery or otherwise providing any financial assistance by imposing *ex-post* assessments on any financial company with assets of $10 billion or more. House Financial Services Committee Chairman Barney Frank has stated that he intends to change this recoupment power to an *ex-ante* funding mechanism.

**The term "financial company" is defined in the resolution provisions of the House and Senate versions as follows:**

- any US bank holding company;
- any US identified financial holding company (House version) or specified financial holding company (Senate version);
- any US company predominantly engaged in "financial in nature" activities or activities that have been identified for heightened standards; or
- any subsidiary of the foregoing (other than a subsidiary that is an insurance company, a broker-dealer that is a member of SIPC, or an insured depository institution).

The definition of the term "financial company," set forth in the sidebar, suggests that a broad range of US financial companies with assets of $10 billion or more, including hedge funds, credit and finance companies and any new Section 6 financial holding companies, would be subject to assessment.

## Emergency open assistance

The FDIC's power to provide open assistance that existed in the Administration's prior versions of the resolution authority has been stripped out of the resolution authority subtitle in the House Interim Version. But a new, more constrained version of this power has been added elsewhere in the House Interim Version.[2] The Senate version gets rid of this power altogether. Open assistance refers to assistance provided to a company before it has been put into receivership, qualified receivership or conservatorship.

The FDIC's emergency open assistance authority in the House Interim Version is limited to extending credit or guaranteeing obligations of solvent insured depository institutions or other solvent companies, including identified financial holding companies, that are predominantly engaged in activities that are financial in nature, if necessary to prevent financial instability during times of severe economic distress as determined by the Treasury Secretary (in consultation with the President), upon written recommendation by at least two-thirds of the members of the Federal Reserve Board then serving and two-thirds of the members of the FDIC board then serving. The House Interim Version clarifies that the emergency power does not include the provision of equity in any form.

The House Interim Version defines the term "solvent" as meaning "assets are more than the obligations to creditors." It does not specify whether the assets and obligations are to be valued using historic cost or mark-to-market values for purposes of determining the solvency of any potential recipient of such assistance.

**The general definitions in the House Interim Version define "financial company" as follows:**

- US companies;
- US affiliates or other US operating entities of foreign companies; and
- Federal or state branches or agencies of foreign banks

that are, "in whole or in part, directly or indirectly, engaged in financial activities."

## Covered financial companies

The House Interim Version limits the new resolution authority to "identified financial holding companies" and their covered subsidiaries. But that limitation is more apparent than real for several reasons. First, the term "identified financial holding company" is not defined in the subtitle that contains the resolution authority, but only in the general definitions of the overall bill. Nor is it built on the term "financial company" as defined in the resolution provisions. Instead, it is built on the definition of that term in the general definitions of the bill, which is much broader than its cousin in the resolution provision, and is summarized in the sidebar. Indeed, the definition is broad enough to sweep in a wide range of companies including some that are not ordinarily considered to be predominantly financial in nature, from vehicle manufacturers and retail chains with financing arms, to

[2] Financial Stability Improvement Act of 2009 § 1109 (2009).

conglomerates with vast financial operations, credit and finance companies, hedge funds, insurance companies, asset managers, traditional bank holding companies and similar holding companies currently not treated as bank holding companies.

Second, although a financial company cannot ordinarily be considered to be an identified financial holding company under the House Interim Version unless the proposed new Financial Services Oversight Council (the "Council") designates it as such after a notice and hearing, the Council has the emergency power to designate any financial company as an identified financial holding company at any time without prior notice or hearing, including on the eve of bankruptcy, with the necessary financial distress and systemic risk determinations being made simultaneously.

The breadth of the term "financial company" in the general definitions of the House Interim Version suggest that the term "identified financial holding company" could include the US branches or agencies of a foreign bank or even certain types of commercial companies. We do not believe that such branches, agencies or commercial companies were intended to be included for purposes of the resolution authority. It was probably a technical error that crept in because of the apparent speed with which the bill was drafted and will likely be corrected in subsequent drafts.

The Senate version limits the resolution authority to "specified financial companies," which are defined by reference to the narrower definition of "financial company" in the resolution section.

**Financial distress and systemic risk determinations:**

- the covered company is in default or in danger of default;
- the failure of the covered company and its resolution under the Bankruptcy Code (or other applicable insolvency law) would have serious adverse effects on financial stability or economic conditions in the United States; and
- any action taken with respect to any covered company (including the appointment of the FDIC as receiver) under the proposed resolution authority would avoid or mitigate such adverse effects.

