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The Resolution of Systemically Important Nonbank Financial Companies… Will It Work?

K&L Gates published this alert prior to July 21, 2010, the date on which President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law. However, this alert discusses the final version of the bill that would eventually be signed into law.

One of the glaring problems exposed by the recent financial crisis has been the absence of supervisory authority to deal effectively with the insolvency or collapse of significant, nonbank financial companies. While bank regulators have long been empowered to close and liquidate insolvent banks to protect the public, there was no comparable authority vested in any financial services regulator to close and liquidate insolvent bank holding companies or other kinds of financial companies. To make matters worse, when several systemically important financial companies were on the verge of collapse in September 2008, they were deemed "too big to fail" and given significant government assistance. Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act") addresses the absence of regulatory authority to liquidate systemically important, nonbank financial companies by creating an "orderly liquidation authority" ("OLA") process to allow the Treasury Secretary to close and the Federal Deposit Insurance Corporation ("FDIC") to wind up these companies.

This OLA resolution process for select, nonbank financial companies is patterned after the Federal Deposit Insurance Act (the "FDI Act") which empowers FDIC to liquidate insolvent banks. It can be invoked, however, only with respect to a "covered financial company" that has been determined by the Treasury Secretary to present systemic risk to the U.S. financial system. Once invoked, the OLA process preempts the Bankruptcy Code with respect to a covered financial company. The OLA process is a mandatory scheme to force the liquidation of large, systemically significant but insolvent nonbank financial companies in a process that causes any losses from their failure to be borne by creditors and stockholders, not the taxpayers. In this respect, the OLA resolution process set forth in Title II of the Act seeks to eliminate the moral hazard associated with recent government bailouts of "too big to fail" financial companies. But, unlike the resolution scheme for depository institutions, there is no fund at the ready from which resolution expenses can be paid.

Companies Subject to Orderly Liquidation Authority.

The OLA resolution process set forth in the Act will apply only to a "financial company" that has been designated by the Treasury Secretary as a "covered financial company." A "financial company" is a federal or state chartered company that is: (i) a bank holding company ("BHC"), as defined in the Bank Holding Company Act of 1956 (the "BHCA"), including any BHC the majority of the securities of which are owned by the U.S. or any state; (ii) a nonbank financial company supervised by the Federal Reserve;[1] (iii) any company that is predominantly engaged[2] in activities that the Federal Reserve has determined are "financial in nature or incidental thereto" under

the BHCA; or (iv) any subsidiary of any of the foregoing that is predominantly engaged in activities that are financial in nature or incidental thereto under the BHCA.

The term "financial company" does not include a bank or thrift, insurance company, a Farm Credit System institution, a governmental entity, F.N.M.A., F.H.L.M.C. or any affiliates, or any Federal Home Loan Bank.

To be subject to the OLA resolution process, a financial company must have been designated as a "covered financial company" by the Treasury Secretary.[3] Designation as a covered financial company requires a determination that the affected company represents a systemic risk to the U.S. economy. This systemic risk designation of "covered financial company" status is a fact-specific determination made only in the context of a contemporaneous decision by the Treasury Secretary to place a financial company into FDIC receivership. It is not made generically for all financial companies that might be considered systemically important. But the Treasury Secretary would not be expected to make a "covered financial company" designation for a financial company that has not been currently identified as systemically important by the Financial Stability Oversight Council or a bank holding company with less than $50 billion in consolidated assets. Further, the OLA resolution process is not likely, due to its complexity, to be invoked frequently.

