ALERTS AND UPDATES

U.S. Financial Reform: Too-Big-to-Fail Bailout Avoidance Provisions

August 24, 2010

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("the Act") begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts *on many of the broad topics addressed by the Act, accessible at* www.duanemorris.com/FinancialReform.

Title II of the Act, designated "Orderly Liquidation Authority" – effective July 21, 2010 – establishes what is intended to be an orderly liquidation process for "financial companies" whose collapse or potential collapse are determined to constitute a risk to the financial system as a whole. Such systemically significant institutions would be liquidated under these new procedures, rather than being treated under existing bankruptcy laws. (The intent of Act is that most-failing financial companies will continue to be administered under existing bankruptcy laws.)

A "financial company" is defined as any of the following:

- A bank holding company (as defined in the Bank Holding Company Act of 1956);
- A company that (A) derives 85 percent or more of its annual gross revenues from, or of which at least 85 percent of its consolidated assets are related to, activities that are financial in nature (as defined in the Bank Holding Company Act – this would include, among other things, lending; exchanging; transferring; investing for others; insuring or indemnifying against loss, harm or damage; acting as principal, agent or broker; underwriting, dealing in or making a market in securities; or providing financial, investment or economic advisory services); and (B) the newly created Financial Stability Oversight Council, by a vote of at least two-thirds of its nine members (including the chairperson, the Secretary of the Treasury), determines should be supervised by the Board of Governors of the Federal Reserve System (the "Board of Governors") because its failure or financial distress could pose a risk to the financial stability of the United States;
- Any company predominantly engaged in activities that the Board of Governors has determined are financial in nature (for purposes of the Bank Holding Company Act); and
- Any subsidiary of any company described above that is predominantly engaged in activities that Board of Governors has determined are financial in nature or incidental thereto for purposes of the Bank Holding Company Act (excluding subsidiaries that are insured depository institutions or insurance companies).

If the Treasury Secretary, in consultation with the President (and following receipt of a recommendation described in the next paragraph), determines that a financial company is in default or is in danger of default and, among other things, that the failure of the financial company would have significant adverse effects on financial stability in the United States, the Secretary must notify the company of such determination and of its intention to appoint the FDIC as receiver. (Such a determination may occur before or after a financial company has commenced bankruptcy proceedings.)

If the board of directors of the subject company consents to such appointment, the Treasury Secretary is required to appoint the FDIC as receiver. (The Act creates a specific safe harbor providing that the members of the board of directors of a financial company will not be liable to the company's shareholders or creditors for acquiescing in or consenting in good faith to the appointment of the FDIC as receiver.)

Absent such consent, the Treasury Secretary is required to file a sealed petition with the U.S. District Court for the District of Columbia (the "District Court") seeking an order authorizing the Secretary to appoint the FDIC. The petition will be granted by operation of law within 24 hours after filing unless the District Court rules that the Treasury Secretary's determinations that the company in question is a financial company and is in default or may potentially default were "arbitrary and capricious." The "arbitrary and capricious" standard appears to give the Secretary considerable discretion in making its determinations and will be difficult for a company to overcome.

The Treasury Secretary cannot make a determination described in the previous paragraph unilaterally. The Secretary must first receive a recommendation from the Board of Governors and from the FDIC, based upon a vote of at least two-thirds of the Board of Governors and the board of the FDIC, unless (a) the company in question is a broker dealer, in which case, the written recommendation must come from the SEC and from the Board of Governors, upon votes of at least two-thirds of the members of the SEC and the Board of Governors; or (b) the company in question is an insurance company, in which case, the director of the Federal Insurance Office and the Board of Governors, based on a two-thirds' vote, must make the recommendation. (The Federal Insurance Office is a new office established by the Act within the Department of the Treasury for the purpose of monitoring the insurance industry.)

The Treasury Secretary or the affected company may, no later than 30 days after the date of the District Court's ruling, file an appeal of such ruling with the U.S. Court of Appeals for the D.C. Circuit ("Court of Appeals"), and such an appeal must be considered on an expedited basis. However, if the District Court grants the Secretary's petition, the FDIC's authority to begin acting as receiver will commence immediately – the District Court's decision is not subject to any stay or injunction pending the appeal. Thus, it is possible that the orderly liquidation process could be under way by the time the Court of Appeals issues a ruling. The Court of Appeals' scope of review is limited to deciding whether the Treasury Secretary's determinations that the company fits the definition of a "financial company" and is in default or in danger of default were arbitrary and capricious.

