Client Alert.

July 11, 2011

Dodd-Frank Rulemaking Update:

Resolution Plans/Living Wills

Summary of Final Rule on Orderly Liquidation Authority, and Future Impacts on Financial Companies, Creditors, Potential Investors, and Senior Executives

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The July 6, 2011 Federal Deposit Insurance Corporation Board of Directors (the "**FDIC Board**") meeting marked the changing of the guard from Chairman Sheila Bair to FDIC Vice Chairman Martin Gruenberg. Chairman Bair's valedictory meeting was not merely ceremonial; it also covered several key developments regarding the timing of a final rule on resolution plans under section 165(d) of Title I and a final rule on the Orderly Liquidation Authority ("**OLA**") under Title II.

A. RESOLUTION PLANS/ LIVING WILLS

Although we had hoped to see a final rule on section 165(d) addressing resolution plans or "living wills,"[1] none was forthcoming, to Chairman Bair's evident disappointment. She advised the FDIC Board that FDIC staff continues to work closely with the Federal Reserve Board staff on resolution plan issues and said she expects the final rule on living wills to be completed by the end of August.

Two other important points from the July 6 meeting:

- ***International Efforts***. Michael Krimminger, the FDIC's General Counsel, noted that the final rule implementing section 165(d) will be consistent with the those standards for resolution planning under development by the Financial Stability Board and the Group of 20. Efforts abroad in developing resolution plans are at various stages of development, but Mr. Krimminger indicated that the U.S. and the U.K. are playing leadership roles with respect to resolution planning.
- ***Confidentiality***. On the question of the confidentiality of a resolution plan, which would seem to be a non-issue (because, of course these plans would be protected), the FDIC Board raised more questions than answers. Various concepts were aired, including
    - a delineation in the final rule between confidential and public portions of resolution plans;
    - a requirement that systemically important financial institutions ("**SIFIs**") provide a public statement summarizing their resolution plans; and/or
    - future legislation and/or heightened protections in the final rule reflecting sensitivity towards the confidential nature of resolution plans.

The FDIC Board also discussed whether a decision that a plan was not "credible" would require the institution involved to disclose that fact in an 8-K. If the past is any guide, the FDIC Board will not attempt to resolve this issue and will leave each institution to interpret securities law requirements on its own.

B. FINAL RULE ON ORDERLY LIQUIDATION AUTHORITY (THE "FINAL RULE")

The FDIC Board approved the Final Rule on the orderly liquidation process, which was the culmination of a series of rulemaking efforts begun earlier this year. The rule implements several provisions of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Act**").[2] Title II establishes an "orderly liquidation authority" (the "**OLA**") through which the FDIC can be appointed as receiver and liquidate a covered financial company ("**CFC**"), such as a bank holding company, whose failure threatens to have serious adverse effects on financial stability in the United States.

An in-depth understanding of the Final Rule and its various potential effects is critical not only for financial companies who may fall under Title II's umbrella, but also the creditors of, potential investors in, and senior executives employed by such financial companies. In large measure, the FDIC attempts to abide by the directive in section 209 of the Act that it "harmonize applicable rules and regulations promulgated under this section with the insolvency laws that would otherwise apply" to a CFC.

AN IN-DEPTH UNDERSTANDING OF THE FINAL RULE AND THEIR VARIOUS POTENTIAL EFFECTS IS CRITICAL NOT ONLY FOR FINANCIAL COMPANIES WHO MAY FALL UNDER TITLE II'S UMBRELLA, BUT ALSO THE CREDITORS OF, POTENTIAL INVESTORS IN, AND SENIOR EXECUTIVES EMPLOYED BY SUCH FINANCIAL COMPANIES.

CHRONOLOGY OF OLA RULEMAKING

On October 19, 2010, the FDIC published a notice of proposed rulemaking (the "**October Proposed Rule**") addressing the following four elements of the FDIC's receivership powers:

- the FDIC's authority to make additional payments to certain creditors;
- the continuation of personal service agreements, including collective bargaining agreements, during an orderly liquidation;
- the treatment of contingent claims that are not due and payable on the date of appointment of the FDIC as receiver; and
- any liens on assets of an insurance company or its subsidiaries.