The initiation of the OLA resolution process for the liquidation of a covered financial company first requires a written recommendation by the Federal Reserve and the FDIC (or the SEC for a broker or dealer or the Federal Insurance Office director for an insurance company) to the Treasury Secretary to place the financial company at issue into an FDIC receivership. Any recommendation by the Federal Reserve, FDIC or SEC requires a two-thirds supermajority vote of its board (or of the Commission for the SEC) and must contain the following:

i) an evaluation of whether the company is "in default or in danger of default";

ii) a description of the effects that such default would have on the financial stability of the United States;

iii) a description of the effect that the default would have on economic conditions or financial stability for low income, minority, or underserved communities;

iv) a recommendation as to the nature and the extent of actions to be taken under the Title II OLA;

v) an evaluation of the likelihood of a private sector alternative to prevent the default;

vi) an evaluation of why a case under the Bankruptcy Code is not appropriate;

vii) an evaluation of the effects on creditors, counterparties, and shareholders of the company and other market participants; and

viii) an evaluation of whether the affected company meets the definition of a "financial company."

A financial company is "in default or in danger of default" if:

i) a case has been, or likely will promptly be, commenced with respect to the financial company under the Bankruptcy Code;

ii) the financial 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;

iii) the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or

iv) the financial 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.

Upon receipt of a written recommendation from the Federal Reserve and FDIC (or SEC or Federal Insurance Office, as applicable), the Treasury Secretary (in consultation with the President) must then make a determination under Section 203(b) to put the financial company into FDIC receivership. Once the Treasury Secretary determines to appoint FDIC as receiver for the financial company, it becomes a "covered financial company" and is liquidated.[4]

Before it can place a covered financial company into FDIC receivership, the Treasury Secretary must determine that:

i) the company is "in default or in danger of default";

ii) its failure and resolution under the otherwise available Bankruptcy Code or state law would have serious adverse effects on U.S. financial stability;

iii) there is no viable private sector alternative available to prevent the default;

iv) any effect of an orderly liquidation of the company under the OLA process upon creditors, counterparties, and shareholders of the financial company and other market participants is appropriate given the impact that use of the OLA process would have on U.S. financial stability;

v) use of the OLA process would avoid or mitigate adverse effects upon the financial system and the U.S. Treasury;

vi) a federal regulatory authority has ordered the company to convert all convertible debt instruments subject to regulatory order; and

vii) the company in fact is a "financial company."[5]

Once the Treasury Secretary determines that the above criteria are satisfied, he or she must notify FDIC and the covered financial company of such determination.[6] If the company's board of directors consents, FDIC is immediately appointed as receiver and begins the liquidation process. If the company does not consent, the Treasury Secretary must petition the U.S. District Court for the District of Columbia ("District Court") for an order authorizing the appointment of FDIC as receiver. The District Court must determine within 24 hours whether the Secretary's decision was arbitrary and capricious. The company is entitled to oppose the order at a hearing. If a determination is not made within 24 hours, the receivership order is deemed automatically granted by operation of law. While the company may appeal to the U.S. Court of Appeals for the District of Columbia and then to the Supreme Court, any appeal does not stay the order or the appointment of FDIC as receiver. Review on appeal is limited to whether the Secretary's determination was arbitrary and capricious.

The Treasury Secretary's determination to liquidate a covered financial company and any subsequent petition and pending District Court proceedings are to be kept confidential, at least initially. The Act imposes criminal penalties on any person who "recklessly" discloses the Treasury Secretary's determination to liquidate a financial company or any related District Court petition or pending District Court proceedings.

Orderly Liquidation Fund – The Financial Impact of Title II of the Act.

Title II of the Act establishes an Orderly Liquidation Fund within the Treasury Department from which the costs of actions taken pursuant to Title II, including the liquidation of financial companies, the payment of administrative expenses, the payment of principal and interest by FDIC on obligations issued to the Treasury Secretary (described below), and the exercise of the authorities of FDIC, are to be paid. Once funded,

the Orderly Liquidation Fund is to be managed by FDIC.

Unlike the FDIC Deposit Insurance Fund, the Orderly Liquidation Fund currently has no assets or government funding.[7] Its costs will be initially funded through the issuance of obligations by FDIC, as receiver for a covered financial company, to the Treasury. The Treasury can re-sell those obligations upon such terms and conditions as it determines.