**"Default or in danger or default" means:**

- a case has been, or likely will promptly be, commenced with respect to the company under the Bankruptcy Code;
- the company is critically undercapitalized, as such term has been or may be defined by the Federal Reserve;
- the company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion without assistance under the authority;
- the company's assets are, or are likely to be, less than its obligations to creditors and others; or
- the company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business.

## Systemic risk determinations

The proposed resolution authority would only apply to an identified financial holding company and its covered subsidiaries under the House Interim Version if the Treasury Secretary, upon written recommendation from the Federal Reserve and the FDIC, or in certain circumstances, the SEC, in consultation with the President, makes the financial distress and systemic risk determinations set forth in the sidebar. Under the Senate version, the proposed resolution authority would only apply to a specified financial company and its covered subsidiaries if the Treasury Secretary, upon written recommendation from the new Financial Institutions Regulatory Administration and the FDIC, or in certain circumstances, the SEC, in consultation with the President, makes the financial distress and systemic risk determinations set forth in the sidebar.

## Ancillary claims process

The FDIC would have the exclusive authority to conduct an ancillary claims process for resolving the claims of left-behind creditors and counterparties. This process would be modeled on the process contained in the Federal Deposit Insurance Act. The FDIC's actions would be subject to no judicial review until the process was completed, at which point *de novo* review of a person's claim could be sought from a federal court. The rules defining creditors' rights would be the rules contained in the Federal Deposit Insurance Act, with only a few minor modifications. Even though each left-behind creditor and counterparty would be entitled to receive the same recovery that would have been received in a liquidation under the

Bankruptcy Code, the rules defining creditors' rights contained in the Bankruptcy Code would not otherwise be binding on the FDIC.

### Mandatory / permissive rulemaking

The House Interim Version would require the FDIC to promulgate rules governing the claims process. Otherwise, the FDIC's rulemaking authority would be permissive only. This is in contrast to the prior versions of the Administration's proposals, which only included permissive rulemaking authority. In contrast, the FDIC's rulemaking authority under the Senate version is permissive only.

### Qualified financial contracts

Under the House Interim Version, counterparties on qualified financial contracts (QFCs) would be stayed from exercising their close-out rights for one business day to give the FDIC time to determine whether to transfer such QFCs to a third party or bridge financial company. Under the Senate version that stay period would be extended to three business days.

### Living wills

As a supplement to resolution authority, the House and Senate versions would require the Federal Reserve (House version) or the new Financial Institutions Regulatory Administration (Senate version) to require identified financial holding companies (House version) or specified financial companies (Senate version) to prepare and report periodically on plans for their rapid resolution in the event of severe financial distress. These rapid resolution plans, however, would not be legally binding on the FDIC or a bankruptcy court that is authorized or required to resolve such identified financial holding companies or their subsidiaries or affiliates.

### Mandatory bankruptcy

As part of the new prompt corrective action provisions for identified financial holding companies (House version) or specified financial companies (Senate version), and as a further supplement to the resolution authority, the Federal Reserve (House version) or the Financial Institutions Regulatory Administration (Senate version) would be required to cause a bankruptcy proceeding to be commenced against an identified financial holding company (House version) or specified financial company (Senate version) within 90 days after it becomes critically undercapitalized, unless the FDIC is appointed as the company's receiver under the resolution authority.

### Section 13(3)

The House and Senate versions would both amend Section 13(3) of the Federal Reserve Act. Section 13(3) allows the Federal Reserve, in "unusual and exigent circumstances," by affirmative vote of not less than five members to provide emergency financing to any individual, partnership and corporation. The House Interim Version would add a requirement to obtain the written consent of the Treasury Secretary, and to allow emergency financing only as part of a broadly available credit or other

facility. The Federal Reserve would not be allowed to provide financing for only a single and specific individual, partnership or corporation. The Senate version would limit the Federal Reserve's Section 13(3) emergency lending powers so that assistance is available only with respect to financial utilities or payment, clearing or settlement activities that are systemically important, or any program or facility with broad-based participation, not to any individual, partnership or corporation.

