RESTRUCTURING LARGE, SYSTEMICALLY-IMPORTANT, FINANCIAL COMPANIES

An Analysis of the Orderly Liquidation Authority, Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act

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During the last several years, the United States has faced the most significant economic upheaval since the Great Depression. The causes included government policies and lending standards that favored home ownership at the expense of prudent lending practices; a massive increase in the amount of debt and spending by businesses, consumers, and all levels of government; and large financial institutions which have become highly interconnected as a result of increased leverage and complex financial relationships. What began in the spring of 2007 as a localized disruption that many believed would be limited to the sub-prime home lending sector rapidly spread and, ultimately, jeopardized the integrity of the entire United States financial system.

The situation became most acute in the fall of 2008. Lehman Brothers Holdings collapsed, resulting in the largest bankruptcy in history.[1] American Insurance Group, one of the largest insurance conglomerates in the world, probably would have succumbed to the same fate had the United States government not intervened with over one hundred billion dollars in assistance.[2] The same may have been true of Merrill Lynch and Wachovia had the government not facilitated takeovers of each entity by Bank of America and Wells Fargo, respectively.[3] Other Wall Street titans obtained huge infusions of government capital.[4] Unprecedented,

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[1] *See* Kristin N. Johnson, *From Diagnosing the Dilemma to Divining a Cure: Post-Crisis Regulation of Financial Markets*, 40 SETON HALL L. REV. 1299, 1311 (2010) ("Lehman Brothers' filing marked the largest bankruptcy in U.S. history and severely undermined consumer confidence in the stability of capital and credit markets.") (footnote omitted).

[2] *See America's Loathed TARP May Turn a Profit. That Could be a Problem*, ECONOMIST, June 11, 2011, at 77 (showing AIG has received 111.6 billion dollars in bail-out funds from United States Treasury and Federal Reserve since 2008).

[3] *See* Press Release, Bank of America Corp., Bank of America Completes Merrill Lynch Purchase (Jan. 1, 2009), *available at* http://mediaroom.bankofamerica.com/phoenix.-zhtml?c=234503&p=irolnewsArticle&ID=1390188&highlight= (announcing Bank of America's acquisition of Merrill Lynch); Press Release, Wells Fargo and Co., Wells Fargo and Wachovia Merger Completed (Jan. 1, 2009), *available at* https://www.wellsfargo.com/press/2009/20090101_Wachovia_Merger (announcing merger of Wells Fargo and Wachovia).

[4] *See* U.S. DEP'T OF THE TREASURY, OFFICE OF FIN. STABILITY, TROUBLED ASSET RELIEF PROGRAM TRANSACTIONS REPORT, at 1 (2010), *available at* http://www.treasury.gov/initiatives/financial-stability/briefing-room/reports/tarp-transactions/DocumentsTARPTransactions/5-14-

emergency legislation was enacted that obligated the federal government—and ultimately, taxpayers—to provide hundreds of billions of dollars in bailouts and guarantees.[5]

Public opinion quickly turned against those who were perceived to have created a financial environment that was overly-dependent on high leverage and Byzantine structured products, derivatives and other financial instruments, and against the government's legislative and other intervention. Public dissatisfaction grew over time, fueled by revelations regarding, and government investigations into, allegations that Lehman and other institutions engaged in short-term, repurchase agreement financing that allegedly grossly understated their leverage, and that other major financial institutions allegedly created and marketed collateralized debt obligations without proper disclosure to the detriment of their investors.[6]

In light of the foregoing, it was no surprise that there would be a massive, legislative response mandating comprehensive financial reform. Accordingly, in the summer of 2010, Congress passed, and the President signed into law, the Dodd-Frank Wall Street Reform and Consumer Protection Act.[7] The Act spans over 2,300 pages and affects almost every aspect of the United States financial services industry. The Act eliminates the Office of Thrift Supervision—while creating a dozen new federal agencies, each with far-reaching powers.[8] The Act commissions several dozen detailed studies of numerous aspects of the financial sector and regulatory policy.[9] And it directs existing and newly-created agencies to promulgate rules implementing the Act, a massive, iterative process that has been underway for many months.[10]

The purpose of the Act is to improve financial stability, to mitigate risk, to end "too big to fail," and to protect taxpayers by "ending bailouts."[11] The Act purports to

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10%20Transactions%20Report%20as%20of%205-12-10.pdf (detailing TARP transactions to major financial firms).

[5] *E.g.*, American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (aiming to preserve and create jobs in order to promote economic recovery); Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, Div.A, 122 Stat. 3765 (providing Secretary of the Treasury with resources to restore liquidity and stability to United States financial system); Federal Housing Finance Regulatory Reform Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (reforming housing finance in response to the subprime mortgage crisis).

[6] *See, e.g., The Causes and Effects of the Lehman Brothers Bankruptcy: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 2 (2008) (exploring Lehman Brothers' role in financial meltdown during congressional hearing).

[7] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified throughout 2010 supplement to Title 12 of U.S. Code) (hereinafter the "Act").

[8] *E.g.*, Act § 313, 12 U.S.C. § 5413 (Supp. 2010) (establishing timeline for abolishment of Office of Thrift Supervision).

[9] *E.g.*, Act § 123, 12 U.S.C. § 5333 (authorizing Financial Stability Oversight Council to study "economic impact of possible financial services regulatory limitations intended to reduce systemic risk.").

[10] *E.g.*, Act § 209, 12 U.S.C. § 5389 (vesting Federal Deposit Insurance Corporation and Financial Stability Oversight Council with power to prescribe regulations "with respect to the rights, interests, and priorities of creditors, counterparties, security entitlement holders, or other persons with respect to any covered financial company or any assets or other property of or held by such covered financial company.").

[11] Dodd-Frank Wall Street Reform and Consumer Protection Act Pmbl. (describing purpose of the Act).

achieve these aims by, among other things, restricting the range of financial companies' activities and by imposing more stringent capital requirements.[12] These measures ostensibly will reduce the chances of systemic disruptions and the odds that a large financial company will fail. In order to be prepared for such failure, however, Title II of the Act, titled "Orderly Liquidation Authority," creates an entirely new insolvency regime for large, interconnected, systemically-important financial companies, including broker-dealers, whose failure poses a significant risk to the financial stability of the United States.[13] It provides for federal receivership proceedings of qualifying financial companies, with the Federal Deposit Insurance Corporation (the "FDIC") serving as receiver.[14]

Any receivership under Title II is subject to exceptionally broad input and control by the FDIC and numerous other government authorities, including the Board of Governors of the Federal Reserve, the Secretary of the Treasury, the Congress, and the President of the United States.[15] It is modeled in part on those provisions of the Federal Deposit Insurance Act (the "FDIA") regarding insolvencies of federal banks and savings and loans.[16] It also imports numerous provisions from the United States Bankruptcy Code (the "Code")[17], and provides significant authority to the government, similar to that applicable to bank insolvencies and the special conservatorships governing Freddie Mac and Fannie Mae.[18]

This article provides an overview and analysis of Title II. It summarizes the types of entities that may be placed into federal receivership and the process for doing so. It also summarizes the basic attributes of the receivership process, including a mechanism by which the FDIC can create a so-called "bridge financial company"—similar to the process by which the FDIC can create a so-called "bridge bank" under the FDIA—to succeed to selected assets and liabilities of the entity in receivership and that can continue operating as a restructured, going concern, pending transfer to a private acquirer. Title II contains highly particularized provisions governing financial responsibility for a receivership, including who

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[12] *See* Act § 115(a), 12 U.S.C. § 5325(a) (stating Council may recommend more stringent requirements on nonbank financial companies which are governed by Board of Governors than those applicable to other financial companies).

[13] Act § 204(a), 12 U.S.C. § 5384(a) (providing authority to liquidate failing financial companies posing significant risk to financial stability of United States).

[14] *See* Act § 204(b), 12 U.S.C. § 5384(b).

[15] *See* Act § 203(a)–(c), 12 U.S.C. § 5383(a)–(c) (requiring Secretary of Treasury to make written recommendation for FDIC to become receiver of covered company and regularly consult and report to multiple government authorities).

[16] 12 U.S.C. § 1811 *et seq.*

[17] 11 U.S.C. § 101–1532 (2006) (governing bankruptcy proceedings of individuals and most business organizations).

[18] *See* Federal Housing Finance Regulatory Reform Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (2008) (codified in multiple sections of the United States Code); Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C. § 4501 *et seq.* (2006).

may—and who may not—be forced to pay for the costs of a receivership.[19] There are also several provisions governing derivatives agreements and the potential consequences for management found to be responsible for a financial company's collapse.[20]

Many of the provisions of the Act and the powers delegated to the FDIC and other government authorities may be draconian when implemented. The right to decide whether to initiate receivership proceedings is vested in government authorities, not in financial companies' boards, management, or stakeholders, and is subject only to very limited judicial review that is highly deferential to such authorities.[21] A bridge financial company can be created, with no stakeholder input, that houses a troubled financial company's "good" assets, while leaving behind the "bad" assets and liabilities.[22] A financial company or a bridge financial company can be sold to or merged with a private acquirer on no notice, with no stakeholder input, and with limited regard for the consequences to them.[23] The government is forbidden from "bailing out" failing financial companies and, in fact, is empowered to assess other financial companies for the costs of a receivership.[24] The traditional rights of derivatives counterparties are restricted in several important respects. The Act effectively declares open season on failed financial company directors and management.

The potential harshness of the Act ultimately may mean that receiverships under the Act rarely will be implemented, even during a crisis. In particular, the Act's broad provisions and the powers vested in the FDIC collectively may work best when used as a threat to compel a predominantly private solution, facilitated by the government, including solutions that are largely consensual and that rely on a federal receivership solely for quick implementation—and even solutions that avoid federal receivership altogether. Indeed, the Act affirmatively requires the Board of Governors, the Secretary of Treasury, and the FDIC to consider private alternatives to receiverships.[25] The Act further requires financial companies to develop

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[19] *See, e.g.*, Act § 202(d)(6), 12 U.S.C. § 5382(d)(6) (freeing FDIC and Deposit Insurance Fund from liability for unresolved claims arising from receivership after termination of receivership).

[20] *See* Act § 204(a)(3), 12 U.S.C. § 5384(a)(3) (requiring parties responsible for financial condition of company to bear losses).

[21] *See* Act § 202(a)(1)(A)(i), 12 U.S.C. § 5382 (a)(1)(A)(i) (authorizing Secretary to initiate receivership proceedings and appoint FDIC as receiver if covered company consents to appointment, and gives Secretary power to petition United States District Court for the District of Columbia for order authorizing appointment of FDIC as receiver, if covered company does not consent to FDIC's appointment).

[22] *See* Act § 210(h)(1), 12 U.S.C. § 5390(h)(1) (allowing for creation of bridge financial company with the authority to "assume such liabilities . . . as the Corporation may, in its discretion, determine to be appropriate.").

[23] Act § 210(h)(13), 12 U.S.C. § 5390 (h)(13) (providing for termination of bridge financial company by election of FDIC to sell majority of capital stock of bridge financial company, or through merger of bridge financial company with another entity).

[24] *See* Act § 204(a), 12 U.S.C. § 5384(a) (calling for liquidation of large failing financial companies with losses borne by creditors, shareholders and management, rather than government bail-outs funded by taxpayers).

[25] Act § 203(a)(2)(E), 12 U.S.C. § 5383(a)(2)(E) ("Any written recommendation . . . shall contain an evaluation of the likelihood of a private sector alternative to prevent the default of the financial company.").

contingency plans for resolving their affairs under the Code, and to submit such plans to the FDIC and the Board of Governors for their consideration as alternatives to receiverships under the Act.[26] These requirements might foster more thoughtful, value-additive, private solutions that avoid catastrophic collapses and bailouts.

I. ENTITIES SUBJECT TO THE ACT: FINANCIAL COMPANIES

A. Other Insolvency Law Alternatives

In the United States today, there are four main categories of insolvency laws: the Code; the FDIA, which governs insolvency proceedings of banks and savings and loans; state laws concerning the rehabilitation and liquidation of insurance companies; and specialized laws governing the liquidation of brokers and dealers.[27] The Code is by far the most comprehensive of these four regimes. Almost any business entity can become a debtor under the Code, where it can either liquidate its assets or attempt to reorganize its affairs pursuant to chapter 7 or chapter 11.[28]

However, banks, savings and loan associations, insurance companies, and numerous other statutorily-defined financial entities may not become debtors under the Code.[29] Such entities are subject to their own particular insolvency regimes, including the FDIA in the case of federally-chartered banks and savings and loan associations, and state laws in the case of insurance companies.[30] Insolvent brokers and dealers typically are liquidated pursuant to the Securities Investor Protection Act ("SIPA"), although stockbrokers can also be liquidated under the Code.[31]

The insolvency laws governing banks and saving and loans—more specifically, insured depository institutions—and insurance companies remain virtually unchanged by the Act.[32] Accordingly, insured depository institutions and insurance

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[26] Act § 165(d), 12 U.S.C. § 5365(d).

[27] *See* Stephen J. Lubben, *Bringing Chapter 11 Cases Back Home and Reforming the Dodd-Frank OLA*, 30 AM. BANKR. INST. J., July/Aug. 2011 at 81 (noting four existing insolvency systems "such as chapter 11, FDIA [Federal Deposit Insurance Act], SIPA, and the state insurance receivership statutes.").

[28] *See* 11 U.S.C. § 101(41) (2006) (defining word "person" to include individuals, partnerships and corporations); *id.* at § 109 (defining who may be a debtor).

[29] 11 U.S.C. § 109(b)(2) (stating under Code financial entities such as "a domestic insurance company, bank, savings bank" may not become debtors).

[30] *See* 12 U.S.C. § 1811 (2006) (establishing Federal Deposit Insurance Corporation to insure deposits of banks and savings associations and facilitate liquidation of banks and savings associations); Laura S. McAlister, *The Inefficiencies of Exclusion: The Importance of Including Insurance Companies in the Bankruptcy Code*, 24 EMORY BANKR. DEV. J. 129, 129 (2008) (noting insurance and financial institutions are excluded from Code, and therefore insurance company insolvencies take place in state courts under state laws).

[31] 11 U.S.C. §§ 741–753 . "Stockbroker" is defined under section 101(53A) of the Code as an individual, partnership or corporation, with respect to which there is a customer, and that is engaged in the business of effecting transactions in securities either for the account of others or with members of the general public, for such entity's own account. *Id.* at § 101(53A).

[32] An insured depository institution is defined under section 3(c) of the FDIA as any bank or savings association the deposits of which are insured by the FDIC pursuant to the FDIA. 12 U.S.C. § 1813(c)(2) . Under section 201(a)(13) of the Act, an insurance company is any entity that is engaged in the business of

companies will continue to remain subject to existing insolvency laws and, hence, are not subject to federal receivership under the Act.[33] Additionally, federal home loan banks, farm credit institutions, government sponsored enterprises (including Fannie Mae and Freddie Mac, as well as any affiliate of either), and government entities are not subject to receivership.[34]

B. Definition of "Financial Companies"

Certain business entities that currently may become debtors under the Code are now subject to federal receivership under the Act. The Act defines this class of business entities as "financial companies."[35] The Act describes four categories of financial companies. The first category consists of "bank holding companies," as defined in section 2(a) of the Bank Holding Company Act (the "BHCA").[36] A bank holding company is any company that has control over any bank or over any company that is or becomes a bank holding company by virtue of the BHCA.[37] The term "bank" includes banks, the deposits of which are insured in accordance with the terms of the FDIA, and institutions that accept demand deposits or deposits that the depositor may withdraw by check or similar means and that are engaged in the business of making commercial loans.[38]

The second category of financial company covered by the Act consists of nonbank financial companies supervised by the Board of Governors, which in turn includes nonbank financial companies that the Financial Stability Oversight Council (the "Council") has determined must be supervised by the Board of Governors.[39] Nonbank financial companies are companies "predominantly engaged in financial

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insurance; subject to regulation by a state insurance regulator; and covered by a state law that is designed to specifically deal with the rehabilitation, liquidation or insolvency of an insurance company. Act § 201(a)(13), 12 U.S.C. § 5381(a)(13) (Supp. 2010) (defining "insurance company").