There are limits to the amount of debt FDIC can incur in connection with any single covered financial company receivership. FDIC may not incur obligations in an orderly liquidation of a covered financial company that exceed (i) 10% of the total consolidated assets of the covered financial company during the 30-day period immediately following the date of appointment of FDIC as receiver; and (ii) 90% of the fair value of the total consolidated assets of the financial company that are available for repayment after such 30-day period.

Before FDIC can issue an obligation to the Treasury, it must have an agreement in effect with the Treasury Secretary that (i) provides a specific plan and schedule to achieve the repayment of the outstanding amount of any such borrowing; and (ii) demonstrates that income to FDIC from the liquidated assets of the financial company and assessments (described below) will be sufficient to amortize the outstanding balance within the period established in the repayment schedule and pay the interest accruing on such balance within a 5 year period. FDIC may, with the approval of the Treasury Secretary, extend the 5 year time period if determined necessary to avoid a serious adverse effect on the U.S. financial system.

If FDIC will be unable to pay in full the obligations issued by FDIC to the Treasury Secretary within 5 years of the date of issuance (as extended, if necessary), FDIC is required to charge assessments to make up the difference. "Recoupment assessments" are first imposed by FDIC, as soon as practicable, on any claimant that received additional payments or amounts from FDIC in excess of the amount such claimant would have received in liquidation under a Chapter 7 Bankruptcy Code proceeding (except for payments or amounts necessary to initiate and continue operations essential to implementation of the receivership or any bridge financial company) such that FDIC recovers the entire amount of such excess.

If recoupment assessments are insufficient, then FDIC must impose additional assessments on "eligible financial companies" (any bank holding company with total consolidated assets of at least $50 billion and any nonbank financial company supervised by the Federal Reserve) and large financial companies with total consolidated assets of at least $50 billion that are not eligible financial companies ("large financial companies").

The requirement that any deficit in the Orderly Liquidation Fund from an OLA receivership be paid for through assessments on eligible and large financial companies stems from Title II's mandate that all costs associated with the liquidation of covered financial companies be borne by the "financial sector." Accordingly, every eligible or large financial company is exposed to liability for potentially significant and unplanned assessments to fund losses arising out of the invocation of the OLA process to liquidate an unrelated covered financial company.

Title II does not set forth the basis upon which eligible or large financial companies may be liable for assessments. For one reason, not all financial companies can be certain that they are even liable for Fund assessments. As stated above, the companies subject to assessment are bank holding companies with total consolidated assets of at least $50 billion, nonbank financial companies supervised by the Federal Reserve and any other financial company with total consolidated assets of at least $50 billion. A bank holding company with over $50 million in consolidated assets will certainly be aware of its exposure to assessment. So will a nonbank financial company which the Financial Stability Oversight Council has placed under the supervision of the Federal Reserve pursuant to Title I of the Act. But a company with at least $50 billion in consolidated assets may also be subject to assessment if it is considered to be "predominantly engaged" in activities that are "financial in nature or incidental thereto" so that it meets the definition of a financial company. Given the somewhat subjective nature of this determination, and the fact that there is no

requirement that companies which meet this definition be notified in advance, it may not be clear to some of these companies that they are "large financial companies" subject to assessment prior to an assessment actually being made.

Another complicating factor is the fact that Title II provides little guidance regarding how assessments will be allocated among eligible or large financial companies, aside from stating that financial companies having greater assets and risk are to be assessed at a higher rate. The degree of risk posed by a financial company is to be determined with the aid of a "risk matrix," to be developed by the Financial Stability Oversight Council and applied by FDIC based on a number of identified economic factors. It is not clear exactly how assessments or differentiations in assessments will be made based upon a company's size, lines of business, financial strength or overall risk. The financial service industry includes several major sectors: banks, investment banks, mutual funds, investment companies, securities dealers and insurance companies. Imagine the consternation and distress if a systemically important financial company in one sector fails and the systemically important companies with no involvement in that sector are assessed the cost of liquidating a financial firm outside their sector of the financial services industry. Making assessment determinations, particularly on a retrospective basis, will be quite difficult. Furthermore, if undue emphasis is placed on a company's size, Title II could cause those financial companies with the deepest pockets to fund the liquidation of their failed counterparts, irrespective of the degree of risk such companies posed to the financial system.