### Open bank assistance limit

Both the House and Senate versions would also change the "systemic risk exception" for open bank assistance in the Federal Deposit Insurance Act. The Federal Deposit Insurance Act allows the FDIC to provide open bank financial assistance, notwithstanding the "least cost resolution" requirement in the statute, if, upon written recommendation of at least two-thirds of the Federal Reserve Board and the FDIC board, the Treasury Secretary makes a systemic risk determination. This has been the basis for the FDIC's temporary liquidity guarantee and other assistance programs to insured depository institutions and their holding companies and affiliates in the recent financial crisis.

As amended in the House and Senate versions, the systemic risk exception would be limited so that it could be used only for an insured depository institution, except where severe financial conditions exist which threaten the stability of a significant number of insured depository institutions. The Senate version would also replace the Federal Reserve Board with the Financial Institutions Regulatory Administration board.

## Key Policy Issues

### Why not Bankruptcy Code?

In the absence of the required financial distress and systemic risk determinations, the Bankruptcy Code would govern the liquidation or reorganization of a financial company other than an insured depository institution or insurance company. Even broker-dealers that are members of the Securities Investor Protection Corporation are resolved under the Bankruptcy Code, with the Securities Investor Protection Act supplementing its provisions with respect to customer property. The Bankruptcy Code prevents moral hazard—that is, the incentive to take excessive risks if investors are entitled to the upside from their investments but are protected from the downside—by ensuring that shareholders, creditors and counterparties of covered financial companies suffer appropriate losses if such companies are insolvent. The bankruptcy process is generally considered to be transparent and consistent with due process. It has rules governing creditors' rights that are widely understood and considered to be neutral among similarly situated classes of creditors.

### "Too big to fail" / moral hazard debate

Treasury and other proponents of the proposed resolution authority argue that some form of resolution authority is necessary to eliminate taxpayer-

funded bailouts of financial companies that are perceived to be "too big to fail," and the moral hazard that such bailouts produce, in a way that does not destabilize the financial system. The only alternatives to such resolution authority are to allow these companies to fail in a disorderly fashion the way Lehman Brothers was or to rescue them in an *ad hoc* fashion the way AIG was.

These proponents argue that the resolution of large, interconnected financial companies through the normal bankruptcy process occurs far too slowly. This is because of the extraordinary speed with which both credit disappears during a financial crisis and the value of certain assets dissipates upon the commencement of bankruptcy proceedings. The follow-on effects of this loss of value are distributed throughout the financial system, potentially causing other financial companies to fall like dominos, thereby increasing systemic risk and the cost of government intervention to stabilize the financial system.

Critics argue that the proposed resolution authority will not end "too big to fail" or reduce moral hazard, but rather institutionalize them. They point to the financial assistance provided to Freddie Mac and Fannie Mae in connection with their conservatorships as examples, and argue that the proposed resolution authority will create 20 new Fannies and Freddies. The institutionalization of such bailouts will increase moral hazard and give potentially covered companies a funding advantage over their competitors. Such critics would leave the Bankruptcy Code in place to insure that shareholders, creditors and counterparties of non-depository institution financial companies suffer appropriate losses if such companies fail.

## Which model for ancillary claims process?

Some proponents of the general concept of resolution authority strongly support giving a federal agency "core resolution powers" modeled on the Federal Deposit Insurance Act. But they believe that the Federal Deposit Insurance Act is the wrong model for the claims process for left-behind assets and liabilities, as applied to non-depository institution financial companies.[3] They argue that an administrative claims process modeled on the Federal Deposit Insurance Act is too opaque and does not provide the same level of due process and judicial review as the Bankruptcy Code. They also argue that the rules defining creditors' rights in the Federal Deposit Insurance Act should not be used for the resolution of non-depository financial companies. Using such rules is inconsistent with provisions in the resolution authority statute which guarantee all creditors that they will receive the same recovery as they would have received in a liquidation under the Bankruptcy Code.

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[3] Testimony of T. Timothy Ryan Jr., President and CEO of the Securities Industry and Financial Markets Association, before the House Financial Services Committee (October 29, 2009), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/ryan_-_sifma.pdf. For a discussion of the Federal Deposit Insurance Act as it applies to insured depository institutions, *see* John L. Douglas & Randall D. Guynn, *Restructuring and Liquidation of U.S. Financial Institutions*, GLOBAL FINANCIAL CRISIS: NAVIGATING AND UNDERSTANDING THE LEGAL AND REGULATORY ASPECTS (September 25, 2009).

