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Dodd-Frank's Liquidation Scheme: Basics for Bankruptcy Practitioners

Contributing Editor:

Douglas E. Deutsch
Chadbourne & Parke LLP; New York
ddeutsch@chadbourne.com

Also Written by:

Eric Daucher
Chadbourne & Parke LLP; New York
edaucher@chadbourne.com

Editor's Note: For other perspectives on the Dodd-Frank OLA, see the Legislative Update on page 10.

In what is likely the most important change to U.S. insolvency law in recent times, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010. Although Dodd-Frank covers a wide range of topics, perhaps no aspect of the law has drawn as much attention as its proponents' claim that it will end the era of "too big to fail." Title II of Dodd-Frank creates the framework to address such company failures.



Douglas E. Deutsch

Pursuant to Title II, titled "Orderly Liquidation Authority" (OLA), large financial institutions are to be wound down and administered prior to a free-fall bankruptcy like that experienced by Lehman Brothers in 2008. The centerpiece of OLA is the creation of a new federal receivership procedure, pursuant to which the Secretary of the Treasury, subject to limited procedural safeguards, may appoint the Federal Deposit Insurance Corp. (FDIC) as receiver for a troubled "covered financial company."¹

¹ Title II of Dodd-Frank also includes procedures for the Securities Investor Protection Corp. to act as receiver for and liquidate brokers and dealers registered with the Securities Exchange Commission. See Dodd-Frank § 205. Those procedures, while often similar to the FDIC procedures described herein, are not the subject of this article.

About the Authors

Doug Deutsch is a partner and Eric Daucher is an associate in Chadbourne & Parke LLP's New York office in its Bankruptcy and Restructuring Group. Mr. Deutsch also serves on ABI's Board of Directors.

The next time a financial institution on the scale of Lehman Brothers fails,² the law that administers the clean-up will likely not be the longstanding and well-tested Bankruptcy Code. Instead, bankruptcy practitioners and others will have to turn to OLA. Accordingly, practitioners would be well-advised to familiarize themselves with the basics of OLA.

What Institutions Are Covered by OLA?

Financial entities placed in receivership through OLA are exempted from

in activities that the Governors deem "financial in nature" or "incidental thereto"; and (4) any subsidiary of any company that falls within the above categories that is predominantly engaged in activities that are financial in nature.³ Even at first glance, the range of entities potentially subject to OLA is exceptionally broad.



Eric Daucher

As part of its larger scheme to promote financial stability, Dodd-Frank created the "Financial Stability and Oversight Council." The council has discretion to identify entities as "systemically important."

Any institution deemed "systemically important" becomes subject to supervision by the Governors and could fall

Building Blocks

the provisions of the Bankruptcy Code, subject to certain limited exceptions. Therefore, it is crucial for bankruptcy practitioners to appreciate what entities may be subject to OLA so that they may advise their clients—potential debtors and creditors alike—accordingly.

Dodd-Frank delineates four types of "financial companies" that are eligible for FDIC receivership pursuant to OLA: (1) bank holding companies; (2) non-bank financial companies supervised by the Federal Reserve's Board of Governors (the "Governors"); (3) any company predominately engaged

under category two of the "financial companies" definition noted above. Categories three and four are similarly broad: A company may be deemed to be predominately engaged in financial activities if at least 85 percent of its total revenue stems from "financial activities," which can include anything from selling insurance to trading derivatives.⁴

Investment banks on the scale of Lehman Brothers are obviously intended to be covered by OLA. Equally obvious is that smaller institutions, such as retail store chains, are not intended to be covered by OLA, but what about organizations that fall somewhere in between?

³ See Dodd-Frank § 201(a)(11).

⁴ See *id.* § 201(b).