Finally, because the Orderly Liquidation Fund is funded only after liquidation proceedings actually commence, the degree of any company's liability for assessments will remain unclear until a covered financial company is in the process of being liquidated. Even then, FDIC might not be able to estimate reliably the cost of initial OLA receiverships given its total lack of prior experience liquidating nonbank financial companies.

Another problem with the ex-post funding of the Orderly Liquidation Fund is that when the OLA process is actually implemented, absent large-scale fraud at the failed financial company, it will likely be a time of widespread distress across the entire U.S. financial sector. This would be the least opportune time for FDIC to impose a potentially large, unexpected Fund assessment on even comparably healthy financial companies. Credit unions suffered from a similar timing exposure in 2009 as a result of the widespread distress at several large corporate credit unions.

Given these various uncertainties, FDIC will need to issue regulations with reasonable dispatch if eligible and large financial companies are to understand and quantify their potential liability under Title II and ensure that they have adequately accrued for such liability.

Resolution of a Covered Financial Company – Purpose and General Principles.

In general.

Upon FDIC's appointment as receiver of a covered financial company, all matters related to the company are governed exclusively by the OLA resolution process set forth in Title II of the Act. Provisions of the Bankruptcy Code no longer apply. They are superseded by Title II in a covered financial company OLA receivership.

Unlike a proceeding under the Bankruptcy Code, which allows for the reorganization of companies if possible, the only outcome for a covered financial company under Title II is liquidation. The only protection for a financial company is the legal requirement that Treasury first determine, among other things, that there are no private sector alternatives to receivership and liquidation and that resolution of such financial company under the Bankruptcy Code would have serious adverse effects on U.S. financial stability.

Section 204 of Title II sets forth the general principles which are to guide FDIC as receiver in the liquidation of a covered financial company. In general, FDIC as receiver in an OLA resolution must conduct itself in a manner that mitigates any risk to financial stability in the United States and minimizes moral hazard. This focus differs from a bankruptcy proceeding, where the protection of creditors' rights is emphasized. Under Title II,

creditors and shareholders are to bear any losses attributable to the failure of a covered financial company. Management responsible for the company's insolvent condition is to be removed. All parties having responsibility for the covered financial company's condition are to be made accountable consistent with their legal responsibility through actions for damages, restitution, and recoupment of compensation and other gains not compatible with such responsibility.

While Title II establishes general principles that FDIC is to follow in liquidating a covered financial institution, it does not establish a plan for FDIC to follow in liquidating any particular company. It is up to FDIC, as receiver, to develop an orderly liquidation plan. But FDIC has no experience liquidating nonbank financial companies. To help bridge this gap, Title I of the Act rather ingeniously provides that the Federal Reserve must require certain financial companies (bank holding companies with at least $50 billion in assets and nonbank financial companies that are supervised by the Federal Reserve) to develop and submit plans to the Financial Stability Oversight Council, FDIC and the Federal Reserve for the company's "rapid and orderly resolution" in the event of material financial distress or failure (so-called "living wills"). Living wills generally must include full descriptions of the company's ownership structure, assets, liabilities, and contractual obligations, an identification of cross-guarantees tied to different securities, an identification of major counterparties, and a process for determining to whom the collateral of the company is pledged. The living wills required to be submitted by certain financial companies under Title I will provide FDIC with a blueprint for their liquidation in an OLA receivership.

No bailouts permitted; company must be liquidated.