In addition, the Federal Deposit Insurance Act rules were deliberately designed to reinforce the priority of deposit creditors—a class of creditors that does not exist for non-depository institutions—over unsecured non-deposit creditors—a class of creditors that account for only a tiny portion of the balance sheets of most depository institutions. The rule allowing the FDIC to set security interests aside if they were taken "in contemplation of insolvency" will also create a serious risk that otherwise perfected security interests may be set aside when applied to non-bank financial companies, thus causing secured credit (other than repos) to dry up during times of financial stress.

Instead, they argue that the resolution authority should be amended so that it provides a more transparent claims process, additional judicial review, neutral rules governing creditors' rights and protection of secured creditors rights modeled on the Bankruptcy Code. Attached as Annex A to this memorandum is a chart comparing the key differences between the Bankruptcy Code and the proposed resolution authority.

Finally, they argue that unless the proposed resolution authority is amended to be a compromise between the Federal Deposit Insurance Act and bankruptcy models, it will have the unintended consequence of making our credit markets inefficient—increasing the cost and reducing the availability of credit to these financial companies, consumers, small businesses and others in the system; slowing jobs growth; increasing unemployment; and causing liquidity to dry up during times of financial stress.

Defenders of the bank insolvency model for both the core resolution powers and the ancillary claims process counter that the right of *de novo* judicial review after the administrative claims process has been completed provides adequate due process. They argue that there is no significant difference in outcomes between the FDIC's application of the rules defining creditors' rights in the Federal Deposit Insurance Act and a typical bankruptcy court's application of the rules in the Bankruptcy Code. As a result, the unintended consequences are more feared than real.

Proponents of the bankruptcy model for the ancillary claims process have responses to each of these defenses. First, the administrative claims process under the Federal Deposit Insurance Act is in fact more opaque and provides far less due process and judicial review than a bankruptcy process. Second, there are in fact significant differences in outcomes between the two sets of rules. Moreover, if there really were no significant differences in outcomes, the FDIC should be required to apply the rules under the Bankruptcy Code to avoid creating any legal uncertainty about the matter and to avoid any inconsistencies between the applicable rules and the minimum recovery guarantees in both the House and Senate versions.

Other defenders of the bank insolvency model for both the core resolution powers and the ancillary claims process argue that if the rules governing creditors' rights in the proposed resolution authority would impose greater losses on creditors or subject them to greater legal uncertainty of recovery than the Bankruptcy Code, they serve the important public policy purpose of further enhancing market discipline and reducing moral hazard.

Proponents of the bankruptcy model for the ancillary claims process counter that it is inconsistent with the minimum recovery provisions in the resolution authority to impose greater losses on creditors than they would have suffered in a liquidation under the Bankruptcy Code. Moreover, the public policy goals in favor of market discipline and reducing moral hazard must be balanced against the important public policy goals of due process and fundamental fairness. Otherwise, Congress could deny all recovery to creditors even if there were some assets available to satisfy all or part of their claims.

## Who should pay?

Under both the House and Senate versions, the FDIC would have the power to recover its cost of providing any financial assistance by imposing *ex-post* assessments on US financial companies with $10 billion or more in assets.

A serious policy question arises as to whether it is appropriate to impose the cost of the new resolution authority on this pool of large companies. The direct beneficiaries of the financial assistance would not be these companies, except to the extent that they were among the creditors or counterparties whose claims are assumed by a third party or bridge financial company pursuant to the FDIC's exercise of its core resolution powers. Instead, the direct beneficiaries would be the creditors and counterparties whose claims are assumed. To the extent the transfer of these claims helps to stabilize the financial system, the indirect beneficiaries would be everyone who benefits from financial stability.

Unless the creditors and counterparties whose claims are assumed bear the cost of the financial assistance, they will be insulated from losses. This could undermine market discipline and create a degree of moral hazard that would not exist if all financial companies were resolved under the Bankruptcy Code. But if a tax is imposed on these creditors and counterparties equal to the difference between what they would have received in a bankruptcy liquidation and what they actually received because of the third-party assumption of liabilities, it might undo the stabilization benefits of giving the FDIC the power to transfer the claims.

There is also a vigorous debate that is just beginning over whether the tax to recover these costs should be imposed before or after the resolution authority is exercised. The principal argument advanced so far in favor of an *ex-ante* tax is that an *ex-post* tax would allow the companies that are resolved to escape bearing any of the cost of their own resolution. The principal argument advanced so far against an *ex-ante* tax and in favor of an *ex-post* tax is that it is impossible to know whether the resolution authority will ever be used or how much it will cost if used.