[33] Act § 203(e)(1), 12 U.S.C. § 5383(e)(1) (stating any insurance company liquidation will be governed by applicable state law). Insurance companies technically are within the scope of the Act. However, if an insurance company or insurance company subsidiary otherwise qualifies under the Act, the liquidation or rehabilitation of such entity will be conducted as provided under state law, not the Act—provided that if the appropriate state agency fails to act within 60 days of a determination of the Secretary that an insurance company would otherwise qualify for receivership, then the FDIC may act in place of such agency and pursue relief under state law. Act §§ 202(b), 203(e), 12 U.S.C. §§ 5382(b), 5383(e).

[34] Act § 201(a)(11), 12 U.S.C. § 5381(a)(11) (limiting the type of institutions that qualify as financial companies for purposes of the Act).

[35] *Id.*

[36] *See* Act § 102(a)(1), 12 U.S.C. § 5311(a)(1) (adopting definition of bank holding company as stated in BHCA); 12 U.S.C. § 1841(a) (2006) (codifying BHCA definition of bank holding company).

[37] A company "has control over a bank or a company", pursuant to section 2(a) of the BHCA, if (a) it directly or indirectly has the power to vote 25% or more of any class of voting securities of the bank or company; (b) it controls in any manner the election of a majority of directors or trustees of the bank or company; or (c) the Board of Governors determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company. 12 U.S.C. § 1841(a)(2).

[38] 12 U.S.C. § 1841(c)(1)(B) (defining "banks" under BHCA).

[39] Act § 102(a)(4), 12 U.S.C. § 5311(a)(4).

activities."[40] A company satisfies this definition if it and all of its subsidiaries collectively derive either 85% of their annual gross revenues or 85% of their consolidated assets from activities that are "financial in nature" or incidental to a financial activity, or from the ownership or control of one or more insured depository institutions.[41]

Section 4(k) of the BHCA includes an extensive list of activities designated as "financial in nature," including lending, exchanging or investing money or securities; insuring, guaranteeing or indemnifying against loss, harm, damage, illness, and death; providing and issuing annuities; providing financial, investment, or economic advisory services; issuing or selling instruments representing pools of assets permissible for a bank to hold directly; and underwriting, dealing in or making a market in securities.[42] The Act authorizes the Council, by a vote of not fewer than two-thirds of the members then serving, and an affirmative vote by the chairperson of the Council, to determine that a nonbank financial company will be supervised by the Board of Governors and subject to heightened prudential standards, if the Council determines that material financial distress at such company would pose a threat to the financial stability of the United States.[43]

The third category of financial company covered by the Act consists of subsidiaries of the two foregoing categories of financial companies, other than subsidiaries that are insured depository institutions or insurance companies which, as noted above, remain subject to existing insolvency regimes.[44]

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[40] Act § 102(a)(4)(A)(ii), (B)(ii), 12 U.S.C. § 5311(a)(4)(A)(ii), (B)(ii).

[41] Act § 102(a)(6)(A), (B), 12 U.S.C. § 5311(a)(6)(A), (B). Pursuant to a rule issued by the FDIC, a company is deemed "predominantly engaged" in financial activities if (a) at least 85 percent of the total consolidated revenues of the company for *either* of its two most recent fiscal years were derived, directly or indirectly, from financial activities, *or* (b) based upon all the relevant facts and circumstances, the FDIC determines that the consolidated revenues of the company from financial activities constitute 85 percent or more of the total consolidated revenues of the company. The phrase "total consolidated revenues" is defined in the rule as the total gross revenues of a company and all entities subject to consolidation as determined in accordance with accounting standards used by the company in the ordinary course of its business, so long as those standards are U.S. generally accepted accounting principles, international financial reporting standards, or such other accounting standards that the FDIC determines to be appropriate. Orderly Liquidation Authority, 12 C.F.R. § 380.8 (2011). This rule has been reserved and has yet to be finalized, as the FDIC and Federal Reserve (which is responsible for establishing a definition for the same term under Title I of the Act) continue to coordinate regarding how the term should be defined. *See* Certain Orderly Liquidation Authority Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 41,626, 41,628 (July 15, 2011).

[42] *See* 12 U.S.C. § 1843(k)(4)(A)–(I) (enumerating activities designated as financial in nature under BHCA).

[43] Act § 113(a)(1), 12 U.S.C. § 5323(a)(1) (providing authority and procedure for Council to determine if U.S. nonbank financial companies should be supervised by the Board of Governors). On October 11, 2011, the Financial Stability Oversight Council issued a second notice of proposed rulemaking describing how the Council intends to determine whether a nonblank financial company should be supervised by the Board of Governors. *See* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 64264 (Oct. 18, 2011).

[44] Act § 201(a)(11)(B)(iv), 12 U.S.C. § 5381(a)(11)(B)(iv) (including under Board of Governors' supervision subsidiaries of financial companies that are financial in nature).

The fourth category consists of brokers and dealers that are registered with the SEC and members of SIPC.[45] While stockbrokers are eligible to become debtors under the Code as well, they may only liquidate pursuant to chapter 7; they are ineligible to attempt to reorganize under chapter 11.[46] Moreover, as noted above, brokers and dealers also remain subject to their own, highly-specialized insolvency regime under SIPA.[47]

II. "SYSTEMIC RISK DETERMINATION"

A. Who Makes the Determination

Not every financial company may be placed into federal receivership under the Act. To be eligible, the financial company must constitute a "covered financial company," a term which the Act defines with great particularity. A covered financial company is a financial company as to which a "systemic risk determination" has been made by the authorities identified in the Act.[48] The process for determining whether the insolvency of a particular financial company presents systemic risk begins with the recommendations of the FDIC and the Board of Governors, with respect to a covered financial company other than a covered broker or dealer; the SEC and the Board of Governors, with respect to a covered broker or dealer; and the Director of the Federal Insurance Office and the Board of Governors, with respect to an insurance company.[49]

On their own initiative, or at the request of the Secretary, the FDIC (or the SEC, in the case of a covered broker or dealer, or the Director of the Federal Insurance Office, in the case of an insurance company) and the Board of Governors must make a written recommendation regarding whether a financial company presents systemic risk and, hence, whether the Secretary should appoint the FDIC as receiver.[50] Such recommendation must be made upon a vote of not fewer than two-thirds of the then serving members of the Board of Governors and the board of directors of the FDIC (or in the case of a covered broker or dealer, the members of the SEC then serving, and in consultation with the FDIC, and in the case of an insurance company, the Director of the Federal Insurance office), respectively.[51]

These written recommendations must contain, among other things, an evaluation of whether the financial company is "in default or in danger of default" (a phrase defined below); a description of the effect that the default of the financial

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[45] Act § 201(a)(7)(A), (B), 12 U.S.C. § 5381(a)(7)(A), (B) (defining necessary elements under Act to be considered "covered broker or dealer").

[46] *Compare* 11 U.S.C. §§ 741–84 (2006) (detailing stockbroker liquidation under chapter 7 of Code), *with id.* at. §§ 1101–16 (excluding stockbroker from definition of who may qualify for chapter 11 reorganization).

[47] *See* Act § 205, 12 U.S.C. § 5385 (describing process for orderly liquidation of covered brokers and dealers under SIPA).

[48] *See* Act § 203, 12 U.S.C. § 5383 (describing process for systematic risk determination under Act).

[49] *See* Act § 203(a), 12 U.S.C. § 5383(a).

[50] *See id.*

[51] *See id.*

company would have on the financial stability of the United States; an evaluation of the likelihood of a private sector alternative to prevent the default; an evaluation of why a bankruptcy case is not appropriate for the financial company; and an evaluation of the effects on creditors, counterparties, and shareholders of the financial company and other market participants of a receivership under the Act.[52]

B. Factors in Making the Determination

Upon receipt of these recommendations, the Secretary—in consultation with the President of the United States—must seek appointment of the FDIC as receiver for the covered financial company if the Secretary determines, among other things, that the financial company is in default or in danger of default; the default of the financial company would have a serious adverse effect on the financial stability of the United States; no viable private sector alternative is available to prevent the default; the effect on the claims or interests of creditors, counterparties, and shareholders of the financial company and other market participants of proceedings under the Act is appropriate, given the impact that any action under the Act would have on financial stability in the United States; and an orderly liquidation would avoid or mitigate such adverse effects.[53]

Three aspects of these standards warrant emphasis. First, the phrase "in default or in danger of default" affords the Board of Governors, the FDIC, the SEC, and the Secretary fairly broad discretion.[54] Specifically, a financial company is in default or in danger of default if:

> [a bankruptcy] case has been, or likely will promptly be, commenced with respect to the financial company. . .; 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; the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or the financial company is, or is likely to

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[52] *See* Act § 203(a)(2), 12 U.S.C. § 5383(a)(2) (enumerating required contents of written recommendations). As discussed below, the Act requires financial companies to develop contingency plans for resolving their affairs under the Code. *See infra* Part 8 and notes 266–73 (highlighting enhanced supervision required by Act, including requiring financial companies to submit resolution plans under Code as a contingency for reorganizing or liquidating). Such plans undoubtedly will be used in assessing whether a case under the Code is or is not appropriate for a financial company.

[53] *See* Act § 203(b), 12 U.S.C. § 5383(b). In the case of covered brokers and dealers, the FDIC will serve as receiver, but the SIPC will serve as trustee. Upon appointment as trustee, the SIPC must file an application for a protective decree under SIPA. Assets retained by the broker or dealer and not transferred to a covered financial company must be administered pursuant to SIPA. *See* Act § 205(a), 12 U.S.C. § 5385(a) (requiring SIPC to act as trustee for any covered broker or dealer and defining powers and duties of SIPC as trustee).

[54] *See* Act § 203(c)(4), 12 U.S.C. § 5383(c)(4).

> be, unable to pay its obligations (other than those subject to a bona fide dispute) in the [ordinary] course of business.[55]

The definition's repeated use of the forward-looking phrase "is likely to" gives the government discretion to make necessary judgments as events unfold, rather than after the fact.

Second, no financial company can be placed into receivership without an assessment of whether the Code already provides an appropriate remedy.[56] This requirement is important, as it forces consideration of alternatives under a long-standing and well-understood insolvency regime that affords a comprehensive mechanism for reorganizing a troubled entity, and that affords creditors and other stakeholders significant input into, and control over, the reorganization process—input and control that does not exist in receiverships under the Act. Third, the Board of Governors, the FDIC, and the SEC cannot recommend receivership without considering the viability of private sector alternatives.[57] More importantly, the Secretary cannot commence a receivership unless the Secretary has determined that "*no* viable private sector alternative is available."[58]

These second and third requirements provide significant, common-sense checks on the federal receivership process envisioned by the Act, and undoubtedly reflect the alternatives the government considered and implemented as the country faced crisis after crisis in the fall of 2008. Indeed, a troubled company's most likely source of rescue is its existing stakeholders—those with the greatest, and most vested, interest in a successful outcome.[59] The Code itself was designed to foster private, negotiated solutions among a debtor and its stakeholders. The restructuring process works best when the toughest remedies afforded by the Code are never used in litigation, but are instead used to prod stakeholders to a sensible, private solution.[60] The Act requires careful assessment of these considerations and alternatives as well.

A recent example of how this process worked well is the restructuring of The CIT Group, Inc., one of the largest bank holding companies in the country. Although the government infused capital into CIT during the depths of the crisis, it

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[55] *Id*.

[56] *See* Act § 203(b)(2), 12 U.S.C. § 5383(b)(2) (limiting receivership to those financial companies that have shown any solution found under applicable federal law would be hazardous to United States' financial stability).

[57] *See* Act § 203(b)(3), 12 U.S.C. § 5383(b)(3) (requiring written recommendation to appoint receiver to include an analysis of likelihood of financial company's default with implementation of private sector alternatives).

[58] *See* Act § 203(b)(3), 12 U.S.C. § 5383(b)(3) (preventing Secretary from taking action until it is determined that no private sector alternative is available to prevent default).

[59] Mark S. Scarberry, Kenneth N. Klee, Grant W. Newton, & Steve H. Nickles, BUSINESS REORGANIZATION IN BANKRUPTCY; CASES AND MATERIALS 245 (3d ed. 2006) (stating current management and stakeholders generally give financially distressed company best chance to reorganize).

[60] *See In re* Colonial Ford, Inc., 24 B.R. 1014, 1015–16 (Bankr. D. Utah 1982) (explaining Code favors out-of-court workouts because workouts are more flexible, speedy, economic, and require inter-party cooperation).

refused to make further investments despite CIT's continued troubles.[61] CIT therefore was compelled to work with its stakeholders on a series of transactions designed to shed over $10 billion in debt.[62] The result was a largely consensual, private solution, financed by the company's stakeholders, that was implemented via a pre-packaged chapter 11 reorganization plan that limited the company's stay in bankruptcy to only 40 days.[63] The Act presumably was designed to foster solutions such as this—especially through the Act's prohibition on government infusions of capital into troubled financial companies (discussed below).[64]

Under the Act, however, if the Secretary determines that there are no private alternatives available for a financial company, then the Secretary must so notify the FDIC and the company.[65] The company is then given the opportunity to consent to appointment of the FDIC as receiver.[66] If the directors and officers of a troubled financial company decide to acquiesce in the appointment of the FDIC as receiver, the Act provides that such directors and officers are absolved of liability to stakeholders for such acquiescence.[67] If they do not consent, then the Secretary is required to petition the United States District Court for the District of Columbia for an order authorizing the Secretary to appoint the FDIC as receiver.[68] The petition must be filed under seal.[69]

The Court is directed to hold a hearing, on a strictly confidential basis, in which the company may oppose the petition.[70] The Court's task is limited to deciding whether the Secretary's determinations were "arbitrary and capricious," a standard that is very deferential to the Secretary and effectively presumes the validity of the Secretary's determinations.[71] If the Court answers the "arbitrary and capricious" question in the negative, the Court is required to issue an order immediately authorizing the Secretary to appoint the FDIC as receiver.[72] If the Court answers this question affirmatively, the Court is required to provide the Secretary with a written statement explaining its rationale, and must afford the Secretary an immediate opportunity to amend and refile the petition.[73]

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[61] *See* Michael J. de la Merced, *CIT Leaves Bankruptcy, With Questions*, N.Y. TIMES, Dec. 10, 2009, at B7.

[62] *See id.*

[63] *See id*.

[64] *See infra* Part 5.a. (examining how Act prohibits government bailouts in lieu of private funding for covered companies).

[65] Act § 203(b)(3), 12 U.S.C. § 5383(b)(3) (Supp. 2010).

[66] Act § 202(a)(1)(A)(i), 12 U.S.C. § 5382(a)(1)(A)(i).

[67] Act § 207, 12 U.S.C. § 5387 ("[B]oard of directors (or body performing similar functions) of a covered financial company shall not be liable to the shareholders or creditors thereof for acquiescing in or consenting in good faith to the appointment of the Corporation as receiver . . . .").

[68] Act § 202(a)(1)(A)(i), 12 U.S.C. § 5382(a)(1)(A)(i) .

[69] Act § 202(a)(1)(A)(ii), 12 U.S.C. § 5382(a)(1)(A)(ii).

[70] Act § 202(a)(1)(A)(iii), 12 U.S.C. § 5382(a)(1)(A)(iii).