Title II intends to end the "too big to fail" doctrine and taxpayer bailouts of large financial institutions. Although FDIC is authorized to take over large, systemically significant nonbank financial companies and administer their liquidation, the federal government is not supposed to foot the bill. Specifically, Section 214 requires that covered financial companies put into FDIC receivership be liquidated. No taxpayer funds may be used to prevent the liquidation of a covered financial company. Any funds expended by the government in administering the liquidation are to be recovered in the first instance from the disposition of the failed company's assets. If they are not, the other systemically significant financial companies are to be charged the costs of the liquidation through assessments. In carrying out an OLA liquidation of a covered financial company, FDIC is to determine that all actions it takes are necessary for purposes of the financial stability of the United States, and not for the purpose of preserving the covered financial company. FDIC is expressly prohibited from taking an equity interest in or becoming a shareholder of any failed financial company.

Liquidation of brokers and dealers.

The liquidation procedures applicable to a covered financial company which is a "covered broker or dealer"[8] differ from those applicable to other types of covered financial companies. For one, FDIC, as receiver, must appoint the Securities Investor Protection Corporation ("SIPC") to act as trustee for the liquidation of the covered broker or dealer under the Securities Investor Protection Act of 1970 (15 U.S.C. §78aaa et seq.) ("SIPA"). In general, the powers and duties afforded to the SIPC as trustee, and the rules and procedures applicable to the liquidation of a covered broker or dealer, are governed by SIPA, rather than Title II.

Treatment of Subsidiaries.

Once appointed the receiver of a covered financial company, FDIC may seize, and appoint itself as receiver of, any U.S. subsidiary of such company (other than a bank or insurance company) if FDIC and the Treasury Secretary jointly determine that: (i) the subsidiary is in default or in danger of default; (ii) the action would avoid or mitigate serious adverse effects on U.S. financial stability or economic conditions; and (iii) the action would facilitate the orderly liquidation of the covered financial company. As receiver of a covered subsidiary, FDIC has the same powers and rights with respect to the subsidiary as it does with respect to the covered financial company.

Administration of the Receivership Estate by FDIC.

In general.

The rules applicable to the resolution of a covered financial company under Title II are largely but not completely patterned after those applicable to the resolution of a bank under the FDI Act. In a number of places, provisions of the Bankruptcy Code have been retained for OLA proceedings (*e.g.,* to generally allow recovery of preferences). Upon appointment, FDIC as receiver succeeds to all rights, titles, powers, and privileges of the failed financial company, and has the general authority to operate the company's business, exercise all of its corporate powers, and liquidate and wind up its affairs. In liquidating the company, FDIC must recognize all legally enforceable and perfected security interests and all legally enforceable security entitlements in respect of the company's assets.

FDIC can utilize resolution procedures it deems appropriate to administer an orderly liquidating authority receivership, including sale of the company's assets, merging it with another company or transferring its assets and/or liabilities to an existing company or a new "bridge financial company" established for such purpose. FDIC can take such actions without obtaining any judicial or other approval or consent, but subject to any Federal agency approval and Federal antitrust review.

In disposing of receivership assets, FDIC is directed to choose the course of action that, to the greatest extent possible, maximizes the net present value return from the sale or disposition of those assets, minimizes the amount of any loss, mitigates the potential for serious adverse effects to the financial system, ensures timely and adequate competition and fair and consistent treatment of offerors and prohibits discrimination on the basis of race, sex, or ethnic group in the solicitation and consideration of offers.

Authority to establish bridge financial companies.

FDIC, as receiver, is authorized to organize bridge financial companies to hold assets of a covered financial company until they can be liquidated. This authority tracks to the power FDIC has to establish bridge banks to facilitate the disposition of a failed bank's assets in a bank receivership.

Notice of receivership and determination of claims.

After its appointment as receiver, FDIC is charged with notifying creditors and potential claimants to file claims by a bar date which must be at least 90 days after the date on which notice is published. Notice is to be published three times, at monthly intervals. FDIC is also required to mail notice directly to any creditor shown on the books and records of the covered financial company.