## Resolving agency?

Under both the House and Senate versions, the FDIC would be appointed as the receiver for all covered financial companies. The FDIC would be required to consult with the state or federal regulators of a covered financial company in carrying out its functions as receiver. But nothing would require the FDIC to follow the direction of any other regulator.

Some observers have argued that that the FDIC does not have the experience necessary to resolve the type of large, complex and global financial institutions that would be the subject of the new resolution authority. Its supervisory experience is limited to community banks and other relatively small insured depository institutions. Under the Senate discussion draft, it would lose even this experience over time because its supervisory authority would be transferred to the new Financial Institutions Regulatory Administration. Although the FDIC has resolved at least one relatively large savings association (Washington Mutual), that savings association had relatively simple activities compared to the targets of the proposed resolution authority.

To ensure that adequate experience is brought to bear on the resolution process, some observers have argued that a Systemic Resolution Board should be created consisting of the Treasury Secretary, the Chairman of the Federal Reserve (or the Financial Institutions Regulatory Administration), the Chairperson of the FDIC and the primary federal regulator of the company being resolved. The FDIC would carry out the resolution powers under the new authority, subject to the direction of the Systemic Resolution Board. The Systemic Resolution Board would also be the rulemaking authority under the proposed resolution authority and be responsible for international coordination.

## Covered companies?

The original impetus for the proposed resolution authority was the disorderly failure of Lehman Brothers and the rescue of AIG. The government argued that it needed the proposed resolution authority to be able to resolve the AIGs or Lehmans of the future.

But the proposed resolution authority excludes both insurance company subsidiaries and broker-dealers that are members of the Securities Investor Protection Corporation from its scope of coverage. As a result, this resolution authority would not give the government authority over the entire AIG or Lehman groups. It would give the FDIC power to resolve a future AIG holding company or AIG Financial Products—where most of the AIG losses were located this time—but it would not extend to AIG's insurance company subsidiaries—which represent the vast majority of its operations, where the losses could be located next time. Similarly, the proposed resolution authority would allow the FDIC to resolve the Lehman holding company and certain of its subsidiaries, but not its flagship broker-dealer. Indeed, it would exclude virtually all US broker-dealers from its scope of coverage because almost all of them are members of the Securities Investor Protection Corporation.

## Mandatory rulemaking?

A number of observers have commented that the FDIC does not have a culture of transparency in providing *ex-ante* legal certainty on how ambiguities in the Federal Deposit Insurance Act are to be resolved. Although it has permissive rulemaking authority under the Federal Deposit Insurance Act, it has rarely exercised that authority. It has also been very sparing in providing other forms of legal guidance, including policy

statements, general counsel opinions and other interpretations. In addition, all of these sources of legal guidance can be withdrawn by the FDIC at any time with, or in some cases without, notice.

These observers argue that the proposed resolution authority should include mandatory rulemaking authority, with the requirement that the FDIC or Systemic Resolution Board use this authority for the purposes of increasing *ex-ante* legal certainty and harmonizing the rules governing creditors' rights to those in the Bankruptcy Code.

### Valuation of transfers?

None of the proposals for resolution authority have included any specific procedures for ensuring that the FDIC obtains the highest possible price for any assets and liabilities sold or transferred pursuant to its exercise of core resolution powers. Because the amount received for such assets and liabilities has a direct relationship to the size of the difference between what left-behind claimants can obtain from left-behind assets and what they would have received in a liquidation under the Bankruptcy Code if any transfer of assets and liabilities had not occurred, the government should probably consider adding some incentives and procedures to ensure that the FDIC does not sell any assets or liabilities at below the maximum value possible over some reasonable time period.

## International Coordination

Under both the House and Senate versions, the FDIC would be required to consult with the state and federal regulators of each covered financial company in exercising its powers as receiver. The FDIC would also be required to consult with the primary regulators for non-US subsidiaries and coordinate regarding the resolution of those entities.

Many large US financial companies have international operations outside the United States through a network of branches, offices and subsidiaries. These branches, offices and subsidiaries are generally subject to different bankruptcy laws in different national jurisdictions. Currently, there is no set of international agreements or arrangements that provide any overarching coordination when a major cross-border financial firm fails. The failures of a few major cross-border financial firms during the financial crisis have been a real wake-up call to the international community.