On January 25, 2011, the FDIC adopted and published an interim final rule (the "**Interim Final Rule**"), which was effective on that date, clarifying how certain claims and other matters would be treated under the OLA.[3]

On March 15, 2011, the FDIC issued a Notice of Proposed Rulemaking (the "**March Proposed Rule**") addressing (1) the ability of the FDIC to recoup compensation from senior executives who are "substantially responsible" for the financial condition of a CFC; (2) a priority scheme for creditor payments; and (3) the procedures for filing claims in an orderly liquidation, including how to contest the treatment of claims in court.[4]

Below is a summary of select provisions.

SUMMARY OF THE FINAL RULE

No Additional Payments to Shareholders, Subordinated Debt Holders, or Long-Term Bondholders

Under the Act, certain categories of creditors, such as subordinated debt holders and long-term bondholders, will not be entitled to additional payments. Generally, section 210(b)(4)(A) of the Act permits the FDIC to pay certain creditors in a receivership more than similarly situated creditors if necessary to (1) maximize the value of a CFC's assets; (2) initiate and continue operations essential to implementation of the receivership or any bridge financial company;[5] (3) maximize returns from the sale of the CFC's assets; or (4) minimize losses from the orderly liquidation of the CFC.

Section 380.27 of the Final Rule makes clear that certain categories of creditors, including creditors holding unsecured debt with a term of more than 360 days, will not be given additional payments compared to other general trade creditors or any general or senior liability of the CFC. No exceptions will be made for favorable treatment of holders of subordinated debt, shareholders, or other equity holders. This concept is analogous to the Bankruptcy Code's policy of treating similarly situated creditors equally.[6]

Valuation and Disposition of Collateral

Section 380.50(a) affirms that under section 210(a)(3)(D)(ii) of the Act, a claim is secured to the extent of the value of the property securing the claim. This concept is modeled on section 506 of the Bankruptcy Code—i.e., a claim that is secured by property of the CFC may be treated as an unsecured claim to the extent that the claim exceeds the fair market value of the property.

Section 380.50(b) provides that the fair market value of such property shall be determined in light of the purpose of the valuation and of the proposed disposition or use of the property and at the time of the proposed disposition or use. This approach is intended to more accurate valuations, protect the rights of secured creditors, and provide flexibility for the FDIC. This concept also follows the comparable provision of the Bankruptcy Code.[7]

Section 380.51 states that secured claimants may request the consent of the FDIC to obtain possession of or exercise control over their collateral. The Final Rule provides in section 380.51(c) that the receiver will grant consent unless it decides to use, sell or lease the property, in which case it must provide adequate protection of the claimant's interest in the property, consistent with parallel provisions in the Bankruptcy Code.[8] Section 380.51(g) notes that this provision will not apply in a case where the receiver repudiates or disaffirms a secured contract.

Personal Service Agreements May Continue Upon Appointment of the FDIC

Section 380.3 of the Final Rule permits the FDIC to continue, on an interim basis, personal service agreements, including collective bargaining agreements, for any services accepted by the FDIC as receiver of a CFC, or during any period where some or all of the operations of the CFC are continued by a bridge financial company. Payments for such services will be treated as administrative expenses. Acceptance of such services will not, however, limit or impair the FDIC's authority to disaffirm or repudiate any personal service agreement in accordance with the provisions of the Act, nor does it impair the FDIC's ability to negotiate different terms by mutual agreement.

There are two qualifications to this rule. First, under section 380.3(c), a party acquiring a CFC or any operational unit, subsidiary, or assets of the CFC will not be bound by any personal service agreement unless the acquiring party expressly assumes the agreement. Second, section 380.3(e) states that the rule does not apply to senior executives or directors of a CFC, nor does it limit the power to recover compensation previously paid to senior executives or directors under section 210(d) of the Act.

Scope of Claims Process; Determination of Claims

Section 380.31 has been revised in the Final Rule to address the scope of the claims process. It clarifies that the claims process shall not apply to a bridge financial company or to any extension of credit from a Federal Reserve Bank or the FDIC to a CFC.

Section 380.32 provides that upon the FDIC's appointment as receiver, the FDIC shall establish a claims bar date by which date creditors of the CFC are required to present their claims, together with proof, to the FDIC. The claims bar date shall not be less than 90 days after the date on which notice to creditors to file claims is first published under section 380.33.

Section 380.37 states that notification of claims determination shall be provided to the claimant by mail; failure to notify a claimant before the end of the 180-day claims determination period, or before any related extension, shall mean the claim is disallowed, although claimants may file or continue their actions in court.