Section 210(a)(3) of Title II gives FDIC the power to allow or disallow claims in a receivership and sets out the exclusive process by which unsecured claims in the receivership are to be presented and determined. A potential claimant must generally file a proof of claim with FDIC within 90 days after notice is published. FDIC has 180 days to allow or disallow the claim. FDIC can disallow any claim which is not proved to its satisfaction. If the claim is disallowed, the creditor has 60 days to file suit or seek administrative review in the district or territorial court of the United States for the district within which the principal place of business of the financial company is located. If FDIC, as receiver, does not determine a claim within 180 days of filing, it is automatically deemed disallowed. Creditors in an orderly liquidated authority proceeding who do not follow the statutory claim process set forth in section 210(a) will have their claims barred and have no further recourse against FDIC. Expedited processing of claims is available to certain secured creditors if the ordinary claims procedure would cause irreparable injury.

Claims are allowed if they are timely filed and proved to the satisfaction of FDIC as receiver. The statutory superpowers granted FDIC as receiver of a failed financial company may make it quite difficult to successfully assert a claim against the receivership estate. Further, even where a claim is allowed, damages are generally limited. Moreover, given the provisions governing the priority and payment of claims, discussed below, a general unsecured creditor will be unlikely to recover its entire allowed claim.

Payment of allowed claims.

FDIC may, in its discretion and to the extent funds are available, pay allowed, authorized or judicially recognized claims. All claimants of a covered financial company that are similarly situated under the priority of claims set forth below are to be treated in a similar manner unless FDIC determines that (i) other treatment is necessary to maximize the value of the company's assets and (ii) all claimants that are similarly situated receive not less than the amount that they would have received in a Chapter 7 bankruptcy proceeding, or any similar provision of state insolvency law applicable to the covered financial company. FDIC can also make additional payments to any claimant or category of claimants if it determines that such payments are necessary or appropriate to minimize losses to FDIC as receiver; provided that no claimant may receive more than the face value of its claim. Claimants receiving additional funds pursuant to these sections are subject to "recoupment assessments," described above.

Priority of expenses and unsecured claims.

Expenses and allowed unsecured claims in an OLA proceeding are paid in the following order of priority, to the extent funds are available:

i) Repayment of post-receivership financing obtained by FDIC as receiver on behalf of the financial company (to be obtained only if unsecured credit is not available from commercial sources);

ii) Administrative expenses of the receiver;

iii) Any amounts owed to the United States, unless the United States agrees or consents otherwise;

iv) Wages, salaries, or commissions, including vacation, severance, and sick leave pay earned by an individual (other than a senior executive or director) in an amount up to $11,725 per person (adjusted for inflation) earned not later than 180 days before the appointment of FDIC as receiver;

v) Contributions owed to employee benefit plans arising from services rendered not later than 180 days before the date of appointment of FDIC as receiver, in an amount up to $11,725 per employee covered by each such plan (adjusted for inflation) *less* the aggregate amount paid to such employee under subparagraph (iv), *plus* the aggregate amount paid by the receivership on behalf of such employee to any other employee benefit plan;

vi) Any other general or senior liability of the covered financial company other than those described below (i.e., allowed claims of general, unsecured creditors);

vii) Any obligation subordinated to general creditors that is not described below;

viii) Any wages, salaries, or commissions, including vacation, severance, and sick leave pay earned, owed to senior executives and directors of the covered financial company; and

ix) Any obligation to equity holders of the covered financial company arising as a result of their status as equity holders.

Unsecured claims of the United States shall, at a minimum, have a higher priority than liabilities of the covered financial company that count as regulatory capital.

"Special Powers" Granted to FDIC as Receiver.

Title II grants FDIC a number of special powers as receiver in an OLA proceeding which can be used to limit or defeat both affirmative claims and defenses asserted by counterparties to the failed financial company or FDIC as its receiver. In large part, these powers are similar to those granted to FDIC when acting as receiver of a failed bank under the FDI Act. A number of powers, however, such

as those applicable to the avoidance of preferential transfers and related transferee rights and defenses, are instead modeled after provisions of the Bankruptcy Code. Some of the most significant powers granted to FDIC under Title II are discussed below.