The G-20 summit in Pittsburgh specifically endorsed two major international initiatives to develop cross-border bank resolution frameworks.[4] One initiative is the Cross-Border Bank Resolution Group of the Basel Committee on Banking Supervision. That group issued a consultative paper in September that proposes specific actions to improve efficiency and

[4] See *Overview of Progress in Implementing the London Summit Recommendations for Strengthening Financial Stability, Report of the Financial Stability Board to G-20 Leaders*, Financial Stability Board (September 25, 2009), *available at* http://www.financialstabilityboard.org/publications/r_090925a.pdf.

effectiveness of cross-border crisis management and bank resolutions.[5] Among other things, the Basel Committee recommended that national authorities and multinational groups should seek convergence on national resolution regimes and put in place bilateral or multilateral procedures to facilitate mutual recognition of crisis management and resolution proceedings. The other initiative is the IMF/World Bank Global Bank Insolvency Initiative, which issued an interim report in April 2009 and will issue a final report in the spring of 2010.[6] The final report is expected to include practical steps to achieve consistency among national laws for crisis intervention and bank resolution.

[5] See *Report and Recommendations of the Cross-border Bank Resolution Group*, the Basel Committee (September 2009), *available at* http://www.bis.org/publ/bcbs162.pdf?noframes=1.

[6] See *An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency*, International Monetary Fund and the World Bank Group (April 17, 2009), *available at* http://www.imf.org/external/np/pp/eng/2009/041709.pdf.

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## Annex A

# Certain Key Differences Between the Resolution of Assets and Claims under the Bankruptcy Code and under the House Interim Version

| Topic | Bankruptcy Code | Proposed Resolution Authority |
|---|---|---|
| ***Applicability*** | Most individuals and business entities with specified connections to the US are covered, but not domestic insurance companies and insured depository institutions, among others. | Virtually any US financial company and its affiliates (other than insured depository institutions, insurance companies or broker-dealers that are members of SIPC), subject to financial distress and systemic risk determinations. Can include companies that are not bank holding companies, such as credit and finance companies that have significant amounts of assets and unsecured public debt. |
| ***Commencement of Proceedings*** | By debtor (voluntarily) or creditors (involuntarily). | By the Treasury Secretary, after financial distress and systemic risk determinations. |
| ***Control of Business*** | Debtor in possession or bankruptcy trustee. | The FDIC, as receiver. Upon appointment, the FDIC automatically succeeds by operation of law to all of the rights, titles, powers and privileges of any stockholder, member, officer, or director of the covered financial company. |
| ***Stay of Litigation*** | Automatic stay during the proceedings. Creditors may not prosecute litigation that was or could have been commenced before the filing of the petition; remedies against property (like foreclosure) also generally stayed. | No automatic stay under proposed legislation, except for automatic temporary one-business day stay of the exercise of close-out rights on QFCs (see below). The FDIC as receiver may request a stay of litigation not to exceed 90 days. |
| ***Close-Out of Certain Financial Contracts by Counterparties*** | Protected financial contracts can be closed-out/netted immediately, and remedies against collateral exercised under stay exceptions. | Close-out/netting of qualified financial contracts (QFCs) by counterparties temporarily stayed for one business day in the case of a receivership (otherwise same as Bankruptcy Code) to allow receiver to determine which QFCs to transfer (all-or-none with a particular counterparty). |
| ***Customer Property*** | Customer property held by stockbrokers and commodity brokers is treated separately and specific rules govern its distribution. Customer name securities to be delivered to customers, with certain exceptions in the case of negative net equity. | Incorporates by reference Bankruptcy Code rules for customer property held by non-SIPC member stockbrokers and commodity brokers. No express provisions protecting customer property held by non-broker-dealer financial companies. Under very old case law under bank resolution statute on which new resolution authority is modeled, customer property rights are respected only if properly segregated from bank's assets. Substantial legal uncertainty under that case law regarding what is required to satisfy segregation requirements short of physical segregation given the dematerialization of securities and other assets since those cases were decided. |
| ***Financial Assistance*** | Subject to the requirement of "adequate protection" of existing lien holders, the debtor may obtain post-bankruptcy (DIP)-financing and lenders can receive priming liens and super-priority claims (subject to Bankruptcy Court approval). Such financing can be provided by any source, including the federal government. | *Emergency Open Assistance:* Upon a systemic risk determination by the FDIC, the Fed and the Treasury Secretary in consultation with the President, the FDIC may extend credit to or guarantee obligations of solvent entities during severe economic distress to prevent financial instability, subject to specified limitations.<br><br>*Closed Assistance*: As receiver, the FDIC may |