Contingent Claims are Provable Against the FDIC as Receiver

Section 380.39 of the Final Rule permits a contingent obligation of a CFC to be provable against the FDIC as receiver even though the obligation may not have become due and payable as of the date of the FDIC's appointment as receiver. The key takeaway from Section 380.39 is that the FDIC will not disallow a claim under a guarantee or letter of credit just because such guarantee or letter of credit was contingent as of the date the FDIC was appointed as receiver.

Under the Final Rule, the treatment of contingent claims under the Act parallels the treatment of contingent claims under the Bankruptcy Code.[9] The FDIC as receiver must estimate the value of contingent obligations based on the likelihood that the obligation will become fixed and the probable magnitude of the claim. Although the Bankruptcy Code does not specify when a contingent claim should be estimated, section 380.39(c) provides that the receiver will estimate the value of a contingent claim before the end of either the 180-day period beginning on the date the claim is filed or any mutually agreed upon extension of this time period.

THE FDIC WILL NOT DISALLOW A CLAIM UNDER A GUARANTEE OR LETTER OF CREDIT JUST BECAUSE SUCH GUARANTEE OR LETTER OF CREDIT WAS CONTINGENT AS OF THE DATE THE FDIC WAS APPOINTED AS RECEIVER.

Section 380.39(b) makes clear that damages for repudiation of a contingent guarantee, letter of credit, loan, or similar credit obligation must be no less than the estimated value of the claim as of the date of the appointment of the FDIC as receiver (measured based on the above criteria).

Recoupment of Compensation from Senior Executives or Directors

Section 380.7 of the Final Rule allows the FDIC as receiver to recoup compensation from current or former senior executives or directors who are "substantially responsible" for the financial condition of the CFC. The recoupment would cover "any compensation received during the 2-year period preceding the date on which the [FDIC] was appointed as the receiver of the [CFC], except that, in the case of fraud, no time limit shall apply." [10]

The class of "senior executives" potentially subject to the recoupment rule is defined under section 380.1 of the Final Rule to include:

> any person who participates or has authority to participate (other than in the capacity of a director) in major policymaking functions of the company, whether or not: the person has an official title; the title designates the officer an assistant; or the person is serving without salary or other compensation. The chairman of the board, the president, every vice president, the secretary, and the treasurer or chief financial officer, general partner and manager of a company are considered

> senior executives, unless the person is excluded, by resolution of the board of directors, the bylaws, the operating agreement or the partnership agreement of the company, from participation (other than in the capacity of a director) in major policymaking functions of the company, and the person does not actually participate therein.

The legal standard for a recoupment claim is that a director or senior executive was "substantially responsible" the "failed condition" of a CFC. "Substantially responsible" means that a director or senior executive "failed to conduct his or her responsibilities with the degree of skill and care an ordinarily prudent person in a like position would exercise under similar circumstances," and, as result, "individually or collectively caused a loss" to the CFC that "materially contribut[ed] to the failure" of the CFC.

The preamble to the final rule is clear that section 380.7(a)(1) incorporates a simple negligence standard—the lowest standard of liability. Together with a shift in the burden of proof, the Final Rule gives the FDIC the ability to recover compensation with a modest amount of evidence. The legal standard is more generous to the FDIC than the gross negligence standard that applies in civil damage actions by the FDIC against directors and senior executives of failed banks. The Act does not require this result.

SECTION 380.7(a)(1) INCORPORATES A SIMPLE NEGLIGENCE STANDARD—THE LOWEST STANDARD OF LIABILITY. TOGETHER WITH A SHIFT IN THE BURDEN OF PROOF, THE FINAL RULE GIVES THE FDIC THE ABILITY TO RECOVER COMPENSATION WITH THE LEAST EVIDENCE POSSIBLE.

Section 380.7(b)(1) switches the burden of proof from the FDIC to executives through several broad presumptions that a director and senior executive must rebut with evidence. Among other provisions, a director or officer is presumed to have acted negligently and to have caused a loss materially contributing to failure if he or she was chairman of the board, CEO, president, or CFO (or had responsibility for strategic, policymaking, or company-wide operational decisions). The director or senior executive then is required to establish his or her non-negligence. The preamble to the final rule is explicit that business judgment or similar state law presumptions do not apply to recoupment claims.

In short, the FDIC could, under its proposed standards, state a claim against a former director or senior executive officer solely by alleging the failure of the CFC and the director or officer's position at the CFC. In such a case, it appears that a director or officer could held liable even if he or she could demonstrate lack of causation.