Repudiation of contracts.

One of the most important powers granted to FDIC is the authority to repudiate contracts or leases to which the company is a party. FDIC can repudiate such agreements within a "reasonable period" following its appointment if it: (i) deems performance of the contract or lease to be "burdensome"; and (ii) determines that repudiation or disaffirmance of the contract or lease would promote the orderly administration of the company's affairs. In general, the damages recoverable against FDIC for repudiating a contract are limited to the counterparty's actual direct, compensatory damages. Consequential damages for lost profits, punitive damages and pain and suffering are barred. Special rules apply in the case of damages arising from the repudiation of qualified financial contracts, debt obligations, certain contingent obligations and leases to which the covered financial company is a party.

The broad power granted to FDIC to repudiate contracts does not authorize it to set aside (i) any legally enforceable or perfected security interest in any of the assets of any covered financial company, except for certain avoidable fraudulent and preferential transfers, or (ii) any legally enforceable interest in customer property, security entitlements in respect of assets or property held by the covered financial company for any security entitlement holder.

Enforcement of contracts.

The Act would grant FDIC power to enforce most contracts (other than a qualified financial contract) notwithstanding a so-called "ipso facto" clause allowing the counterparty to the covered financial company to terminate or accelerate the contract or exercise any other right solely by reason of the company's insolvency or receivership. FDIC is also entitled to enforce contracts of subsidiaries or affiliates of a covered financial company. No third party is permitted to enforce a contract against FDIC, as receiver, during the first 90 days of the receivership. As under the FDI Act, special rules apply to the enforcement of qualified financial contracts.

Avoidance of fraudulent and preferential transfers.

FDIC, as receiver, would have the ability to avoid a transfer or obligation made or incurred by the company within two years prior to FDIC's appointment if (i) the transfer was made or the obligation was incurred with the intent to hinder, delay, or defraud the company or the company did not receive a reasonably equivalent value in exchange for such transfer or obligation, and (ii) at the time the transaction occurred, the company was or became insolvent, was significantly undercapitalized or would not be able to pay its debts when due, or the transaction was for the benefit of an insider under an employment contract not in the ordinary course of business.

As receiver, FDIC could avoid certain preferential transfers made (i) to or for the benefit of a creditor, (ii) for or on account of an antecedent debt owed by the company, (iii) while the company was insolvent, (iv) within the 90 days preceding the appointment of FDIC (or within one year where the creditor was an insider), and (v) that enable the creditor to receive more than the creditor would receive if the transfer had not been made, the company had been liquidated under the Bankruptcy Code and the creditor received payment of such debt to the extent provided by the Bankruptcy Code. The power to avoid preferential transfers is a significant addition to FDIC's powers in an OLA receivership. FDIC has no similar power to avoid preferences when acting as the receiver of a failed bank under the FDI Act.

Improperly documented side agreements.

No agreement which tends to defeat or diminish FDIC's interest in an asset is valid unless it: (i) is in writing; (ii) was executed by an authorized officer or representative of the financial company, or confirmed in the ordinary course of business; and (iii) has been continuously from time of execution an official record of the company or the party claiming under the agreement provides documentation, acceptable to FDIC, of such agreement and its authorized execution or

confirmation by the financial company. This rule is similar to the so-called *D'Oench, Duhme* doctrine which is available to FDIC under the FDI Act; however, the variation set forth in Title II is not as protective to FDIC.

Unanswered Questions.

By preempting the application of the Bankruptcy Code, Title II changes the rules governing the insolvency of covered financial companies. But the special OLA resolution process will apply to the insolvency of only a handful of "covered financial companies." The resolution of most financial company insolvencies will continue to be determined under the federal Bankruptcy Code. Moreover, any reorganizations of covered financial companies would have to take place under the Bankruptcy Code, as opposed to an FDIC conservatorship process. The uncertainty as to how and when Title II will apply to a financial company insolvency may leave many unanswered questions for financial companies and their counterparties.