| Topic | Bankruptcy Code | Proposed Resolution Authority |
|---|---|---|
| | | provide wide range of financial assistance to assist in the resolution of the covered financial company. |
| ***Bridge Company*** | No concept of a bridge company, other than the debtor in possession itself. The business can be reorganized as a continuation of the existing debtor or a new entity or entities. A plan of reorganization will sometimes distribute certain non-operating assets (e.g. litigation claims) to a liquidating trust for the benefit of creditors. | The FDIC can organize a bridge financial company to assume liabilities or purchase assets of the covered company, and such liabilities and assets can be quickly transferred to such entity. |
| ***Prompt Transfer of Assets and Liabilities to Buyer*** | Sale of assets to a third party permitted after notice and hearing if good business reasons (like declining values) can be demonstrated. | The FDIC would have broad discretion to sell or transfer assets and liabilities to a third party, notwithstanding any otherwise applicable consent requirements, subject to certain limitations in the statute but no meaningful judicial review. |
| ***Cherry-Picking of Assets to Transfer and Liabilities to Assume*** | Selected assets can be sold free and clear of claims and liens, subject to court approval of the transfer, but limited by close-outs of protected financial contracts and subject to providing for the value of existing liens. Selected liabilities may be assumed by a buyer if good business reasons, such as enhanced value of estate for left-behind creditors, are demonstrated. | The FDIC would have broad discretion to cherry pick which assets or liabilities to transfer even among the same class of creditors, subject to three limits: (i) any left-behind claimants would be entitled to a minimum distribution equal to what they would have received in a Chapter 7 liquidation in the absence of such transfer; (ii) if the FDIC transfers any QFCs with a particular counterparty, it must transfer all QFCs with that counterparty; and (iii) all assets are transferred subject to pre-existing liens unless the FDIC is able to invalidate the lien pursuant to one of its "super powers" discussed below. |
| ***Assumption or Rejection of Executory Contracts and Leases*** | Executory contracts or leases must either be assumed and performed/assigned or rejected upon approval of the Bankruptcy Court. | The FDIC would have broad discretion to repudiate or disaffirm any contract or lease (not merely executory contracts) within a reasonable period of time (not defined) after its appointment as receiver. |
| ***Damages for Rejected or Repudiated Contracts*** | Breach of contract damages generally allowed for rejected contracts. Administrative expense claims often allowed to the extent the debtor accepted benefits under the contract after the petition date. | Damages for repudiation or disaffirmance are limited to "actual direct compensatory damages" (resulting in smaller damages claims than for identical contracts rejected under the Bankruptcy Code) determined as of the date of the appointment of the receiver, with the exception of QFCs, for which damages are calculated as of the date of disaffirmance or repudiation and are measured in accordance with market custom (cost of cover included). |
| ***Enforceability of Ipso Facto Clauses*** | Generally unenforceable, with exceptions for financing contracts, protected financial contracts and other protected agreements. | Unenforceable in any contracts (other than QFCs in receivership, D&O insurance policies, and other very limited exceptions). |
| ***Oral contracts*** | In some cases, oral agreements can form the basis of a claim. | Only properly authorized written contracts will be recognized under the statute. |
| ***Definition of a "Claim"; Contingent Claims*** | A right to payment, including a contingent or unliquidated right. Generally speaking, contingent claims, such as under undrawn guarantees or letters of credit, loan commitments or unused portions of committed lines of credit, are estimated by the Bankruptcy Court for purposes of allowance. | Not defined. Generally speaking, the amount of an allowed claim is determined by applicable non-insolvency law. The FDIC takes the position under the bank insolvency statute on which this proposed statute is modeled that contingent claims, such as under undrawn guarantees or letters of credit, unused loan commitments or unused portions of committed lines of credit, are not provable. |