Section 380.7(c) of the Final Rule provides that the FDIC as receiver may seek recoupment in any civil action for the benefit of the FDIC as receiver and has a "savings clause" to preserve the rights of the FDIC as receiver to recoup compensation under all applicable laws.

Reserving Decision on "Predominantly Engaged"

In addition to bank holding companies and nonbank financial companies supervised by the Federal Reserve Board (and such companies' subsidiaries), any nonbank financial company that is "predominantly engaged in financial activities" may, upon a determination of threat to financial stability and other facts may be placed in the OLA process. The March Proposed Rule proposed that a CFC would be "predominantly engaged in financial activities," for purposes of the OLA, if its organization derived at least 85 percent of its total consolidated revenue from financial activities over the two most recent fiscal years.

In the Final Rule, however, the FDIC acknowledged that the Board has undertaken a parallel rulemaking to define the phrase "predominantly engaged" for purposes of Title I.[11] Accordingly, the FDIC withheld the definition from the Final Rule. The FDIC has committed to coordinating with Board staff going forward.

The Board's proposed rule is slightly different from the FDIC's proposal on "predominantly engaged." The Board proposal would provide that a company is predominantly engaged in financial activities if (1) annual gross revenues from financial activities in either of the two most recently completed fiscal years represent 85 percent or more of a company's consolidated annual gross revenues in that fiscal year, or (2) the total financial assets of the company as of the end of either of its two most recently completed fiscal years represent 85 percent or more of the company's consolidated total assets.[12] In other words, if, based on the nonbank financial company's consolidated financial statements, the company exceeds 85 percent for either measure in either of the last two fiscal years, the Board would consider the company "predominantly engaged in financial activities."

The Board's proposed rule also would allow the Board to make a case-by-case determination of whether the nonbank financial company is predominantly engaged in financial activities if, for example, the company's mix of activities changes as a result of a merger or acquisition. It is unclear whether such discretion would extend to a determination under Title II.

Preferential and Fraudulent Transfers

Section 380.9 of the Final Rule provides that the preferential and fraudulent transfer provisions of the Act must be implemented consistently with the corresponding provisions of the Bankruptcy Code so that the transferees of assets will have the same treatment in a liquidation under the Act as they would in bankruptcy proceedings.

We welcome your feedback and questions on the Final Rule and on any other topics raised in this Alert.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

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[1] For additional background on section 165(d), please refer to our earlier published client update and publication: http://www.mofo.com/files/Uploads/Images/110331-Dodd-Frank.pdf and http://www.mofo.com/files/Uploads/Images/110601-Market-SolutionsVol20.pdf.

[2] For additional background on the Title II of the Act, please refer to our earlier published client update and publication: http://www.mofo.com/files/Uploads/Images/100831TitleII.pdf and http://www.mofo.com/files/Uploads/Images/Newsletter-2010-4-Dec-MarketSolutions.pdf.

[3] 76 Fed. Reg. 4207 (January 25, 2011).

[4] 76 Fed. Reg. 16324 (March 23, 2011).

[5] As discussed in more detail in our Client Alert dated August 30, 2010, the FDIC has the power to create a "bridge financial company" ("**BFC**") to acquire the assets and liabilities of the CFC, either as receiver or in anticipation of its appointment as receiver. The BFC may operate without any capital or surplus, or with such capital that the FDIC deems appropriate. The FDIC has no obligation to capitalize the BFC or issue stock on its behalf.

[6] See, e.g., 11 U.S.C. § 1123(a)(4).

[7] *See id*. at § 506(a).

[8] *See id.* at §§ 361, 363.

[9] *See* 11 U.S.C. § 502(c)(1).

[10] *See* § 380.7(a).

[11] *See* 76 Fed. Reg. 7731 (February 11, 2001). The Board proposes to define "predominantly engaged in financial activities" for purposes of designating nonbank financial companies for supervision by the Board.

[12] The March Proposed Rule and the Board's proposed rule appear to have two key differences: First, under the Board's proposed definition, a nonbank financial company may be determined to be predominantly engaged in financial activities based on annual gross financial revenues or total consolidated financial assets. The definition from the March Proposed Rule, on the other hand, only considers financial revenues. Second, the Board's proposed rule does not appear to include in financial activities those activities that are incidental to financial activities, while the March Proposed Rule does cover incidental activities.