[71] *Id.*

[72] As noted above, in broker-dealer liquidations, the FDIC is appointed as receiver, but SIPC must be appointed as trustee. Act § 205(a)(1), 12 U.S.C. § 5385(a)(1).

[73] Act § 202(a)(1)(A)(iv)(II), 12 U.S.C. § 5382(a)(1)(A)(iv)(II).

If the Court does not make a determination within 24 hours of receiving the petition, the petition will be granted by operation of law, the Secretary will appoint the FDIC as receiver, and liquidation under the statute will automatically be commenced.[74] The Act provides a process for highly expedited appeals of these determinations, though implementation of a receivership may not be stayed pending appeal.[75]

The upshot of these provisions is obvious: the courts have virtually no meaningful role in the receivership process. Indeed, no court reasonably can be expected to intelligently assess, in a mere 24 hours, a matter as complex and momentous as whether a large financial company's imminent failure poses a systemic threat to the United States. No court will ever have the expertise in such matters sufficient to seriously assess regulators' determinations, especially under a standard that is so highly deferential to such regulators. Accordingly, the most likely response of a court to the filing of a petition is no response at all—in which case the petition is deemed granted as a matter of law.

III. BASIC ELEMENTS OF THE RECEIVERSHIP PROCESS

A. Control is Concentrated in the FDIC

Once the FDIC is appointed receiver of a covered financial company, it assumes virtually complete control over the company and the receivership process.[76] The perfunctory role of the courts in the core receivership process ends, and there are limited avenues for challenging the various ancillary decisions that the FDIC may make in pursuing the liquidation.[77] The role of the FDIC in federal receiverships under the Act is akin to its role in connection with insolvency proceedings involving federal banks and savings and loans. This role contrasts sharply with reorganization proceedings under chapter 11 of the Code, where a debtor's board and management stay in place, the debtor remains in possession of its business, and the normal rules of corporate governance and decision-making

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[74] Act § 202(a)(1)(A)(v), 12 U.S.C. § 5382(a)(1)(A)(v).

[75] Appeals of the District Court's determination may be taken to the United States Court of Appeals for the District of Columbia. The appeal must be filed within 30 days of the District Court's decision and must be heard on an expedited basis. As noted, the Court's decision is not subject to any stay or injunction pending appeal. The appellate court's decision may be appealed to the United States Supreme Court. Any such appeal must be filed within 30 days of the appellate court's decision and heard on an expedited basis. Review in each case is limited to whether the Secretary's determination that a covered financial company is in default or in danger of default and satisfies the definition of a covered financial company is arbitrary and capricious. Act §§ 202(a)(2)(A) & (B), 12 U.S.C §§ 5382(a)(2)(A) & (B).

[76] *See* Act § 204(b)–(d), 12 U.S.C. § 5384(b)–(d) (stating FDIC will act as receiver and have all rights and obligations set forth therein, including consultation with agencies of covered financial company and making funds available for liquidation of financial company).

[77] Act § 210(a)(9)(D), 12 U.S.C. § 5390(a)(9)(D) (limiting judicial review over "any claim or action for payment from, or any action seeking a determination of rights with respect to, the assets of any covered financial company for which the [FDIC] has been appointed receiver").

continue to apply (subject to the requirement that transactions outside the ordinary course of business require advance court approval).[78]

Accordingly, when the FDIC is appointed receiver for a covered financial company, it succeeds to "all rights, titles, powers, and privileges of the . . . company and its assets, and of any stockholder, member, officer, or director of [the] company."[79] The FDIC may operate the company with all of the powers of the company's shareholders, directors and officers, and may conduct all aspects of the company's business.[80] It may liquidate and wind-up the affairs of the company in such manner as it deems appropriate, including through the sale of assets, the transfer of assets to a bridge financial company (discussed in more detail below), or the exercise of any other rights or privileges granted to the receiver.[81] For example, the FDIC may merge the financial company with another company, or transfer any asset or liability of the company without obtaining any approval, assignment, or consent from any stakeholder.[82]

While the Act affords the FDIC virtually unfettered control in these matters, the Act does identify several principles that guide the FDIC's conduct. For instance, in disposing of assets, the FDIC must use best efforts to maximize returns, minimize losses, and mitigate the potential for serious adverse effects to the financial system.[83] In deciding upon a course of action, the FDIC must also determine that such action is necessary for the financial stability of the United States, and not for the purpose of preserving the company; ensure that the shareholders of the covered financial company do not receive payment until after all other claims are fully paid; and ensure that unsecured creditors bear losses in accordance with the priority of claim provisions.[84] Significantly, the FDIC may not take an equity interest in or become a shareholder of the covered financial company or any covered subsidiary.[85]

The FDIC is given several other powers that are consistent with the powers afforded it in connection with insolvency proceedings of banks under the FDIA, the powers afforded SIPC trustees in connection with insolvency proceedings of broker-dealers under SIPA, and the powers afforded bankruptcy trustees in connection with liquidation proceedings under chapter 7 of the Code. These powers

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[78] *See* 11 U.S.C. §§ 363(b), 1107–08 (2006) (authorizing debtor in possession to continue operating business except for transactions outside of the ordinary course of business or unless court orders otherwise). *See generally* Manville Corp. v. Equity Sec. Holders Comm. (*In re* Johns-Manville Corp.), 801 F.2d 60, 64 (2d Cir. 1986) ("[T]he right to compel a shareholders' meeting for the purpose of electing a new board subsists during reorganization proceedings.").

[79] Act § 210(a)(1)(A), 12 U.S.C. § 5390(a)(1)(A).

[80] Act § 210(a)(1)(B), 12 U.S.C. § 5390(a)(1)(B).

[81] Act § 210(a)(1)(D), 12 U.S.C. § 5390(a)(1)(D).

[82] Act § 210(a)(1)(G), 12 U.S.C. § 5390(a)(1)(G).

[83] Act § 210(a)(9)(E), 12 U.S.C. § 5390(a)(9)(E) (requiring receiver to dispose of assets with best interests of covered financial company in mind).

[84] *See* Act § 206, 12 U.S.C. § 5386 (ensuring liquidation is orderly and conducted in manner to preserve financial stability of United States).

[85] Act § 206(6), 12 U.S.C. § 5386(6).

can be grouped into three main categories: resolution and payment of claims; disposition of existing contracts and similar obligations; and recovery of pre-receivership fraudulent conveyances and preferential transfers.

B. Resolution and Payment of Claims

With respect to the resolution and payment of claims, the FDIC is given unilateral authority to review claims and to make determinations either allowing them or disallowing them.[86] This unilateral authority, while similar to that granted the FDIC and SIPC trustees under the FDIA and SIPA, respectively, differs from that afforded chapter 7 trustees under the Code. Under the Code, a claim is deemed allowed unless the chapter 7 trustee files an objection to the claim with the bankruptcy court and the claimant is afforded an opportunity to appear and be heard on the objection.[87] The claim is disallowed only if the claimant fails to appear or the court otherwise determines that the claim should be disallowed.[88] Under the Act, by contrast, a claimant wishing to contest a claim determination by the FDIC must file suit with the district court for the district where the principal place of business of the covered financial company is located.[89]

The Act identifies the priorities in which claims may be paid, with the costs of the receivership being afforded first priority after provision is made for secured claims.[90] Claims owed to the United States come next, followed by all other claims against the covered financial company.[91] Similar to the rules governing other insolvency regimes, the Act requires that all claimants who are similarly-situated be treated in a similar manner (except that, as noted above, claims of the United States are paid first).[92] Unlike other insolvency regimes, however, the FDIC may deviate

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[86] Act § 210(a)(2), 12 U.S.C. § 5390(a)(2) (granting Corporation as receiver of financial company power to determine validity of claims).

[87] 11 U.S.C. § 502(a) ("A claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest, including a creditor of a general partner in a partnership that is a debtor in a case under chapter 7 of this title, objects.").

[88] *See id.* at § 502(b) (enumerating reasons court may disallow claims).

[89] Act § 210(a)(4), 12 U.S.C. § 5390(a)(4) (limiting venue for contesting claims when FDIC is receiver). The FDIC has issued a rule that implements the statutory procedures under which a claimant may seek judicial determination of its claim[s]. Under the rule, a claimant must file suit within 60 days of the earlier of the date of any notice of disallowance of a claim or the end of the claims determination period. Further, a court has no jurisdiction to determine a claim until the claimant has exhausted the administrative claims process. Orderly Liquidation Authority, 76 Fed. Reg. 41,626, 41,645 (July 15, 2011) (to be codified at 12 C.F.R. § 380.38).

[90] Act § 210(b)(5), 12 U.S.C. § 5390(b)(5) ("This section shall not affect secured claims or security entitlements in respect of assets or property held by the covered financial company . . . ."). The FDIC has issued a rule containing a detailed priority scheme for unsecured claims, which sets out eleven classes of claims. Orderly Liquidation Authority, 76 Fed. Reg. 41,626, 41,642 (July 15, 2011) (to be codified at 12 C.F.R. §§ 380.21–27).

[90] Act § 210(b)(1), 12 U.S.C. § 5390(b)(1).

[91] *See id.* (listing priority of expenses and unsecured claims).

[92] *Compare* Act § 210(b)(3), (4), 12 U.S.C. § 5390(b)(3), (4) (prioritizing claims of United States above claims of other creditors similarly situated), *with* 11 U.S.C. § 1123(a)(4) (requiring "same treatment for each claim or interest of a particular class").

from this principle as necessary to maximize the value of the assets of the covered financial company; to initiate and continue operations essential to implementation of the receivership or any bridge financial company; to maximize the present value return from the sale or other disposition of the assets of the company; or to minimize the amount of any loss realized upon the sale or other disposition of the assets of the company.[93]

C. Disposition of Existing Contracts and Related Obligations

With respect to the disposition of existing contracts and related obligations, the Act provides that the FDIC may, within a reasonable period of time, disaffirm or repudiate any contract or lease to which the financial company is a party where continued performance is too burdensome or where disaffirmance or repudiation would otherwise promote orderly administration.[94] The FDIC can do so regardless of whether the contract or lease is "executory," i.e., whether there are unperformed obligations remaining by both parties. Under the Code, by contrast, only contracts or leases that are executory may be rejected.[95] With few exceptions, damages for such repudiation under the Act are limited to actual, direct compensatory damages; punitive or exemplary damages and claims for lost profits or opportunities are not allowed.[96]

Alternatively, the FDIC may determine to transfer its rights and obligations under a contract or lease to an acquirer of the covered financial company's assets.[97] It may do so notwithstanding so-called "ipso facto" clauses which excuse a counterparty from performing by reason of the company's insolvency, the appointment of a receiver, and similar circumstances.[98] These powers are largely consistent with the powers afforded the FDIC, SIPC trustees, and bankruptcy trustees under the FDIA, SIPA, and the Code, respectively, though the process involves significant counterparty input and court supervision in the case of the Code.

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[93] Act § 210(b)(4), 12 U.S.C. § 5390(b)(4).

[94] Act § 210(c)(1)–(2), 12 U.S.C. § 5390(c)(1)–(2).

[95] *See* 11 U.S.C. § 365 ("[T]he trustee, subject to the court's approval, may assume or reject any executory contract, or unexpired lease of the debtor.").

[96] Act § 210(c)(3), 12 U.S.C. § 5390(c)(3). The FDIC may reject contingent obligations of a covered financial company under a guarantee, letter of credit, loan commitment, or similar obligation, in which case actual, direct compensatory damages shall be the estimated value based on the likelihood that such contingent claim would become filed and the probable magnitude thereof. The FDIC has issued a final rule to this effect. 12 C.F.R. § 380.39.

[97] Act § 210(a)(1)(G)(i), 12 U.S.C. § 5390(a)(1)(G)(i) (authorizing transfer of any assets or liabilities). If the FDIC proposes to transfer any "qualified financial contracts," discussed in greater detail below, with a particular counterparty, the FDIC must transfer all of such contracts with that counterparty; alternatively, it must repudiate all such contracts with such counterparty. *See* Act § 210(c)(9)(A), 12 U.S.C. § 5390(c)(9)(A).

[98] *See* Act § 210(c)(13)(C)(i), 12 U.S.C. § 5390(c)(13)(C)(i) (providing ipso facto clauses unenforceable against covered company).

A separate provision of the Act pertains to contracts of subsidiaries that a parent financial company in receivership has guaranteed.[99] The FDIC, as receiver, may enforce such contracts notwithstanding any contractual right of the counterparty of a subsidiary to terminate, liquidate, or accelerate the contract based on the receivership of the parent financial company if either the guaranty and related assets and liabilities are transferred to and assumed by a bridge financial company (discussed below)[100] or a third party no later than the business day following appointment of the FDIC as receiver, or the FDIC otherwise provides adequate protection with respect to such obligations.[101]

There is no counterpart to this provision in the Code. This difference between the Act and the Code is potentially very significant, and can be illustrated by the events that transpired in the Lehman bankruptcy proceedings. The Lehman enterprise was comprised of thousands of individual legal entities.[102] This is true of most large, complex, financial businesses. However, when Lehman commenced its bankruptcy proceedings on September 15, 2008, only a single legal entity filed: the ultimate parent company, Lehman Brothers Holdings, Inc.[103] The company had not prepared any of its other entities to file as of that date, resulting in serial bankruptcy filings by various Lehman entities over the course of the ensuing month.[104] Subsidiaries of the parent company were parties to innumerable contracts, including hundreds of thousands of derivatives trades.[105] Lehman Brothers Holdings had guaranteed its subsidiaries' obligations under those contracts.[106] The filing by Lehman Brothers Holdings constituted an event of default under those contracts, allowing the counterparties to terminate them.[107]

Had Lehman Brothers Holdings been placed into receivership under the Act, the result could have been very different. In particular, the fact that the subsidiaries

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[99] *See* Act § 210(c)(16), 12 U.S.C. § 5390(c)(16) (addressing contracts guaranteed by covered financial company).

[100] *See infra* notes 136–42 and accompanying text (detailing purpose of bridge financial company and how bridge financial company is created).

[101] Act § 210(c)(16)(A), 12 U.S.C. § 5390(c)(16)(A) (authorizing enforcement of contracts guaranteed by covered financial company, with limitations); *see also* Act § 210(c)(10)(A), 12 U.S.C § 5390(c)(10)(A) (giving FDIC one business day after being appointed receiver to transfer qualifying contracts).

[102] *See In re* Lehman Bros. Holdings, Inc., 415 B.R. 77, 79 (S.D.N.Y. 2009) (acknowledging Lehman Brothers Holding Inc. as parent company of numerous subsidiaries and affiliates making up Lehman Enterprise).

[103] *See In re* Lehman Bros. Holdings, Inc., No. 08-13555(JMP), 2011 WL 1831779, at *5 (S.D.N.Y. 2011) (noting Lehman Brothers Holdings, Inc. was first Lehman entity to file bankruptcy).

[104] *See* Motion of New York State Comptroller for Appointment of a Trustee or, in the Alternative, an Examiner with Expanded Powers at 7, *In re* Lehman Bros. Holdings, Inc., (No. 08-13555) (Bankr. S.D.N.Y. Nov. 4, 2008) (mentioning bankruptcy petitions filed by various Lehman subsidiaries and affiliates).

[105] *See* Report of Anton R. Valukas, Examiner, *In re* Lehman Bros. Holdings, Inc. (No. 08-13555) (Bankr. S.D.N.Y. Mar. 11, 2011) at 569 (noting thousands of derivatives contracts to which Lehman Bros. was party).

[106] *See, e.g., In re* Lehman Bros. Holdings, Inc., 433 B.R. 101, 104 (Bankr. S.D.N.Y. 2010) (stating Lehman Brothers served as guarantor with respect to certain agreements between Swedbank and Lehman affiliates).