| Topic | Bankruptcy Code | Proposed Resolution Authority |
|---|---|---|
| ***Less than Fully Secured Creditors*** | Partially secured claims are divided into secured and unsecured portions based on the value of the collateral. The secured portion generally must receive the value of the collateral; the unsecured portion receives distributions comparable to other similar claims. | Portion of claim that exceeds the value of the collateral considered unsecured. No payments may be made with respect to unsecured claims other than in connection with the disposition of all unsecured claims. |
| ***Post-Insolvency Interest*** | Generally disallowed, except (i) where the debtor is solvent and (ii) to the extent the value of a secured creditor's collateral exceeds its principal claim. | Generally not payable, with exceptions for QFCs or as the FDIC may provide by regulation, policy statement or staff interpretation. |
| ***Unequal Treatment of Similarly Situated Creditors*** | Generally, similarly situated creditors are required to receive similar treatment in a reorganization under Chapter 11 or a liquidation under Chapter 7, although favored treatment for selected creditors can be authorized by the Bankruptcy Court if such treatment is found to preserve or enhance the value of the estate for remaining creditors. For example, critical vendors payments may be approved by the Bankruptcy Court, and selected liabilities may be assumed by a buyer in a Bankruptcy Court approved sale, subject to the good business reason test described above. | The FDIC has broad authority to take actions that result in unequal treatment of similarly situated creditors (cherry-picking liabilities to be assumed by third party or bridge company, as described above). While the proposed statute requires left-behind creditors to receive at least as much as they would have received in a Chapter 7 liquidation, it is unclear who makes this determination, the degree to which judicial review will be available, and the remedy for failure to meet this standard after transfer of assets to a bridge company or third party. |
| ***Priority of US Claims*** | Tax claims and allowed unsecured claims based upon any commitment by the debtor to a federal depository institution's regulatory agency, or the predecessor to such agency, to maintain the capital of an insured depository institution have priority junior to administrative expenses, but generally senior to other unsecured creditors. | Claims by the FDIC for administrative expenses as receiver and claims of amounts owed to the US generally have priority over general or senior liabilities of the company. |
| ***Avoidability of Perfected Security Interests*** | "Preferential" transfers may be avoided. Defenses include transfers for "new value" or in the ordinary course of business. See also "Fraudulent Transfer" below. | The FDIC would have the power to avoid any security interest (unless securing a QFC) if taken "in contemplation of the company's insolvency." No insolvency requirement or new value exception. Substantial legal uncertainty about scope of this avoidance power when applied to non-bank financial companies because old case law applicable to banks is conditioned on factors that would not apply to non-bank financial companies. Security interests taken to secure QFCs are avoidable only if taken with "actual intent" to hinder, delay, or defraud. |
| ***Fraudulent Transfer*** | Pre-bankruptcy transfers made or obligations incurred on or within two years prior to the petition date (i) with actual intent to hinder, delay or defraud creditors or (ii) for less than "reasonably equivalent value" and while the debtor was insolvent or that rendered the debtor insolvent, are generally voidable, subject to certain defenses. State law fraudulent conveyance laws can also apply. | The FDIC has the power to set aside fraudulent transfers based on applicable state fraudulent transfer law. In addition, the FDIC has the power to set aside transfers by certain insiders or debtors of the financial company if made within five years of the receivership with the intent to hinder, delay or defraud. The FDIC's power under this special provision is superior to that of a trustee in bankruptcy. Certain defenses are available. |
| ***Judicial Supervision of Claims Process*** | Yes, by the Bankruptcy Court. | No, the FDIC has broad authority to conduct the administrative claims process, subject only to after-the-fact de novo judicial review. |
| ***Rulemaking and Legal Guidance*** | There are statutory requirements of notice and hearing for most substantive actions, as well as procedural rules, case law and legal commentary interpreting the Bankruptcy Code. The Federal | The FDIC would be required to make rules and regulations governing the allowance/or disallowance of claims, but without any further guidance as to the goals of any such rules or |

| Topic | Bankruptcy Code | Proposed Resolution Authority |
|---|---|---|
| | Rules of Bankruptcy Procedure are prescribed by the federal judiciary, subject to the right of Congress to reject or modify such Rules. The various Bankruptcy Courts may enact their own Local Rules. | regulations. Otherwise, the FDIC's rulemaking power is permissive only. |
| ***Assessments*** | Administrative creditors of the debtor are granted priority over pre-bankruptcy creditors with respect to estate assets, and trustees and professionals receive compensation subject to approval of the Bankruptcy Court. | The FDIC would have the power to recoup its costs, if any, of resolving a covered financial company by imposing after-the-fact assessments on certain large financial institutions. |