Title II directs FDIC, in consultation with the Financial Stability Oversight Council, to promulgate regulations implementing Title II with respect to the rights, interests, and priorities of creditors, counterparties, security entitlement holders, or other persons doing business with a covered financial company. To the extent possible, FDIC is directed to harmonize these regulations with the existing insolvency laws that would otherwise apply to a covered financial company. FDIC regulations will undoubtedly help rationalize the broad resolution powers authorized by Title II to end "too big to fail" with existing law.

Whether Title II will effectively end "too big to fail" may not be answered for many years. Many commenters, including former FDIC Chairman William Isaac, continue to believe that the U.S. government will, as a practical matter, prefer to support a "too big to fail" financial company rather than risk the economic consequences of utilizing an insolvency OLA process that inflicts prompt and severe distress upon the many counterparties dealing with that company. Certainly, the Act's failure to provide a funding mechanism to pay for the anticipated cost of an OLA resolution of a "too big to fail" company until the financial system is at considerable risk indicates that Title II's solution to "too big to fail" may not have effectively mitigated the problem.

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[1] Title I of the Act allows the Financial Stability Oversight Council to require, by a two-thirds vote, any nonbank financial company to be supervised by, and registered with, the Federal Reserve if it determines, based on certain enumerated criteria, that material financial distress at the company or the nature, scope, size, scale, concentration, interconnectedness or the company's mix of activities could pose a threat to U.S. financial stability. A "nonbank financial company" is any company (other than a BHC or a Farm Credit System institution or a national securities exchange (or parent thereof), clearing agency (or parent thereof, unless the parent is a BHC), security-based swap execution facility, or security-based swap data repository registered with the SEC, or a board of trade designated as a contract market (or parent thereof), or a derivatives clearing organization (or parent thereof, unless the parent is a BHC), swap execution facility or a swap data repository registered with the CFTC) that is predominantly engaged (i.e., 85% of revenues or assets) in financial activities. Upon the Council's determination, any such company is a "nonbank financial company supervised by the Federal Reserve" for purposes of Title II. Once made, the Council's determination is to be reevaluated annually and can be rescinded by a two-thirds vote.

[2] For this purpose, no company is considered to be predominantly engaged in activities that are financial in nature or incidental thereto if the consolidated revenues of the company from such activities (including those from the ownership of a depository institution) constitute less than 85% of the company's total consolidated revenues.

[3] A "financial company" without a designation as a "covered financial company" by the Treasury Secretary is not subject to the OLA resolution process and can seek protection and reorganize under the Bankruptcy Code. A company with the designation, however, cannot and must be liquidated by FDIC.

[4] In the case of a covered financial company which is an insurance company, or any insurance company subsidiary of a covered financial company, the Treasury Secretary's determination does not cause the insurance company to be put into a FDIC receivership. Instead, its liquidation is conducted in accordance with applicable state law. If, however, within 60 days of the Treasury Secretary's determination, the applicable state regulator has not taken appropriate judicial actions to commence the liquidation proceedings, FDIC has backup authority to stand in the regulator's place and file the appropriate judicial action in state court.

[5] The Secretary is also likely to require that the company also be a bank holding company with more than $50 billion in consolidated assets or found to be "systemically important" by the Financial Stability Oversight Council under Title I.

[6] The Secretary must also provide written notice to Congress within 24 hours of any determination to invoke the OLA process and the reasons for taking such action.

[7] Proposals for an Orderly Liquidation Fund to be prospectively funded with $50 billion in premium assessment were politically controversial and were removed from the Act prior to approval.

[8] A "covered broker or dealer" is a financial company which is a broker or dealer and is registered with the SEC under section 15(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78o(b)) and is a member of the Securities Investor Protection Corporation.