[107] *See id.* at 104–05 (describing master agreements by which bankruptcy of party to those agreements allowed for early termination of agreement).

were not placed into receivership concurrently with their parent would not necessarily have given rise to an immediately enforceable right of counterparties to terminate their contracts with the subsidiaries solely by virtue of the parent's receivership. Rather, had the parent entity alone been placed into receivership and the guarantee obligations assumed by a third-party acquirer or a bridge financial company within the limited window noted above, the subsidiaries would have been protected against termination of their contracts. This provision dovetails with other provisions of the Act, described below, that impose a one business day stay on the right of derivatives counterparties to terminate trades with a financial company in receivership so long as their trades are assumed by an acquirer or bridge financial company within that same narrow window.[108]

Because parent guarantees and cross-default provisions in contracts are common features of the business arrangements of large, complex commercial enterprises, this provision of the Act and the related derivatives provisions discussed below[109] together afford the FDIC, as receiver, a very significant tool for avoiding a wave of contract terminations, commensurate loss of value, and massive market disruption. So long as the FDIC creates a bridge financial company and causes it to assume a parent guarantee of derivatives and other contracts within the one business day window, it can maintain the status quo.[110] It obtains this protection for the benefit of a covered financial company's subsidiaries, without having to place all such subsidiaries into receivership. This in turn avoids the need for an extensive and time-consuming cross-default analysis of the sort that typically must be done in preparing most other enterprises for the possibility of commencing insolvency proceedings, along with the related time and expense of preparing and filing multiple legal entities—time that may not be available in a crisis.

A final aspect of the Act relating to executory contracts that differs from the Code concerns executory contracts to make loans. Under the Code, a debtor may not assume a contract to make a loan or to provide other financial accommodations to the debtor.[111] Thus, a debtor cannot compel a pre-petition lender to continue making loans to the debtor once it files bankruptcy. Under the Act, however, the FDIC may, as receiver, enforce any contract to extend credit to the covered financial company or bridge financial company.[112] If enforced, any obligation to repay such debt shall be an administrative expense of the receivership.[113]

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[108] *See infra* note 199 and accompanying text (detailing special protections to several classes of derivatives contracts).

[109] *See id.* (defining derivatives contracts or "qualified financial contracts").

[110] Act § 210(h)(2)(E), 12 U.S.C. § 5390(h)(2)(E) (Supp. 2010) (authorizing FDIC to create bridge financial company to succeed and assume rights, powers, authorities, and privileges of covered financial company).

[111] 11 U.S.C. § 365(c)(2) (2006).

[112] Act § 210(c)(13)(A), 12 U.S.C. § 5390(c)(13)(A).

[113] Act § 210(c)(13)(D), 12 U.S.C. § 5390(c)(13)(D).

D. Fraudulent Transfers and Preferential Transfers

Finally, the FDIC has the power under the Act to sue to avoid fraudulent transfers, preferences, and improper setoffs.[114] These powers are substantially similar to the powers afforded the FDIC, SIPC trustees and chapter 7 trustees in bank, broker-dealer, and chapter 7 liquidations, respectively.[115] Indeed, the statutory definitions of fraudulent transfers (transfers made while insolvent for less than reasonably equivalent value) and preferences (payments to or for the benefit of a creditor that allow the creditor to receive more than in a liquidation) are almost identical to the statutory definitions of these terms contained in the Code.[116] Moreover, the statutory defenses available to recipients of allegedly fraudulent or preferential transfers under the Act are the same as under other insolvency regimes.[117]

IV. EXPEDITED PROCESS FOR CREATION OF A RESTRUCTURED SUCCESSOR

Although Title II of the Act is titled "Orderly Liquidation Authority," a federal receivership under the Act will not necessarily result in the termination of a covered financial company's business, including the termination of all of its employees.[118] Of course, termination could be the result, not only under the Act, but also in connection with the insolvency of an entity under the Code or the FDIA. However, one of the purposes of the Act (though clearly not its sole, or even primary, purpose), the Code, and the FDIA, is to maximize value and creditor recovery, which is most frequently achieved through some form of restructuring of the troubled company's core business and balance sheet.[119] The Act includes

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[114] Act § 210(a)(11)(A)–(B), (12), 12 U.S.C. § 5390(a)(11)(A)–(B), (12) (enumerating methods for avoiding transfers and improper setoffs).

[115] *See, e.g.*, 12 U.S.C. § 1821(d)(17) (authorizing FDIC to avoid fraudulent transfers); 12 C.F.R. § 313.20 (2011) (authorizing FDIC to offset); 11 U.S.C. §§ 547(b), 548, 553 (authorizing chapter 7 trustee to avoid fraudulent transfers, preferences, and improper setoffs, respectively); 15 U.S.C. § 78fff-l(a) (vesting SIPC trustee with same powers and title with respect to debtor and property of debtor as trustee in bankruptcy case).

[116] *Compare* Act § 210(a)(11)(A), (B), 12 U.S.C. § 5390(a)(11)(A), (B) (enumerating ways in which Corporation may avoid fraudulent or preferential transfers, respectively), *with* 11 U.S.C. §§ 547(b), 548 (enumerating ways in which trustee may avoid preferential or fraudulent transfers, respectively).

[117] *Compare* Act § 210(a)(11)(F), 12 U.S.C. § 5390(a)(11)(F) (stating allowable defenses are same as and subject to sections 547, 548, and 549 of Code), *with* 11 U.S.C. §§ 547(c), 548(c), 550 (enumerating defenses to trustee avoidance powers), *and* 12 U.S.C § 1821(d)(17)(C) (prohibiting FDIC or conservator from recovering against good faith transferees). A rule issued by the FDIC seeks to harmonize aspects of the law of fraudulent transfers and preferences under the Act and the Code. Orderly Liquidation Authority, 76 Fed. Reg. 41,626, 41,641 (July 15, 2011) (to be codified at 12 C.F.R. § 380.9).

[118] *See* Act § 210(a)(1)(B), 12 U.S.C. § 5390(a)(1)(B) (allowing FDIC to perform duties in name of covered financial company).

[119] *See, e.g.*, Jamieson L. Hardee, Note, *The Orderly Liquidation Authority: The Creditor's Perspective*, 15 N.C. BANKING INST. 259, 276 (2011) (identifying goal of bankruptcy system to be maximization of creditor recovery).

mechanisms for achieving this result, although those mechanisms are much more similar to the mechanisms applicable to banks and savings and loans under the FDIA than the mechanisms under the Code.

In particular, as noted above, the FDIC has broad power to arrange for the sale of selected assets of a covered financial company to one or more private acquirers, subject to any applicable antitrust laws and other applicable agency review. Similarly, it may arrange for the merger of a covered financial company with one or more private acquirers, subject to the same antitrust and other regulatory qualifications.[120] In connection with any sale or merger, the FDIC can arrange for the acquirer to assume selected contracts and liabilities, including outstanding derivatives contracts.[121]

The FDIC may facilitate such transactions without advance notice to, input from, or consent of creditors, shareholders and contract counter-parties. Moreover, no party in interest can challenge any such transaction, as a fraudulent conveyance or otherwise, because the Act divests the courts of power to entertain any challenges to, or to restrain, any such transactions.[122]

Arguably, there are reasonable explanations for the broad authority granted the FDIC under the Act. Financial services businesses are relatively fragile enterprises. They are not comprised of "bricks and mortar," and they do not sell physical goods. They instead are comprised of people—ideas and talent—and they sell advice, trust and confidence. These are businesses that cannot easily weather the storm and delays of contested court proceedings. Accordingly, if a financial company is to have any chance at salvaging a core enterprise for the benefit of all, and if there is to be any chance of doing so in a fashion designed to ensure stability to the economy as a whole, the sale and restructuring of that core enterprise must occur very rapidly under the supervision of an independent authority with industry expertise and broad power to broker transactions on very short notice.

Indeed, this is typical of how the FDIC handles many bank insolvencies.[123] For example, the FDIC may begin working behind the scenes with a troubled bank's board and possible suitors, then implement a transaction after hours on a Friday afternoon and before the "new" bank opens for business the ensuing Monday morning. This does not ensure that all creditors necessarily will be paid in full, but depositors and other customers necessary to the franchise are protected, at least to some extent, thereby enhancing value for creditors and providing confidence in the

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[120] *See* Act § 210(a)(1)(G), 12 U.S.C. § 5390(a)(1)(G).

[121] *See* Act § 210(h)(3), 12 U.S.C. § 5390(h)(3)(A) (authorizing transfer of any asset or liability chosen by FDIC).

[122] Act § 210(a)(9)(D), (e), 12 U.S.C. § 5390(a)(9)(D), (e) (stripping courts of jurisdiction over challenges to actions taken by receiver and prohibiting courts from taking "action to restrain or affected the exercise of powers for functions of the receiver . . . .").

[123] *See* 12 U.S.C. § 1821(d) (prescribing powers of FDIC as receiver in bank liquidation).

financial system.[124] This was similar to the approach taken by the government in facilitating expedited takeovers of financial firms in the fall of 2008.

The foregoing can be contrasted with the process under the Code. Under the Code, a troubled company can sell its operating business free and clear of, or subject to, selected liabilities, but only after notice to all stakeholders, an opportunity for such stakeholders to be heard, and entry of an order by a bankruptcy court approving the sale as in the best interests of the estate.[125] Also under the Code, a troubled company can restructure its operations and liabilities pursuant to a plan of reorganization, but only after impaired stakeholders are provided a detailed disclosure statement describing the plan, impaired stakeholders have been afforded an opportunity to vote to accept or reject the plan or to object to it, and the bankruptcy court has found that the plan complies with numerous requirements imposed by the Code designed to ensure that the plan is fair and feasible.[126]

Despite these additional procedural protections and avenues for stakeholder input, the Code nonetheless affords bankruptcy courts significant flexibility to conduct expedited processes, though minimum standards of due process reflected in the provisions of the Code and related rules requiring some advance notice and an opportunity to be heard necessarily limit this flexibility.[127] This flexibility is demonstrated by cases such as CIT, noted above, where a very large financial institution was able to restructure its affairs under chapter 11 is a very limited period of time.

The same is true of the reorganization proceedings of other large, non-financial companies that are systemically important, including Chrysler and General Motors. The Lehman bankruptcy, however, underscores the practical limits on the effectiveness of process under the Code. Lehman filed its petitions on Sunday September 15, 2008, followed the next day by an announcement of its intention to sell its business to Barclays.[128] The bankruptcy court held a hearing on the proposed sale only four days later, and promptly approved the sale at the hearing.[129]

The bankruptcy court was persuaded to follow this virtually unprecedented timeline based upon its conclusion that Lehman's business was a "melting ice cube"[130]—a concern typical whenever a financial company is in distress.

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[124] *See* Marie T. Reilly, *The FDIC as Holder in Due Course: Some Law and Economics*, 1992 COLUM. BUS . L. REV. 165, 175 (1992) (noting FDIC prefers to keep banks operating in order to maintain consumer confidence in banking system).

[125] 11 U.S.C. § 363(b), (f) (2006). The type of notice required in any given case varies considerably based on the particular circumstances.

[126] *Id.* at §§ 1123, 1125, 1129 (delineating specific requirements of troubled companies undergoing restructuring).

[127] *See, e.g., id.* at § 363(b)(1) (describing notice requirement, including hearing, for sale of property by trustee outside of ordinary course of debtor's business). *But see id.* at § 102(1)(B) (authorizing circumstances where hearing not required given proper notice).

[128] *See In re* Lehman Bros. Holdings, Inc., 415 B.R. 77, 78 (Bankr. S.D.N.Y. 2009) (noting sale of Lehman Brothers to Barclays within days of Lehman's bankruptcy filing).

[129] *Id*. at 79 (affirming order of sale of Lehman to Barclays on September 20, 2008).

[130] *See In re* Lehman Bros. Holdings Inc., 445 B.R. 143, 180–81 (Bankr. S.D.N.Y. 2011) (providing rationale for approving § 363 sale).

Customers were rapidly withdrawing their accounts, resulting in dwindling prospects for Lehman's business.[131] Only by effectuating a rapid sale to a financially stable party could this exodus be stopped. The downside to this approach, however, is that there was considerable confusion at the time regarding the precise scope and value of the assets being sold and the liabilities that ultimately were assumed. Indeed, over two years after the sale was approved, Lehman and Barclays remained embroiled in litigation over the terms of the sale.[132] This confusion arguably could be minimized when a regulator who is more schooled in the intricacies of the financial services industry exercises unilateral control over the process.

Indeed, the Act provides a mechanism to address situations, such as that presented by Lehman, where the government simply may not have enough time to facilitate a private transaction prior to commencing receivership proceedings. In particular, the FDIC may create a "bridge financial company" to succeed to selected assets and liabilities of the covered financial company or covered broker dealer.[133] A bankruptcy court does not have any such power under the Code.

A bridge financial company can be created without notice to, input from, or consent of, any creditors or shareholders. It can be created without the need to obtain approval from a court.[134] The bridge company need not be funded with capital or surplus,[135] though the aggregate amount of liabilities assumed by a bridge company may not exceed the aggregate amount of assets that are transferred to it.[136] Once created, the bridge company is to be managed by a board of directors appointed by the FDIC.[137] The bridge company may follow the corporate governance rules of Delaware or the state in which the applicable covered financial company is organized.[138] Upon approval of its articles of association by the FDIC, a bridge financial company created with respect to a covered broker-dealer is deemed registered with the SEC and a member of SIPC.[139]

Notwithstanding this broad grant of power to the FDIC, the Act does restrict the transfer of assets or liabilities of a covered financial company or broker-dealer. First, the Act requires the FDIC to treat similarly-situated creditors equally when transferring the assets or liabilities of the covered financial company to a bridge company.[140] The FDIC need not comply with this principle, however, if it determines that unequal treatment is necessary to maximize the value and returns

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[131] *See id*. at 155 (describing rapid destruction of longstanding Wall Street institutions).

[132] *See id*. at 181 (noting two and a half years passed from Sale Hearing to Sale Order).

[133] Act § 210(h), 12 U.S.C. § 5390 (h) (Supp. 2010) (authorizing FDIC to create bridge financial companies and select which liabilities to assume and assets to buy from covered financial company).

[134] *See* Act § 210(e), 12 U.S.C. § 5390(e) (prohibiting courts from interfering with powers of FDIC in receivership).

[135] Act § 210(h)(2)(E), (h)(5), (G), 12 U.S.C. § 5390(h)(2)(E), (h)(5), (G) (allowing bridge financial companies to operate without capital or surplus).

[136] Act § 210(h)(5)(F), 12 U.S.C. § 5390(h)(5)(F) (limiting aggregate amount of transferrable liabilities).

[137] Act § 210(h)(2)(B), 12 U.S.C. § 5390 (h)(2)(B).

[138] Act § 210(h)(2)(F), 12 U.S.C. § 5390(h)(2)(F).