Would Enron, with its enormous energy trading and derivatives operations, have been covered? In short, at least at this point in time, it is unclear which institutions are eligible for OLA proceedings. This uncertainty is a point of serious concern because application of OLA may deprive a company's creditors of some of the protections that are taken for granted under the Bankruptcy Code.⁵

OLA Receivership Criteria

Before a company can be put into receivership under OLA, the Secretary of the Treasury must make a determination that the company is a "financial company" that is either in—or is in danger of—default and that a default would have "serious adverse effects on financial stability in the United States." Additionally, the Secretary must determine that (1) no viable private-sector alternative to OLA is available to prevent a default, (2) any consequences for the company's various stakeholders from applying OLA are appropriate in light of the benefit that using OLA would provide to the U.S.'s financial stability, (3) use of OLA would mitigate the adverse consequences to the United States' financial stability and (4) the company has already been instructed to convert any and all convertible debt instruments. While the FDIC and Governors may independently (or at the Secretary's request) offer written recommendations on whether a company should be put into receivership based on the above-noted criteria, the ultimate decision on whether an entity must be put into receivership rests with the Secretary, in consultation with the President. In sum, the Secretary is given a great deal of discretion to decide when an OLA receivership is, or is not, an appropriate remedy in any given situation.

How Is a Receivership Commenced?

In order to commence an OLA receivership, the Secretary files a sealed petition with the U.S. District Court for the District of Columbia setting forth its reasons why each of the criteria have been satisfied. If the board of directors (or the equivalent) of the company at issue agrees to the appointment of the FDIC as receiver, no further action is required by the court. However, if the company objects, the court's discretion to deny such a petition is extremely limited; it may only do so if it finds that the Secretary was arbitrary and capricious

in determining that the company satisfies the definition of "financial company" or has defaulted or is in danger of default.⁶ Moreover, if the court fails to render a decision on a petition within 24 hours of receiving it, the petition is granted automatically.⁷

Given the massive amount of information likely required to reasonably determine whether all of OLA criteria are satisfied in a given situation, it is difficult to see how the court could undertake a meaningful review within the time allotted. While the D.C. Circuit and Supreme Court are authorized to consider appeals of the court's determinations with respect to a petition, their jurisdiction is similarly limited by the "arbitrary and capricious" standard.

FDIC Powers under the Statute

Once the FDIC has been appointed as the receiver, an automatic stay is imposed with respect to actions against the company or its property. In addition to triggering an automatic stay, commencement of a receivership grants the FDIC a broad range of powers over the company and its affairs. Indeed, the designation of the FDIC's powers as "Orderly Liquidation Authority" is a misnomer. While the statute piously declares "Liquidation Required.—All financial companies put into receivership under this title shall be liquidated," the FDIC is, in fact, empowered to reorganize the company by creating new companies (including temporary bridge entities) and spinning them off with the old company's assets while liquidating the shell of the old company.⁸ The FDIC may also arrange to sell some or all of the company's assets. Unlike similar transactions under the Bankruptcy Code, the FDIC does not need court approval for a sale or spinoff under OLA. Indeed, there is not even a requirement that the FDIC provide notice of a sale or spinoff transaction to stakeholders.

The FDIC is given authority to establish a bar date for filing claims and allow or disallow claims at its discretion, although exercise of that authority is subject to judicial review.⁹ Once claims have been allowed, OLA requires that claims be paid pursuant to its statutory priority scheme.¹⁰ As with distributions under the Bankruptcy Code, the FDIC "shall"

provide the same treatment to similarly situated creditors. Despite this language, OLA further provides that the FDIC may treat similarly situated creditors dissimilarly if doing so is necessary to either maximize the value of company assets or to perform operations essential to the receivership or a bridge financial company. Moreover, the *maximum* amount that any creditor may recover under OLA, subject to certain narrow limitations, is that amount that such creditor would have received in a chapter 7 liquidation.¹¹

The FDIC is also given the authority to repudiate any contract to which the company is a party. Unlike a debtor or trustee under the Bankruptcy Code, the FDIC may reject contracts regardless of whether they are executory. Additionally, the FDIC may unwind certain types of transactions. Such transactions include those that would be preferences or fraudulent transfers under the Bankruptcy Code, as well as certain types of setoffs.¹²

While the FDIC is given a great deal of latitude in winding up or reorganizing a failed financial company, its authority is restricted by statute in certain ways that appear to be based on political motivations rather than the practical business needs of a failing institution. For example, while it is common practice under the Bankruptcy Code for managers to retain control of the business during the restructuring, Dodd-Frank requires that any managers deemed "responsible for the condition of the financial company" be removed without regard to the company's need for such managers' services.¹³ In a similar vein, under the heading "Reports to Congress and the Public," the FDIC is given the task of filing a plan for the orderly wind-down of the company within 60 days of its appointment as receiver.¹⁴ Given the ongoing difficulties in liquidating Lehman Brothers years after its filing, the idea that the FDIC could have a reasonable plan to liquidate a substantial multifaceted financial conglomerate within 60 days seems unrealistic.