As a result of this new orderly liquidation regime, creditors of and other transactional counterparties with systemically important financial companies will need to consider, as part of their risk assessment, the possibility that the financial company may enter bankruptcy proceedings, or instead may become subject to the liquidation process under the Act, and to consider how their rights may differ under each scenario.

The FDIC, acting as receiver, has a broad array of powers over the financial company. These powers are similar to those the FDIC has over failed FDIC-insured depository institutions, with some differences. The Act states that, in taking actions as receiver, the FDIC must, among other things:

- Ensure that the shareholders of the financial company do not receive payment until after all other claims and the "Orderly Liquidation Fund" (see below) are fully paid;
- Ensure that unsecured creditors bear losses in accordance with the applicable priority of their claims;
- Ensure that the members of the board of directors and the management of the financial company who were responsible for the failed condition of the company are removed; and
- Not take an equity interest in or become a shareholder of the financial company.

The Act notes that all companies placed into receivership under the Act's provisions should be liquidated, and that no taxpayer funds should be used to prevent any such liquidation.

A new segregated fund, called the Orderly Liquidation Fund, has been established to enable the FDIC to carry out its authorities under Title II of the Act. Once the FDIC submits to the Treasury Secretary a plan for the orderly liquidation of a financial company satisfactory to the Secretary, the FDIC may issue obligations to the Treasury Secretary, the proceeds of which are deposited into the Fund until needed. The maximum amount of obligations that the FDIC may issue with regard to a financial company may not exceed 10 percent of the total consolidated assets of the financial company during the first 30 days of liquidation proceedings, and may not exceed 90 percent of the fair value of the total consolidated assets of the financial company available for repayment following the initial 30-day period. Obligations so incurred by the FDIC have priority over other claims against the company, including administrative expenses.

If necessary in order to enable the FDIC to repay its obligations to the Treasury within 60 months of the date of issuance, the FDIC is required to impose assessments (i) on any claimant of the financial company that received amounts in excess of liquidation value of its claim; and if this is not sufficient to enable the FDIC to recover the amount of its obligations, (ii) on financial companies having consolidated assets of $50 billion or more and nonbank financial companies supervised by the Board of Governors. Any assessments on such financial companies are to be made on a graduated basis, with companies having greater assets and risk being assessed at a higher rate.

Title I of the Act includes provisions permitting the Board of Governors, in certain instances, to break up certain large, complex financial institutions even if they are not insolvent. If the Board of Governors determines that a bank holding company with total consolidated assets of $50 billion or more or a nonbank financial company that is under the supervision of the Federal Reserve poses a "grave threat"[1] to U.S. financial stability, the Board of Governors, following an affirmative vote of at least two-thirds of the voting members of the Financial Stability Oversight Council, is required to:

- Limit the ability of the company to merge, consolidate or otherwise become affiliated with another company;
- Restrict the ability of the company to offer one or more financial products;
- Terminate one or more activities of the company; and
- Impose conditions on the manner in which the company conducts one or more activities.

If the Board of Governors is considering such mitigatory action against a company, it is required, in consultation with the Financial Stability Oversight Council, to notify the institution and provide an explanation of the basis for its proposed mitigatory action. The company may, no later than 30 days after the date of receipt of such notice, request an opportunity for a hearing before the Board of Governors to contest the proposed mitigatory action. The Board of Governors must issue a final decision no later than 60 days following such a hearing (or, if no hearing was held, the date of its notice to the company). Unlike the process described in Title II for the appointment of the FDIC as receiver of a failing or failed financial company, the Act does not specify a judicial appeal process of a final decision of the Board of Governors.

About Duane Morris

Duane Morris has an online **Financial Services Reform Center** – www.duanemorris.com/FinancialReform – which includes videos and the firm's comprehensive series of *Alerts* analyzing the provisions of the Act and emerging policies, as well as links to relevant government websites. Duane Morris' attorneys will be monitoring the rules and regulations released under the Act, as well as the regulatory agencies' interpretive guidance. For subsequent *Alerts* on these and other topics, please revisit www.duanemorris.com and www.duanemorris.com/FinancialReform.

For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact Lee J. Potter, Jr., Benjamin A. Haverstick, any member of the Corporate Practice Group or the attorney in the firm with whom you are most regularly in contact.

Note

1. Section 121(a). This term is not defined in the Act.