[139] Act § 210(h)(2)(H)(i), 12 U.S.C. § 5390(h)(2)(H)(i)

[140] Act § 210(h)(5)(E), 12 U.S.C. § 5390(h)(5)(E).

from the assets or minimize the amount of loss upon sale of the assets.[141] This exception could, as a practical matter, swallow the general rule, as there is no mechanism for creditors to challenge the FDIC's determination. At a minimum, similarly-situated creditors must receive at least the amount they would have received in a liquidation under chapter 7 of the Code and, with respect to the property of a customer of a covered broker or dealer, the same it would have received in a liquidation initiated by SIPC.[142]

Second, the Act requires that, if the FDIC establishes a bridge company with respect to a covered broker-dealer, all customer accounts of the covered broker-dealer shall be transferred to the bridge company.[143] An exception can be made to this requirement only if the FDIC determines, after consulting with the SEC and SIPC, that the customer accounts are likely to be quickly transferred to another covered broker-dealer, or the transfer of the accounts to a bridge company would materially interfere with the FDIC's ability to avoid or mitigate serious adverse effects on the financial stability of the United States.[144]

A bridge company is not meant to have perpetual existence. Rather, it is a temporary creation designed to serve, as its name suggests, as a "bridge" to a permanent transaction with a private acquirer. To ensure a reasonably prompt transaction, a bridge company established under the Act terminates two years after it is granted its charter, although the FDIC has the discretion to extend such status for three additional one-year periods.[145] A bridge company will terminate if it merges with or sells the majority of its assets to a company that is not another bridge company.[146] The FDIC, however, has the ultimate discretion under the Act to dissolve the bridge company at any time.[147] During the life of a bridge company, the FDIC is not subject to the discretion or supervision of any other governmental agency regarding the assets, liabilities, and ultimate disposition of a bridge company.[148]

As noted later in this article, market turbulence dire enough to jeopardize one systemically important company will jeopardize others as well. If this country ever again faces the sort of near-collapse that it experienced in the fall of 2008, the practical result could be the temporary nationalization of many, major financial

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[141] Act § 210(h)(5)(E)(i), 12 U.S.C. § 5390(h)(5)(E)(i) (providing exception to general rule).
[142] Act § 210(h)(5)(E)(ii), 12 U.S.C. § 5390(h)(5)(E)(ii).
[143] Act § 210(a)(1)(O)(i), 12 U.S.C. § 5390(a)(1)(O)(i).
[144] Act § 210(a)(1)(O)(i)(I), 12 U.S.C. § 5390 (a)(1)(O)(i)(I).
[145] Act § 210(h)(12), 12 U.S.C. § 5390 (h)(12).
[146] Act § 210(h)(13), 12 U.S.C. § 5390 (h)(13). Specifically, a bridge company terminates automatically upon (i) merger or consolidation with a company that is not a bridge company or (ii) the sale of 80% or more of its capital stock to a person other than the FDIC or another bridge company. Act § 210(h)(13)(A), (C), 12 U.S.C. § 5390 (h)(13)(A), (C). At the election of the FDIC, a bridge company may terminate upon (i) the sale of a majority of the capital stock of the bridge company to a company other than the FDIC or another bridge company or (ii) the assumption of all or substantially all the liabilities, or the acquisition of all or substantially all of the assets, of the bridge company by a company that is not a bridge company. Act § 210(h)(13)(B), (D), 12 U.S.C. § 5390(h)(13)(B), (D).
[147] Act § 210(h)(15), 12 U.S.C. § 5390(h)(15).
[148] Act § 210(h)(15)(B), 12 U.S.C. § 5390(h)(15)(B).

institutions. In particular, the FDIC could find itself the de facto owner of several such institutions due to the emergency creation of one or more bridge financial companies for each.

V. PROVISIONS FOR PAYING FOR THE PROCESS

A. Mechanisms for Interim Funding

The Act reflects the public's negative response to government rescues of numerous financial institutions. Indeed, the Act includes a statement of principles in this regard. First, the Act provides that "no taxpayer funds shall be used to prevent the liquidation of any financial company under [the legislation]."[149] Second, to drive home the point, the Act provides that "taxpayers shall bear no losses from the exercise of any authority under this title."[150] Third, the Act provides that creditors and shareholders must bear all losses in connection with the liquidation of a covered financial company,[151] and that the FDIC shall "not take an equity interest in, or become a shareholder of, any covered financial company."[152]

This last point is important: many of the bailouts in 2008 and 2009 took the form of government purchases of stock in the troubled companies.[153] The Act ostensibly closed off that avenue—though curiously, it actually does not expressly prohibit government agencies other than the FDIC from purchasing stock in troubled companies. Finally, the Act provides that "[a]ll funds expended in the liquidation of a financial company under this title shall be recovered from the disposition of assets of such financial company, or shall be the responsibility of the financial sector, through assessments" (discussed below).[154]

While the Act contemplates other financial companies being ultimately responsible for the costs of a liquidation if assets are insufficient, the Act affords means by which the FDIC nonetheless can incur interim debt obligations to fund a liquidation, which can later be recovered through assessments. Specifically, upon appointment as receiver, the FDIC is authorized to issue obligations to the Secretary to fund the liquidation.[155] The Secretary, in turn, may purchase such obligations and may, for such purposes, issue public debt securities.[156]

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[149] Act § 214(a), 12 U.S.C. § 5394(a).
[150] Act § 214(c), 12 U.S.C. § 5394(c).
[151] Act § 204(a)(1), 12 U.S.C. § 5384(a)(1).
[152] Act § 206(6), 12 U.S.C. § 5386(6).
[153] *See, e.g.*, Matthew R. Shahabian, Note, *The Government As Shareholder and Political Risk: Procedural Protections in the Bailout*, 86 N.Y.U. L. REV. 351, 351–52 (2011) (noting Treasury Department became largest shareholder of large corporations in wake of government bailouts).
[154] Act § 214(b), 12 U.S.C. § 5394(b); *see infra* text accompanying notes 169–87.
[155] Act § 210(n)(5)(A), 12 U.S.C. § 5390(n)(5)(A).
[156] Act § 210(n)(5)(B), (E), 12 U.S.C. § 5390(n)(5)(B), (E) (citing chapter 31 of title 31 of the United States Code and granting Secretary authority to purchase obligations and issue public debt securities for such purposes).

However, the Act limits the amount of debt that the FDIC may incur for each financial company. During the first 30 days after the FDIC's appointment as receiver, the amount of debt is limited to a maximum amount equal to 10% of the financial company's total consolidated assets based on its most recent financial statement. Thereafter, the debt limit equals 90% of the fair value of the total consolidated assets of the financial company that are available for repayment.[157]

No debt provided pursuant to that 90% limit, however, may be incurred unless the Secretary and the FDIC first agree to a "specific plan and schedule to achieve the repayment" of any such debt.[158] The plan must demonstrate that income to the FDIC from liquidated assets and assessments will be sufficient to amortize the debt within the period established in the repayment schedule.[159] The Secretary and the FDIC must consult with the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives on the terms of any repayment schedule agreement.[160]

It is not entirely clear how these limitations on debt incurrence would work in an actual crisis. One of the fundamental problems during the crisis of 2008 was the inability of institutions, their stakeholders, and the government to make intelligent assessments of the values of very complicated, opaque financial assets. The problem was exacerbated by a bursting housing bubble that resulted in historic, valuation assumptions being not only questioned, but completely shredded. A recurrence of such systemic market confusion will make application of these debt incurrence limits guesswork at best.

Indeed, while the Act contains broad prohibitions on the use of taxpayer funds to finance a liquidation, there are exceptions. The FDIC may, "in its discretion" and as "necessary or appropriate," make available to the receivership funds for the orderly liquidation of a covered financial company.[161] All such funds are afforded priority in payment.[162] Similarly, the FDIC may provide funding to facilitate transfers to or from a bridge financial company.[163] Lastly, a bridge financial company is authorized to obtain its own financing, including financing secured by a lien that is senior to existing liens.[164] The terms governing such financing are

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[157] Act § 210(n)(6), 12 U.S.C. § 5390(n)(6) (setting maximum debt limit FDIC may assume for each financial company after first 30 days subsequent to appointment as receiver).

[158] Act § 210(n)(9)(B)(i)(I), 12 U.S.C. § 5390(n)(9)(B)(i)(I).

[159] Act § 210(n)(9)(B)(i)(II), 12 U.S.C. § 5390(n)(9)(B)(i)(II).

[160] Act § 210(n)(9)(B)(ii)(I), 12 U.S.C. § 5390(n)(9)(B)(ii)(I).

[161] Act § 204(d), 12 U.S.C. § 5384(d) (defining FDIC's discretionary power in financing of financial company's liquidation).

[162] *Id.*

[163] Act § 210(h)(9), 12 U.S.C. § 5390(h)(9).

[164] Act § 210(h)(16), 12 U.S.C. § 5390(h)(16). In particular, the Act provides that the FDIC may authorize a bridge company to obtain credit or issue debt that is secured by a lien which is senior to existing liens only after a notice and a hearing before a court. Act § 210(h)(16)(C), 12 U.S.C. § 5390(h)(16)(C).

identical to those by which debtors under the Code may obtain financing, including the requirement of court approval, one of the only instances in the Act for same.[165]

B. Risk-Based Assessments

The FDIC is required to charge "one or more risk-based assessments" if necessary for it to pay in full the obligations issued by the FDIC to the Secretary within 60 months of the date of issuance of the obligations, or a later date if an extension is necessary to avoid a serious adverse effect on the financial system.[166] These assessments must first be made against any claimant that received additional payments from the FDIC pursuant to its authority to treat some creditors more favorably than others, as described above.[167] Any assessment against a claimant must be in an amount equal to the difference between the aggregate value the claimant received from the FDIC on its claim under the Act, on the one hand, and the value the claimant was entitled to receive solely from proceeds of the liquidation of the covered financial company, on the other hand.[168] This calculus, while easy to express in words, could be extraordinarily difficult to do in practice, requiring estimated recoveries in hypothetical liquidations. Creditors are afforded no ability to challenge the FDIC's assessments.

If the funds recouped from claimants are insufficient to satisfy the obligations to the Secretary, then the FDIC may assess "eligible financial companies" and certain other financial companies after the fact.[169] "Eligible financial companies" include any bank holding company with total consolidated assets equal to or greater than $50 billion and any nonbank financial company supervised by the Board of Governors.[170] Assessments must be imposed on a "graduated basis," with financial companies having greater assets being assessed at higher rates.[171] Moreover, in imposing assessments, the FDIC must use a "risk matrix."[172]

The Council shall make a recommendation to the FDIC on the risk matrix to be used. In recommending or establishing such risk matrix, the Council and the FDIC, respectively, must take into account a host of factors including, among others, economic conditions generally; the extent to which a particular financial company may already be subject to assessments imposed pursuant to other statutory regimes; the risks presented by the assessed financial company to the financial system and the extent to which it has benefited, or likely would benefit, from the orderly liquidation of a financial company; and any risks presented by the assessed financial

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[165] *Compare* Act § 210(h)(16), 12 U.S.C. § 5390(h)(16) (governing how bridge financial company may obtain credit), *with* 11 U.S.C. § 364 (2006) (detailing how trustee may obtain financing in bankruptcy).
[166] Act § 210(o)(1)(B), (C), 12 U.S.C § 5390(o)(1)(B), (C).
[167] *Supra* text accompanying notes 90–93 (describing priority of payments in orderly liquidation process).
[168] Act § 210(o)(1)(D)(i), 12 U.S.C. § 5390(o)(1)(D)(i).
[169] Act § 210(o)(1)(D)(ii), 12 U.S.C. § 5390(o)(1)(D)(ii).
[170] Act § 210(o)(1)(A), 12 U.S.C. § 5390(o)(1)(A).
[171] Act § 210(o)(2), 12 U.S.C. § 5390(o)(2).
[172] Act § 210(o)(4), 12 U.S.C. § 5390(o)(4).

company during the 10-year period immediately prior to the appointment of the FDIC as receiver for the covered financial company that contributed to the failure of the covered financial company.[173]

Again, there appears to be no mechanism for financial companies to challenge the efficacy of these assessments. And while these factors undergirding the risk matrix arguably make sense as a matter of policy in allocating systemic costs, there is an unquestionable risk of arbitrariness in their actual application. Indeed, while, as noted above, it will be complicated to estimate the extent to which one creditor benefited from a resolution, matters became geometrically more complex when estimating fair assessments across an entire industry, many of whose participants could be very weak after a major economic shock like the country experienced in 2008.

In any event, funds raised by the FDIC through borrowings from the Secretary and through assessments on the financial sector are to be deposited into the Treasury in a separate fund known as the "Orderly Liquidation Fund."[174] Amounts in the Fund are available to the FDIC to carry out its responsibilities under the Act, including the payment of principal and interest on obligations it issues to the Secretary.[175] However, the FDIC may utilize amounts in the Fund with respect to a covered financial company only after the FDIC has developed an orderly liquidation plan that is acceptable to the Secretary.[176]

An alternative to recouping losses from financial institutions that was contained in the House Bill and in early versions of the Act was the creation of a pre-funded reserve—$150 billion in the House Bill and $50 billion in early versions of the Act.[177] A pre-funded reserve was strongly supported by Sheila C. Bair, former Chairman of the FDIC. Chairman Bair argued that having a reserve built up in advance would prevent the need to assess financial institutions during an economic crisis and would allow firms to better manage their expenses.[178] It would also assure that the failed firm contributed to the reserve so that all costs would not be borne by surviving firms.[179] Additionally, a pre-funded reserve ostensibly would reduce the likelihood of any taxpayer funding.[180] In a system where assessments are made after the fact, however, the initial funding necessary to provide working capital must be

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[173] Act § 210(o)(4), 12 U.S.C. § 5390(o)(4) (listing necessary considerations in establishing risk matrix).

[174] Act § 210(n)(1), (2), 12 U.S.C. § 5390(n)(1), (2) (establishing "Orderly Liquidation Fund" for FDIC receipts to be deposited).

[175] Act § 210(n)(1), 12 U.S.C. § 5390(n)(1).

[176] Act § 210(n)(9), 12 U.S.C. § 5390(n)(9).

[177] Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 1609(n) (2009) (enacted) (establishing, in House Bill, $150 billion pre-funded reserve).

[178] *Federal Deposit Insurance Corporation on the Causes and Current State of the Financial Crisis before the Financial Crisis Inquiry Commission*, 38 (2010) (statement of Shelia C. Bair, Chairman, FDIC), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2010-01-14%20Sheila%20Bair%20Written%20Testimony.pdf.).

[179] *Id.*

[180] *Id*. (stressing importance that funding come from financial firms and not taxpayers).

borrowed from the Secretary.[181] Such borrowing could be politically charged because it may be seen as a government bailout, or so the argument went.[182]

Despite the practical and political reasons to establish a pre-funded reserve, opponents successfully argued that the existence of a pre-funded reserve would create a moral hazard and increase imprudent risk taking—the very behavior the Act as a whole was designed to curb. Accordingly, the Act adopted the after-the-fact assessment funding mechanism instead.[183]

C. Potential Consequences of Assessments

The Act's provisions for recouping the costs of liquidating a covered financial company through after-the-fact assessments on the financial sector afford the FDIC considerable leverage in attempting to broker private rescues of troubled financial companies. As noted above,[184] private restructuring solutions almost invariably are more value-additive, less expensive, and less risky than those that must be implemented through a formal process. For this reason, the government frequently attempts to facilitate private, consensual solutions regarding troubled banks and other regulated entities.[185] For this same reason, stakeholders of other business entities typically try to develop out-of-court solutions among themselves.[186]

But with the hammer afforded by the assessment provisions, the FDIC will have significantly greater ability to compel financial counterparties to a troubled entity to develop a solution—and pay for it—themselves, without the need for a receivership. Financial counterparties in such a situation should have an incentive to do so, as the potential fallout and costs of a receivership easily could be much greater than if the parties are able to develop and implement a private, non-receivership solution themselves.

The exemplar of an effective out-of-court process in the financial services industry is the restructuring of Long-Term Capital Management.[187] In 1998, Long-Term Capital was a $100 billion dollar hedge fund that was teetering on the brink of collapse.[188] Given the size of Long-Term Capital—it was party to over $1.4 trillion

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[181] *Id*. at 39 (proposing necessary funds be borrowed from Treasury).

[182] *Id*. (stating ex-post funding would be viewed by public negatively as governmental bailout).

[183] 111 CONG. REC. S3224 (daily ed. May. 5, 2010) Amendment No. SA3827 to Act, proposed by Mr. Shelby (amending Senate bill to delete provision that would have established a pre-funded reserve).