Special Treatment of Derivatives and Swaps

As under the Bankruptcy Code, OLA provides special protections to derivative counterparties. Under OLA, derivative counterparties are, with certain restric-

⁵ See *id.* § 201(c).

⁶ See *id.* § 202(A)(iv).

⁷ See *id.* § 202(A)(v).

⁸ See *id.* § 214(a).

⁹ See *id.* § 210(a)(2)-(4).

¹⁰ See *id.* § 208(b)(1).

¹¹ See *id.* § 210(d)(2).

¹² See *id.* § 210(a)(11)(A-B).

¹³ *Id.* § 204(a)(2).

¹⁴ See *id.* § 203(c)(3)(A)(ii).

tions, allowed to terminate, liquidate and accelerate their derivatives contracts in the event of a counterparty insolvency. Unlike the Bankruptcy Code, OLA places two major restrictions on these powers. First, a counterparty may not terminate, liquidate or accelerate a derivative contract until at least 5 p.m. on the business day following the FDIC's appointment as receiver.¹⁵ Moreover, termination, liquidation and acceleration are not permitted if the counterparty is notified that its contract has been transferred or sold.¹⁶ Second, "walk-away" clauses, which generally allow out-of-the-money parties in a derivative contract to "walk-away" from a termination payment if it has not defaulted, are unenforceable under OLA.¹⁷

Funding the Liquidation

According to Congress, "[t]axpayers shall bear no losses from the exercise of any authority under this title."¹⁸ Instead, the FDIC is expected to finance its OLA receivership activities from the newly created Orderly Liquidation Fund (the "Fund"). The Fund is intended to be financed by assessments imposed by the FDIC under OLA, proceeds from debt obligations sold by the FDIC to the Secretary of the Treasury, and interest and proceeds paid by covered companies to the Fund.

Once a liquidation has commenced, the FDIC is empowered to use the Fund to (1) lend to the company, (2) purchase the company's debt, (3) purchase the company's assets or guarantee those assets against loss, (4) assume the obligations of the company to third parties, (5) place liens on the company's assets, (6) sell assets, liabilities or obligations of the company or (7) make certain payments under the statute. If the Fund is insufficient to satisfy the costs of the liquidations, the FDIC may issue "one or more risk-based assessments" and take certain other steps to ensure that the costs are only borne by the financial sector.

Conclusion

The OLA provisions of Dodd-Frank appear to be premised on the belief that the financial shockwaves unleashed by Lehman's bankruptcy filing were due to the Bankruptcy Code's inability to rapidly respond and adapt to the failure of such a large and interconnected institution. Accordingly, OLA allows

the FDIC great flexibility to take whatever action it deems appropriate as rapidly as it sees fit to do so. While this approach may have its merits, it places a great deal of faith in the abilities of the bureaucrats at the FDIC to resolve the affairs of unfamiliar and incredibly complex and interconnected institutions. Moreover, it assumes that whatever virtues are provided by the relative certainty of proceedings under the Bankruptcy Code are outweighed by the benefits of fully insulating taxpayers from the costs of the failure of a financial institution. Meanwhile, the approach also assumes that OLA will be able to protect the broader financial system from the negative effects that would occur in a free-fall bankruptcy filing. All these goals may be too much to realistically ask one statute, or the FDIC, to accomplish.

Ultimately, whether OLA is better or worse at addressing the failures of systemically important financial institutions than the current bankruptcy process will likely take years to determine. As even the Congressional Budget Office conceded, it is presently impossible to determine "whether the estimated costs under the bill would be smaller or larger than the costs of alternative approaches to addressing future financial crises and the risks they pose to the economy as a whole."¹⁹ Whatever the case, we must now all become familiar with OLA and its notable departures from the Bankruptcy Code. ■

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¹⁵ See *id.* § 2010(c)(10)(B)(i)(I).

¹⁶ See *id.* § 2010(c)(10)(B)(i)(II).

¹⁷ See *id.* § 2010(c)(8)(F).

¹⁸ *Id.* § 214(c).

¹⁹ Congressional Budget Office Cost Estimate, § 3207: Restoring American Financial Stability Act of 2010 (April 21, 2010).