[184] *Supra* note 59, and accompanying text (arguing that private resolutions give financially distressed company best chance to reorganize).

[185] *See* Act § 203(b)(3), 12 U.S.C § 5383 (b)(3) (Supp. 2010) (requiring Secretary first seek private solutions).

[186] DJ Baker, John Butler Jr., & Sally M. Henry, *Leading Companies in Financial Distress: Key Issues for Chief Executives*, THE AMERICAS RESTRUCTURING & INSOLVENCY GUIDE 2008/2009 21, 21 (noting companies and stakeholders prefer private solutions to bankruptcy).

[187] *See* PRESIDENT'S WORKING GRP. ON FIN. MKTS., REP. ON HEDGE FUNDS, LEVERAGE, & THE LESSONS OF LONG-TERM CAPITAL MGMT. 12–14 (Apr. 1999) (demonstrating restructuring process of Long Term Capital Management).

[188] *See id.* at 10–12 (highlighting background information about Long-Term Capital and its significant global investment positions).

gross notional amount in outstanding trades—counterparties and the government feared that the company's failure would cause a chain reaction in the markets, leading to catastrophic losses throughout the financial system.[189] To avoid a systemic failure, the Board of Governors convened an emergency session of a consortium of several major Wall Street investment houses at which it effectively "passed the hat."[190]

All participants at the meeting (other than Bear Sterns) agreed that it was in their interests to prop up Long Term Capital, even though it was a rival to many of them, rather than risk the potential consequences of its failure.[191] The participants paid a total of $3.625 billion and received in exchange 90% of Long-Term Capital's equity as well as operational control of the company.[192] By 2000, the participants had been repaid.[193] If a similar situation arises in the future, the FDIC can "pass the hat" again—while telling counterparties that they can "pay now", or they can be forced to "pay later" under circumstances that may entail significantly greater cost.

VI. CRITICAL PROVISIONS REGARDING DERIVATIVES

As noted above,[194] the Act contains numerous provisions regarding the transfer and repudiation of contracts and leases and the related rights of non-debtor parties under various scenarios. The Act also contains separate provisions that afford special protections to derivatives agreements and the rights of derivatives counterparties, protections that are not available in connection with other agreements. In this regard, the Act is consistent with existing law regarding the treatment of derivatives under the Code and the FDIA.

In particular, each of these statutory regimes extends special protections to several classes of derivatives contracts—which are called "qualified financial contracts" under the Act and the FDIA—including repurchase agreements, securities contracts, forward contracts, commodity contracts, and swap agreements and, in each instance, specifically-defined classes of counterparties.[195] The definitions of each of these categories of agreements and protected counterparties

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[189] *See id*. at 11–12, 29 (discussing Long-Term Capital's near collapse and potential effects such collapse would have had on financial system).

[190] *See id.* at 13–14 (describing events in September 1998 leading to consortium of financial firms investing in Long-Term Capital to avoid default).

[191] *See id*. (noting that "fourteen firms agreed to participate in the consortium [at] [t]he Federal Reserve Bank of New York").

[192] *See id*. at 14 ("The firms participating in the consortium invested about $3.6 billion in new equity in the fund, and in return received a 90 percent equity stake in LTCM's portfolio along with operational control.").

[193] *See* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MGMT. 229 (Random House 2000).

[194] *See supra* Part 3c (examining ability of FDIC to repudiate contracts or leases of financial company).

[195] *Compare* Act § 210(a)(8), 12 U.S.C. § 5390(a)(8) (Supp. 2010) (detailing special statutory protections provided for each "qualified financial contract"), *with* 11 U.S.C. §§ 555, 556, 559, 560, 561 (2006) (identifying special protections afforded various classes of financial contracts), *and* 12 U.S.C. § 1821(e)(8) (protecting certain financial contracts during bank liquidation).

are largely the same in the Act, the Code, and the FDIA.[196] Each regime provides that selected non-debtor counterparties to such agreements are free to exercise their contractual rights to terminate, close-out, and liquidate their positions upon the insolvency of their counterparties.[197] This is the reverse of the general rule governing virtually all other agreements: clauses in such agreements that allow a non-debtor to terminate an agreement based upon the financial condition of, or the commencement of insolvency proceedings with respect to, a counterparty are usually unenforceable.[198]

The ostensible rationale behind the special protections afforded counterparties to qualified financial contracts is that the use of such contracts is so prevalent—the amounts involved are so large; the contracts trade so quickly; and such contracts have resulted in financial institutions becoming so highly interconnected and interdependent—that non-debtor counterparties must be free to close out their contracts immediately upon an insolvency event, or else the fallout from the failure of one institution will have uncontrollable, cascading effects across countless trading parties and other institutions. By being able to terminate and close-out qualified financial agreements immediately, the effects of one firm's financial collapse will be contained to that one institution, or so the argument goes.

While this has been the long-standing policy behind the special protections afforded qualified financial contracts—it was, in part, what motivated counterparties to support Long-Term Capital—this policy has not been without controversy.[199] Indeed, at one point during the debate over the bill that ultimately became the Act, Senator Bill Nelson proposed an amendment to the bill that would have repealed the Code protections altogether.[200] The amendment was not adopted, but the fact that it was proposed—along with the numerous other provisions of the

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[196] *Compare* Act § 210(c)(8)(D), 12 U.S.C. § 5390(c)(8)(D) (enumerating types of qualified financial contracts under Act), *with* 11 U.S.C. § 101(25), (53B) (defining various kinds of financial contracts under Code, including forward contracts and swap agreements, respectively), *and* 12 U.S.C. § 1821(e)(8)(D)(i) (defining qualified financial contract under FDIA).

[197] *See* Act § 210(c)(8), 12 U.S.C. § 5390(c)(8) (preserving right to terminate, liquidate, or accelerate qualified contracts with covered financial company); 12 U.S.C. § 1821(e)(8) (maintaining right to terminate, liquidate, or accelerate qualified contract with insured depository institution); 11 U.S.C. §§ 555, 556, 559, 560, 561 (protecting right of parties to terminate, close-out, and liquidate their positions in securities contracts, commodities or forward contracts, repurchase agreements, swap agreements and master netting agreements).

[198] Act § 210(c)(13)(C)(i), 12 U.S.C. § 5390(c)(13)(C)(i) (preventing termination, acceleration, or declaration of default under ordinary contracts without consent of FDIC for ninety days from the date of the appointment of the FDIC as receiver); 11 U.S.C. § 365(e)(1) (prohibiting termination of executory contracts); 11 U.S.C. § 541(c) (stating that interest of debtor in property becomes property of estate, eliminating effect of forfeiture, modification, or termination of debtor's interest); 12 U.S.C. § 1821(e)(10)(B) (temporarily prohibiting party from exercising right to terminate, liquidate, or net qualified financial contract until 5 p.m. (eastern time) one business day following the appointment of the receiver, or after the person has received notice that the contract has been transferred pursuant to 12 U.S.C. § 1821(e)(9)(A)).

[199] *See, e.g.*, Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. PA. J. BUS. L. 61, 73–78 (2009) (discussing weaknesses and limitations of granting derivatives special protections in bankruptcy proceedings).

[200] *See* 156 CONG. REC. S2974 (daily ed. Apr. 29, 2010) (statement of Sen. Bill Nelson) (proposing elimination of safe harbor provision in the Code).

Act that provide for significant regulation of, and that require far greater transparency with respect to, derivatives trades—clearly indicates that the long-standing policy regarding favorable treatment of qualified financial contracts is not universally shared and has been, at least in part, scaled back.[201]

Indeed, the recent failures of many businesses that rely on derivatives, most notably Lehman, have demonstrated that when the financial condition of a derivatives counterparty begins to decline, events tend to move with alarming speed that are not easily contained. This is partly because, under many derivatives contracts, counter-parties mark the values of their positions daily, margin calls must be met within one or two days, and counter-parties frequently have considerable discretion determining market values and, hence, the amounts of their margin calls. As a result, when a company experiences financial trouble—or even a market rumor of trouble—confidence vanishes, the rate of margin calls can spike, and the company therefore can find itself in a liquidity crisis overnight.

This was the fate of the roughly 150 mortgage lenders who have filed bankruptcy since early 2007.[202] When their counterparties lost confidence, liquidity vanished. Virtually all of these lenders collapsed into bankruptcy court. None of them reorganized in the traditional sense. Their only option was rapid sales of their servicing platforms. Some entities in the mortgage securities business did not even have that option. When markets experienced major dislocations and counterparties of funds sponsored by Bear Sterns and Carlyle Capital marked down the value of their securities and made margin calls, the funds were unable to meet the margin calls, counterparties closed out their positions and liquidated tens of billions of dollars in total asset positions in a matter of days, and each fund was left to dissolve pursuant to offshore liquidation regimes, as there simply was nothing to achieve in a proceeding under the Code.[203]

It is perhaps in part because of the fallout from these recent experiences that the Act contains important limitations on typical contractual rights of derivatives counterparties. In particular, the Act prohibits a protected party from terminating, liquidating, or netting out its position solely by reason of the appointment of the FDIC as receiver or the financial condition of the financial company in receivership

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[201] Only a few short years ago, insolvency laws relating to derivatives were actually expanded. In particular, the Code and the FDIA were amended in 2005, and again in 2006, to significantly expand the protections afforded derivatives and the rights of non-debtor counterparties. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109–8, 119 Stat. 23 (2005), (codified throughout Title 11 of United States Code). The changes included much more comprehensive definitions of the categories of protected contracts designed to reflect the dramatic growth in the diversity of sophisticated financial products that occurred in the 1990s and early 2000s. Of particular significance, the definition of qualifying repurchase agreements was expanded to cover mortgage loans and mortgage-related securities. *Id.* at § 901(e)(2)(v)(I) (defining repurchase agreement as "an agreement, including related terms, which provides for the transfer of one or more . . . mortgage related securities").

[202] *See, e.g.*, Mark Gongloff, *How Investors Might Ride Out Market Malaise*, WALL ST. J., Dec. 3, 2007, at C1 (explaining fallout from financial crises).

[203] *See* Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007–2008*, 23 J. ECON. PERSP. 77, 88 (2009) (analyzing how mounting pressure prevented Bear Stearns and Carlyle Capital from meeting margin calls leading to liquidation of assets).

until 5:00 p.m. eastern time on the next business day following the date of appointment of the FDIC.[204] A protected party also is permanently precluded from exercising any such contractual rights after it has received notice that its qualified financial contract has been transferred to another financial institution[205]—including a bridge financial company.[206] The Act requires the FDIC to notify a protected party of any such transfer by 5:00 p.m. eastern time on the next business day following the date of appointment of the FDIC.[207]

These provisions have no parallel in the Code, although the FDIA also provides for a one-day moratorium.[208] Their collective effect is to afford the FDIC one business day after its appointment either to consummate a transfer of a qualified financial contract to a private acquirer, or to transfer it to a newly-created bridge company. Absent one of these two types of transfers within the allotted time-frame, counterparties may exercise their contractual rights.[209] While this period of time is brief, and while the Act does not afford the FDIC any power to attack pre-receivership terminations and closeouts of qualified financial contracts (except in the case of intentional fraud), this limited moratorium could afford considerable stability in the early days of a receivership, thereby avoiding the type of firestorm that engulfed Lehman Brothers when it filed for bankruptcy as thousands of counterparties terminated their contracts and liquidated their positions.

Another limitation on the rights of derivatives counterparties relate to so-called "walkaway" clauses. In the typical derivatives contract, when the contract is terminated, the party who is out of the money must pay the party who is in the money.[210] A walkaway clause overrides this provision by affording the nondefaulting party the right to walk away from a termination payment it otherwise would owe the defaulting party.[211] It may also give the nondefaulting party the right to suspend periodic payments it otherwise may owe to the defaulting party under the contract, an option the nondefaulting party may exercise in lieu of termination in the hope that favorable market movements will reduce any amount owed to the defaulting party.[212]

The Act defines a walkaway clause, in part, as follows: "any provision in a qualified financial contract that suspends, conditions, or extinguishes a payment

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[204] Act § 210(c)(10)(B)(i)(I), 12 U.S.C. § 5390(c)(10)(B)(i)(I).

[205] Act § 210(c)(10)(B)(i)(II), 12 U.S.C. § 5390(c)(10)(B)(i)(II) (excluding individual from exercising right after receiving notice).

[206] Act § 210(c)(9)(D), 12 U.S.C. § 5390(c)(9)(D) (including bridge financial company as qualifying financial institution for transfers).

[207] Act § 210(c)(10)(A)(ii), 12 U.S.C. § 5390(c)(10)(A)(ii).

[208] Federal Deposit Insurance Act, 12 U.S.C. § 1821(e)(10)(B) (2006) (prohibiting actions by protected party until 5:00 p.m. on following business day, or after such party has received notice of transfer of contract).

[209] Act § 210(c)(10)(B), 12 U.S.C. § 5390(c)(10)(B).

[210] *See In re* Lehman Bros. Holdings, Inc., No. 08-13555 (JMP), 2011 WL 1831779, at *2 (Bankr. S.D.N.Y. May 12, 2011) (referring to one such payment plan as "recognized industry methodology").

[211] Act § 210(c)(8)(F)(iii), 12 U.S.C. § 5390(c)(8)(F)(iii) (defining "walkaway clause").

[212] Act § 210(c)(8)(F)(ii), 12 U.S.C. § 5390(c)(8)(F)(ii) (allowing suspension of certain contract obligations).

obligation of a party . . . solely because of the status of such party as a nondefaulting party in connection with the . . . appointment of [the FDIC] as receiver for [a] covered financial company . . . ."[213] The Act provides that no walkaway clause shall be enforceable in a qualified financial contract of a covered financial company in default.[214] It further states that a counterparty may suspend a payment or delivery obligation only for a limited period of time: one day following appointment of the FDIC as receiver.[215] Thereafter, the counterparty must perform.

There are no provisions parallel to these limitations in the Code or SIPA.[216] However, these limitations are consistent with two recent rulings by the bankruptcy court presiding over the Lehman liquidation that involved interpretations of broad provisions of the Code that, by their terms, do not specifically contemplate walkaway clauses. In one case, the bankruptcy court addressed the enforceability of a clause contained in a synthetic collateralized debt obligation transaction.[217] The structure included a swap agreement, along with an agreement between the swap counterparty and the holders of securities that established priorities with respect to collateral for both sets of obligations. Lehman's rights, as swap counterparty, were senior to those of the securities holders—except that in the event of a default by Lehman, that priority was to be inverted.[218]

The Lehman bankruptcy court ruled that this priority inversion was unenforceable because the practical effect, given the value of the collateral, would have been that Lehman would be out of the money if the provision were enforced.[219] In effect, the priority inversion was the same as a walkaway clause. The Lehman court relied, among other things, on a provision of the Code that renders unenforceable contractual provisions that effect a forfeiture or modification of a debtor's rights solely by virtue of its financial condition or the commencement of a bankruptcy case.[220] The Lehman court adopted a similar stance towards a counterparty who suspended payments to Lehman that otherwise would have been due absent Lehman's bankruptcy.[221] The court viewed the counterparty's conduct as

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[213] Act § 210(c)(8)(F)(iii), 12 U.S.C. § 5390(c)(8)(F)(iii).

[214] Act § 210(c)(8)(F)(i), 12 U.S.C. § 5390(c)(8)(F)(i).

[215] Act § 210(c)(8)(F)(ii), 12 U.S.C. § 5390(c)(8)(F)(ii).

[216] *See, e.g.*, 12 U.S.C. § 1821(e)(8)(G)(ii) (2006) (permitting only limited suspension of payment or delivery obligations).

[217] *See In re* Lehman Bros. Holdings Inc., 422 B.R. 407, 420 (Bankr. S.D.N.Y. 2010) ("Provisions in the Transaction Documents purporting to modify LBSF's right to a priority distribution solely as a result of a chapter 11 filing constitute unenforceable ipso facto clauses.").

[218] *Id.* at 413 (noting that in the event of a default the holder of the note "would then be entitled to priority over amounts otherwise payable to LBSF").

[219] *Id.* at 422.

[220] *See* 11 U.S.C. § 541(c) (2006) (transforming interest in property of debtor to property of estate despite agreement based on "insolvency or financial condition of the debtor.").

[221] *See* Transcript of Sept. 15, 2009 Hearing at 102–13, *In re* Lehman Bros. Holdings Inc., No. 08-13555 (JMP) (Bankr. S.D.N.Y. Sept. 15, 2009) (Docket No. 5261) (finding counterparty failed to act timely upon Lehman filing, thereby forfeiting right of termination under walkaway clause); Order Pursuant to Sections 105(a), 362 and 365 of the Bankr. Code to Compel Performance of Contract and to Enforce the Automatic Stay at 1–2, *In re* Lehman Bros. Holding Inc., No. 08-13555 (JMP) (Bankr. S.D.N.Y. Sept. 17, 2009) (Docket No. 5209) (finding in favor of debtor).

inequitable and contrary to a debtor's general right under the Code to compel a counterparty to continue performing pending the debtor's determination whether to assume or reject.[222]

VII. POSSIBLE CONSEQUENCES TO DIRECTORS AND MANAGEMENT

A. Overview of the Act

Underlying much of the public's dissatisfaction with government bailouts was the sentiment that taxpayers had been made to pay for the mistakes (and, in some cases, alleged greed and irresponsibility) of the rescued financial companies' management. This dissatisfaction turned to outright anger when it appeared that management was enriching itself at the taxpayers' expense, as exemplified by the popular outcry at the bonuses paid to executives of companies that had received or benefited from government bailouts.[223]

These sentiments are not new. In 2005, Congress amended the Code to curtail perceived abuses in the process by which management of companies in bankruptcy historically were compensated: "the executives of giant companies [in bankruptcy]. . . lined their own pockets, but left thousands of employees and retirees out in the cold."[224] Prior to the 2005 amendments, it had become standard in bankruptcies to afford management periodic payments to induce them to stay with the company and assist it in restructuring its affairs (so-called "pay to stay" compensation).[225] They often obtained significant severance and incentive compensation packages as well.[226]

These forms of compensation continue in bankruptcy cases today—albeit subject to significant limits imposed by the 2005 amendments. The Code now effectively prohibits retention payments to insiders of a debtor by limiting such payments to circumstances that are unlikely ever to occur.[227] Similarly, the Code

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[222] Transcript of Sept. 15, 2009 Hearing at 102–13, *In re* Lehman Bros. Holdings Inc., No. 08-13555 (JMP) (Bankr. S.D.N.Y. Sept. 15, 2009) (Docket No. 5261) (stating that counterparty's failure to act within first year of filing is "unacceptable and contrary to the spirit of these provisions of the Bankruptcy Code.").

[223] *E.g.*, Jackie Calmes & Louise Story, *418 Got A.I.G. Bonuses; Outcry Grows in Capital*, N.Y. TIMES, Mar. 18, 2009, at A1. (noting A.I.G. had paid $165 billion in bonuses to 418 employees while receiving $200 million in federal bailout funds).

[224] *See In re* Dana Corp., 358 B.R. 567, 575 (Bankr. S.D.N.Y. 2006) (quoting 151 Cong. Rec. S1835–42 (daily ed. Mar. 1, 2005) (statement of Sen. Edward Kennedy)) (expressing his concern over the "glaring abuses of the bankruptcy system").

[225] *See In re* U.S. Airways, Inc., 329 B.R. 793, 797 (Bankr. E.D. Va. 2005) (acknowledging the "shady reputation" of pay to stay compensation programs).

[226] Jessi D. Herman, *Pay to Stay, Pay to Perform, or Pay to Go?: Construing the Threshold Terms of § 503(c)(1) and (2)*, 23 EMORY BANKR. DEV. J. 319, 319 (2007) (discussing how debtors attempt to induce "critical" employees to continue employment through uncertainty of reorganization).

[227] 11 U.S.C. § 503 (2006) (discussing limits on retention payments to insiders of debtor). A debtor may only make retention payments to an insider if the bankruptcy court finds that (a) the payment is essential to the retention of the insider because such insider has a bona fide job offer at the same or greater rate of compensation; (b) the insider's services are essential to the company; and (c) either (i) the amount of the payment is not greater than 10 times the amount of the mean payment of a similar kind given to

strictly limits severance that may be provided to insiders of a debtor,[228] and prohibits the payment of other obligations outside of the ordinary course of business, including incentive compensation, that is "not justified by the facts and circumstances of the case."[229]

Despite these limitations, the Code continues a presumption that the board and management of a company should remain in place while the company reorganizes.[230] Inherent in this presumption is the premise that, absent exceptional circumstances, existing management is best-positioned to maximize the value of a debtor's estate[231]—with the further qualification that board and management of a company in chapter 11 are subject to the supervision of a bankruptcy court and hence, cannot implement decisions outside the ordinary course of business without advance court permission.

However, more recent expressions of public outrage over bonuses paid to management of bailed-out companies has resulted in a significant shift in this presumption: the Act provides, in several sections, that management responsible for the condition of the financial company will be terminated.[232] Additionally, those responsible for the financial condition of the financial company may be made to bear economic consequences consistent with their responsibility.[233]

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nonmanagement employees for any purpose during the calendar year in which the payment was made, or (ii) if no similar payments were made to such nonmanagement employees during such calendar year, the payment is not greater than 25 percent of the amount of the mean payment of a similar kind given to nonmanagement employees for any purpose during the calendar year before the year in which the payment was made.

[228] Section 503(c)(2) prohibits the payment of severance to insiders of a debtor unless (a) such severance payment is part of a program that is generally applicable to all full-time employees; and (b) the amount of the payment is not greater than 10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made. *Id.* at § 503(c)(2).

[229] *Id.* at § 503(c)(3) (stating transfers to insider of debtor are only allowed under certain circumstances).

[230] *Id.* at §§ 1107–08 (discussing rights, powers, and duties of debtor in possession to operate business). Similarly, the Code section 1121 grants the debtor the exclusive right to propose a plan of reorganization during the first 120 days of a chapter 11 case. *Id.* at § 1121(b).

[231] H.R. REP. NO. 95-595, at 233 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6192 ("[V]ery often the creditors will be benefited by continuation of the debtor in possession, both because the expense of a trustee will not be required, and the debtor, who is familiar with his business, will be better able to operate it during the reorganization case. A trustee frequently has to take time to familiarize himself with the business before the reorganization can get under way. Thus, a debtor continued in possession may lead to a greater likelihood of success in the reorganization.").

[232] Act § 206(4), 12 U.S.C. § 5386(4) (Supp. 2010) ("[FDIC] shall ensure that management responsible for the financial condition of the covered financial company is removed"); Act § 210(a)(1)(C), 12 U.S.C. § 5390(a)(1)(C) (stating FDIC may provide for exercise of any function by any member, stockholder, director or officer of covered financial company, but Act presumes FDIC will remove management responsible for company's failed condition).

[233] Act § 204(a)(3), 12 U.S.C. § 5384(a)(3) (requiring FDIC to take all steps necessary to ensure all parties "having responsibility for the condition of the financial company [will] bear losses consistent with their responsibility"); Act § 210(f)(2), 12 U.S.C. § 5390(f)(2) (assigning liability to directors and officers for "gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortuous conduct . . . ."); Act § 210(s), U.S.C. § 5390(s) (permitting FDIC to recoup compensation from senior executives and directors for 2-year period prior to receivership, but in cases of fraud no time limit applies).

Like the Code, the Act also provides that any payment made to, or for the benefit of, an insider, or any obligation incurred to or for the benefit of an insider, under an employment contract and not in the ordinary course of business, may be avoided as a fraudulent transfer if the covered financial company received less than reasonably equivalent value in exchange for such payment or transfer.[234] The target of this provision is severance and buyout payments given to executives. Moreover, the Act, like the Code, provides a limited priority for unpaid claims of employees for wages, salaries, commissions and other benefits.[235] However, unlike the Code, the Act expressly subordinates any such claims held by senior executives and directors to general unsecured claims.[236]

Even more significantly, the Act outlines the circumstances under which culpable management may be banned from the financial services industry for a term of at least two years.[237] Specifically, the Act provides that management may be banned if the FDIC determines that management violated any law or regulation or final cease-and-desist order; engaged or participated in any unsafe or unsound practice; or breached a fiduciary duty and, by reason of any of the foregoing, management received financial gain or other benefit and such violation, practice or breach contributed to the failure of the company, and such practice involved personal dishonesty or demonstrated a willful or continuing disregard for the safety and soundness of the company.[238]

These strong measures may motivate boards and management to remove culpable actors or otherwise cooperate in connection with negotiations designed to reorganize a troubled financial company without receivership. But they could go too far. The presumption of removal could deprive financial companies of the services of management that might be best-positioned to maximize value. Indeed, financial companies in distress may have difficulty retaining or attracting competent management who may be wary of the prospect of being subjected to a presumption of removal notwithstanding their best efforts to avoid liquidation.

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[234] *Compare* 11 U.S.C. § 548(a)(1)(B) (allowing trustee to avoid transfers to insiders where debtor received less than reasonably equivalent), *with* Act § 210(a)(11)(A), 12 U.S.C. § 5390(a)(11)(A) (adopting language found in Code).

[235] *Compare* Act § 210(b)(1), 12 U.S.C. § 5390(b)(1) (subordinating unpaid claims of executive employees for wages, salaries, commissions and other benefits to administrative expenses of receiver and any amounts owed to United States), *with* 11 U.S.C. § 507(a)(4) (placing unpaid claims of employees fourth in priority scheme).

[236] Act § 210(b)(1)(G), 12 U.S.C. § 5390(b)(1)(G) (subordinating claims held by senior executives and directors to all general unsecured claims).

[237] Act § 213(c)(1), 12 U.S.C. § 5393(c)(1).

[238] Act § 213(b), 12 U.S.C. § 5393(b). Upon a finding of the foregoing, the FDIC or the Board of Governors, as appropriate, may serve upon management a written notice of the intention of the agency to prohibit any further participation by management in the affairs of any financial company for a period of time that such agency determines is commensurate with such violation, practice or breach. The due process requirements and other procedures under FDIA section 8(e) apply to actions taken under this section of the Act. Such requirements require the notice to contain a statement of the facts constituting the grounds for the ban and the time and place at which a hearing will be held. Generally, the hearing must be set for a date not earlier than thirty days, nor later than sixty days after the date of service of the notice. Act § 213(c), 12 U.S.C. § 5393(c).

B. Agency Rules Shift Burdens

In accordance with rule-making authority delegated to the FDIC by the Act, on July 6, 2011, the FDIC adopted a rule that inverts existing standards of fiduciary duty law applicable to the directors and senior executives of financial companies.[239] It is designed to implement several sections of the Act, including in particular section 210(s)(1), which specifies that the FDIC may recover from any current or former senior executive or director who is "substantially responsible for the failed condition" of a financial company any compensation received during the two-year period preceding appointment of the FDIC as receiver, except that there is no time limit in the case of fraud.[240]

Under the rule, a director or senior executive "shall be deemed to be substantially responsible" for the failed condition of a financial company if (i) he or she failed to act "with the degree of skill and care an ordinarily prudent person in a like position would exercise under similar circumstances" and (ii) as a result, caused a loss that materially contributed to the failure of the company.[241] This provision, in and of itself, does not say anything controversial. However, the rule does not stop there.

In particular, the rule provides that "[i]t shall be presumed that a senior executive or director is substantially responsible for the failed condition of a covered financial company that is placed into receivership" if the senior executive or director "served as the chairman of the board of directors, chief executive officer, president, chief financial officer, or in any other similar role regardless of his or her title if in this role he or she had responsibility for the strategic, policymaking, or company-wide operational decisions of the covered financial company."[242]

In other words, under the rule, there is a presumption that a senior executive or director is "substantially responsible" for a financial company's failure, and hence, that such senior executive or director must pay back all compensation received by him or her within the two-year period prior to appointment of the FDIC as receiver, based *solely on the fact* that such senior executive or director held one of the enumerated positions with the company, and *regardless* of whether such senior executive or director is alleged to have breached a duty of care or loyalty.

Moreover, the rule places the burden on the senior executive or director to affirmatively prove that he or she acted with due care: "The presumption . . . may be rebutted by evidence that the senior executive or director conducted his or her responsibilities with the degree of skill and care an ordinarily prudent person in a like position would exercise under similar circumstances."[243] This burden applies

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[239] Orderly Liquidation Authority, 76 Fed. Reg. 41,626, 41,640 (July 15, 2011) (to be codified at 12 C.F.R. § 380.7).

[240] Act § 210(s)(1), 12 U.S.C. § 5390(s)(1).

[241] Orderly Liquidation Authority, 76 Fed. Reg. at 41,640 (to be codified at 12 C.F.R. § 380.7(a)).

[242] *Id.* (to be codified at 12 C.F.R. § 380.7(b)(1)(i)).

[243] *Id.* at 41,641 (to be codified at 12 C.F.R. § 380.7(b)(2)).

regardless of whether the senior executives are interested or disinterested,[244] and apparently applies *regardless* of whether the company's charter exculpates directors from unintentional breaches of the duty of care.[245]

The rule does provide limited immunity for crisis leadership. In particular, the presumptions outlined above do not apply to a senior executive or director hired by the financial company during the two years prior to the FDIC's appointment as receiver "to assist in preventing further deterioration of the financial condition of the covered financial company."[246] However, what the FDIC gives with one hand, it takes back with the other. The rule goes on to provide that, notwithstanding the foregoing, the FDIC still may pursue recoupment of compensation from crisis leadership if they are "substantially responsible for the failed condition of the covered financial company."[247] The rule does not define what this phrase means in the context of crisis leadership, which begs the question, "Will crisis managers or turnaround specialists be willing to step into the breach in light of this uncertainty?"

VIII. REQUIREMENTS FOR DEVELOPING GLOBAL, INSOLVENCY CONTINGENCY PLANS

The Act contains many other provisions, apart from Title II, that require enhanced supervision of, and prudential standards for, large, systemically-important financial companies. As part of this comprehensive supervisory oversight, bank holding companies with total consolidated assets equal to or greater than $50 billion, plus nonbank financial companies identified by the Council and supervised by the Board of Governors, must periodically report to the Board of Governors and the FDIC "the plan of such company for rapid and orderly resolution in the event of material financial distress or failure."[248] Among other things, the resolution plan must describe how the plan "facilitate[s] an orderly resolution of the company" under the Code or other applicable insolvency regime.[249]

The Act requires the Board of Governors and FDIC to jointly issue final rules implementing these so-called "living will" provisions by January 21, 2012.[250] On March 29, 2011, the Board of Governors and FDIC jointly issued a notice of

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[244] *Id.* at 41,640 (to be codified at 12 C.F.R. § 380.7(b)(1)(i) (providing that executive or director, if involved in strategic, policy or operations decisions, is presumed responsible for financial company's failure).

[245] *See id.* (serving as executive or director is enough in and of itself to trigger presumption without claim of breached fiduciary duty).

[246] *Id.*. at 41,641 (to be codified at 12 C.F.R. § 380.7(b)(3)).

[247] *Id.* (to be codified at 12 C.F.R. § 380.7(b)(4)).

[248] Act § 165(d)(1), 12 U.S.C. § 5365(d)(1) (Supp. 2010) (mandating that nonbank financial companies covered by Act report periodically on contingency plans for quick response and resolution of possible financial distress or failure).

[249] Act § 165(d)(4), 12 U.S.C. § 5365(d)(4).

[250] Act § 165(d)(8), 12 U.S.C. § 5365(d)(8).

proposed rulemaking pursuant to this directive.[251] After a long period of public comment, the FDIC approved the rule on September 13, 2011 (the "Dodd Frank Rule") and forwarded it to the Board of Governors for its review and approval.[252] The Dodd Frank Rule requires covered financial companies to undertake a comprehensive strategic analysis of their operations, and to prepare and submit to the Board of Governors and FDIC a detailed contingency plan for reorganizing or liquidating the company's affairs in a "rapid and orderly" fashion.[253] The Rule's purpose is to afford companies and regulatory authorities with the information, advance preparation and planning necessary to respond quickly and efficiently in the event of a crisis.[254]

Concurrently with issuance of the Dodd Frank Rule, the FDIC also issued a separate, "interim final" rule ("FDIC Rule") pursuant to its authority under the FDIA that requires significant insured depository institutions to develop and submit separate plans for resolving their affairs under the bank receivership provisions of the FDIA.[255] The commentary to the Dodd-Frank Rule and the FDIC Rule states that they are to operate in tandem. Indeed, many financial enterprises will need to comply with both Rules. Moreover, the Rules dovetail with the orderly liquidation authority. As noted above, in determining whether to place a financial company into receivership under Title II, regulators are required to assess whether the Code or other applicable insolvency regime provides an appropriate alternative for resolving the company's affairs.[256] The information provided by the Rules, which must be updated at least annually, clearly will be critical to this assessment.

A. Scope of the Dodd Frank Rule

1. Scope and Timelines

The Dodd Frank Rule applies to "covered companies," which is defined to include (i) any U.S. bank holding company that has $50 billion or more in consolidated assets, (ii) any foreign bank or company that is a bank holding company, or that is treated as a bank holding company, with $50 billion or more in total consolidated assets, and (iii) any nonbank financial company supervised by the Board of Governors (the identification of such entities is the responsibility of the Council).[257]

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[251] *See* Resolution Plans and Credit Exposure Reports Required, 76 Fed. Reg. 22,648, 22,662 (proposed Mar. 29, 2011) (to be codified at 12 C.F.R. pt. 381).

[252] *See* Resolution Plans Required, 76 Fed. Reg. 67,323 (Nov. 1, 2011) (to be codified at 12 C.F.R. pt. 381).

[253] *See id.*

[254] *Id.*

[255] *See* Resolution Plans Required for Insured Depository Institutions With $50 Billion or More in Total Assets, 76 Fed. Reg. 58,379 (proposed Sept. 13, 2011) (to be codified at 12 C.F.R. pt. 360) ("FDIC Rule").

[256] *See* Act § 203(a)(2)(F), 12 U.S.C. § 5383(a)(2)(F).

[257] Resolution Plans Required, 76 Fed. Reg. at 67,334 (to be codified at 12 C.F.R. § 381.2(f)(1)).

The Dodd Frank Rule requires that each covered company "periodically submit" to the Board of Governors and the FDIC a "plan for such covered company's rapid and orderly resolution in the event of material financial distress or failure" of the covered company.[258] The phrase "rapid and orderly resolution" means a "reorganization or liquidation of the covered company . . . under the Bankruptcy Code that can be accomplished within a reasonable period of time and in a manner that substantially mitigates the risk that the failure of the covered company would have serious adverse effects on financial stability in the United States."[259]

The commentary to the Dodd Frank Rule states that if a covered company is subject to an insolvency regime other than the Code, then the resolution plan for such entity must describe the plan for such entity under such other insolvency regime.[260]

The Dodd Frank Rule provides a staggered schedule by which each covered company must submit its first resolution plan to the Board of Governors and the FDIC:

- July 1, 2012: covered companies with total nonbank assets of $250 billion or more (or, in the case of foreign-based covered companies, $250 billion or more in total U.S. nonbank assets);
- July 1, 2013: covered companies with total nonbank assets between $100 billion and $250 billion (or, in the case of foreign-based covered companies, between $100 billion and $250 billion in total U.S. nonbank assets); and
- December 31, 2013: covered companies with total nonbank assets of less than $100 billion (or, in the case of foreign-based covered companies, less than $100 billion in total U.S. nonbank assets).[261]

Thereafter, each covered company must submit a resolution plan annually on or before the anniversary of its initial resolution plan submission date. If a covered company experiences a material change requiring modification of its initial plan, it must submit a notice of this event within 45 days of the event that summarizes the resulting changes that are required in the plan.[262] The covered company's next annual resolution plan must be revised to take account of such event.[263] The Board of Governors and the FDIC may require more frequent reporting and extend time periods for submitting reports or notices following a material event.[264]

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[258] *Id*. at 67,323.
[259] *Id*. at 67,335 (to be codified at 12 C.F.R. § 381.2(o)).
[260] *Id*. at 67,327 n.8.
[261] *Id*. at 67,335 (to be codified at 12 C.F.R. § 381.3(a)).
[262] *Id*. at 67,335-36 (to be codified at 12 C.F.R. § 381.3(b)(2)).
[263] The commentary to the Dodd Frank Rule clarifies that a covered company need only give notice of a material change when an event results in, or could reasonably be foreseen to have, a material effect on the resolution plan of the covered company. *See id*. at 67,330.
[264] *Id*. at 67,336 (to be codified at 12 C.F.R. § 381.3(c)).

2. Contents of Resolution Plans

a. Strategic Analysis

The most important aspect of a resolution plan is the "strategic analysis." The strategic analysis must include "detailed descriptions" of the "[r]ange of specific actions to be taken by the covered company" if it finds itself in distress; a covered company's "strategy in the event of a failure or discontinuation of a material entity, core business line or critical operation, and the actions that will be taken by the covered company to prevent or mitigate any adverse effects of such failure or discontinuation on the financial stability of the United States"; and the "time period(s)" necessary to "successfully execute each material aspect and step" of the plan.[265]

For purposes of the foregoing, the Dodd Frank Rule defines "core business line" as one that, in the view of the covered company, "upon failure would result in a material loss of revenue, profit, or franchise value."[266] The phrase "critical operations" means those operations, failure or discontinuance of which, "in the view of the covered company or as jointly directed by the Board and the [FDIC], . . . would likely result in a disruption to the U.S. economy or financial markets."[267]

Covered U.S. companies must provide information relating to subsidiaries and operations domiciled in the U.S., "as well as [their] foreign subsidiaries, offices, and operations."[268] Foreign-based covered companies must provide information relating to their U.S. operations; describe the interconnections and interdependencies among their core and critical U.S. operations and foreign affiliates; and explain how their resolution plans for their U.S. operations are "integrated into [their] overall resolution or other contingency planning process."[269] Accordingly, both U.S. and foreign covered company resolution plans must analyze the potential ramifications of differing insolvency regimes among the various jurisdictions in which they operate.[270]

A covered company may exclude from that portion of its plan the strategic analysis that relates to its contingency plans for addressing the failure or discontinuation of a material entity, but only if the entity is subject to an insolvency regime other than the Code, has less than $50 billion in assets, and does not conduct any critical operations. However, if the material entity is subject to an insolvency regime other than the Code and has $50 billion or more in total assets or conducts a critical operation, then the resolution plan must describe the actions and strategy to be taken under such other insolvency regime.

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[265] *Id*. at 67,337 (to be codified at 12 C.F.R. § 381.4(c)).
[266] *Id.* at 37,334 (to be codified at 12 C.F.R. § 381.2(d)).
[267] *Id.* at 67,335 (to be codified at 12 C.F.R. § 381.2(g)).
[268] *Id*. at 67,336 (to be codified at 12 C.F.R. § 381.4(a)).
[269] *Id*.
[270] *See id.* at 67,329.

b. Other Information Requirements

In addition to the strategic analysis, a resolution plan also must include a wealth of other information about a covered company, including a "detailed description" of "all material legal entities"; a "mapping of the covered company's critical operations and core business lines, including material asset holdings and liabilities related to such critical operations and core business lines, to material entities"; a description of the "material components" of the covered company that separately identifies the types and amounts of its liabilities; a description of any material off-balance sheet exposures; and a description of the covered company's and its material subsidiaries' practices related to the booking of trading and derivatives activities.[271]

The resolution plan also must contain a description of all of the covered company and its material entities' material hedges related to trading and derivatives activities; a description of the covered company's major counterparties and "the interconnections, interdependencies and relationships with such major counterparties," as well as an analysis of "whether the failure of each major counterparty would likely have an adverse impact on or result in the material financial distress or failure of the covered company."[272]

In preparing its resolution plan, a covered company is prohibited from assuming that the U.S. or any other government will provide "extraordinary support" to the company or its subsidiaries to prevent its failure.[273] Moreover, the plan must take into account the possibility that its financial distress or failure may occur under "baseline, adverse and severely adverse economic conditions," which are the conditions/scenarios provided to the covered company by the Board of Governors in conjunction with the conduct of annual stress tests.[274] A covered company may submit its initial plan assuming the baseline condition only or, if a baseline scenario is not then available, a reasonable substitute developed by the covered company.[275]

The commentary accompanying the Dodd Frank Rule clarifies that the Board of Governors and the FDIC expect that resolution planning will be an evolving and iterative process over time, involving an "ongoing dialogue with firms."[276] The Board of Governors and FDIC expect that no initial plans will be found deficient.[277] Rather, the initial plans will serve as foundations for more robust annual plans submitted in following years. Plans obviously will vary by company, and the evaluation of plans by the Board of Governors and FDIC will take into account variances in companies'

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[271] *Id.* at 67,337-38 (to be codified at 12 C.F.R. § 381.4(e)).

[272] *Id.* at 67,338

[273] *Id*. at 67,337 (to be codified at 12 C.F.R. § 381.4(a)(3)(ii)).

[274] Act § 165(i)(1)(B), 12 U.S.C. § 5365(i)(1)(B) (Supp. 2010). Details regarding the baseline, adverse, and severely adverse conditions are not yet available.

[275] Resolution Plans Required, 76 Fed. Reg. at 67,336 (to be codified at 12 C.F.R. § 381.4(a)(i)). Subsequent plans should assume that the failure of the covered company will occur under the same economic conditions consistent with the Board of Governors' rule implementing annual "stress tests."

[276] *Id*. at 67,328.

[277] *Id*. at 67,331.

complexity.[278] Accordingly, plans of more complex companies will be more complex and require information that may not be relevant for smaller, less complex companies.

In this regard, and in response to extensive public comment on the proposed rule, especially by foreign institutions, the Dodd Frank Rule allows smaller, less complex U.S. and foreign covered companies to prepare "tailored" resolution plans that require less information, and that focus only on a company's non-banking business. In particular, a covered company may prepare a tailored plan if (i) it has less than $100 billion in total non-bank assets (or, in the case of a foreign covered company, less than $100 billion in U.S. non-bank assets) and (ii) the total insured depository institution assets of which comprise 85% or more of the company's total consolidated assets (or, in the case of a foreign covered company, the assets of the U.S. insured depository institution operations, branches, and agencies comprise 85% or more of such company's U.S. total consolidated assets).[279]

A tailored plan's executive summary, strategic analysis, overview of the covered company's organizational and corporate governance structures, and descriptions of its management information systems need only relate to the covered company itself and its material, non-banking entities. A tailored plan must identify and map interconnections and interdependencies that if disrupted, would materially affect funding or operations, but only with respect to the covered company itself, its insured depository institutions, and its material, non-bank entities.[280]

c. Confidentiality

Finally, in response to public comments on the proposed rule, the Dodd Frank Rule contains confidentiality provisions designed to protect internal proprietary information that could, if subject to public disclosure, impede the quality and extent of information provided by covered companies. Resolution plans must be divided into two sections: a public section and a confidential section.[281] The public section must include, among other things, descriptions of a covered company's core business lines, derivatives activities, foreign operations, governance structure, management information systems and, "at a high level," the company's resolution strategy.[282]

To the extent permitted by law, information comprising the confidential section will be treated as confidential. [283] Confidentiality shall be determined in accordance with, among other things, the Freedom of Information Act ("FOIA"). A covered company desiring confidential treatment may file a request for such treatment in

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[278] *Id*.
[279] *Id*. at 67,336 (to be codified at 12 C.F.R. § 381.4(a)(3)).
[280] *Id*.
[281] *Id*. at 67,340 (to be codified at 12 C.F.R. § 381.8(d)).
[282] *Id*.
[283] *Id*.

accordance with FOIA and each of the Board of Governors' and FDIC's rules regarding availability and disclosure of information.[284]

3. Review/Penalties for Non-Compliance

Both the Act and the Dodd Frank Rule include detailed provisions regarding the review of a covered company's resolution plan and the penalties that may be imposed if a covered company fails to submit a credible plan. As an initial matter, each covered company must provide the Board of Governors and the FDIC with such information and access to personnel as the Board of Governors and the FDIC determine is "necessary to assess the credibility" of the resolution plan.[285] A multi-stage review of each resolution plan is contemplated. First, within 60 days of receiving a covered company's resolution plan, the Board of Governors and FDIC must determine whether the plan satisfies the minimum information requirements and should be accepted for further review.[286] To the extent that a resolution plan is determined to lack the minimum required information, the covered company must submit a revised plan within 30 days after being notified of the informational deficiencies.[287]

Once a resolution plan is accepted for more detailed review, the Board of Governors and FDIC will review the plan to assess its credibility and whether or not the plan would facilitate an orderly resolution of the covered company.[288] In the event that the Board of Governors and the FDIC jointly determine that a resolution plan is not credible or would not facilitate an orderly resolution of the covered company, they will jointly notify the covered company of such determination in writing, identifying those aspects of the resolution plan that have been determined to be deficient.[289] A covered company must, thereafter, address any deficiencies identified by the Board of Governors and FDIC within 90 days after notice of same, or such shorter period as the Board of Governors and the FDIC may jointly determine.[290]

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[284] *Id*.

[285] *Id*. at 67,336 (to be codified at 12 C.F.R. § 381.3(d)).

[286] *See* Act § 165(d)(3), 12 U.S.C. § 5365(d)(3) (Supp. 2010) (establishing general guidelines for review of resolution plans); Resolution Plans Required, 76 Fed. Reg. at 67,339 (to be codified at 12 C.F.R. § 381.5(a)(1)) (setting time limits on orderly and predictable reviews of resolution plans).

[287] *See* Act § 165(d)(4), 12 U.S.C. § 5365(d)(4); Resolution Plans Required, 76 Fed. Reg. at 67,339 (to be codified at 12 C.F.R. § 381.5(a)(2)(ii)).

[288] *See* Act § 165(d)(3), 12 U.S.C. § 5365(d)(3) (creating general rule under which Board of Governors and FDIC will review information submitted by covered company); Resolution Plans Required, 76 Fed. Reg. at 67,339 (to be codified at 12 C.F.R. § 381.5(a)) (explaining joint nature of review process conducted by Board of Governors and FDIC, once resolution plan is accepted for further review).

[289] *See* Act § 165(d)(4)(A), 12 U.S.C. § 5365(d)(4)(A); Resolution Plans Required, 76 Fed. Reg. at 67,339 (to be codified at 12 C.F.R. § 381.5(b)).

[290] *See* Act § 165(d)(4)(B), 12 U.S.C. § 5365(d)(4)(B) (discussing need for company's resubmission of revised resolution plan); Resolution Plans Required, 76 Fed. Reg. at 67,339 (to be codified at 12 C.F.R. § 381.5(c)).

In addition to submitting a revised resolution plan that addresses the deficiencies, the revised plan should also discuss in detail the revisions made to address the deficiencies; changes to business operations and corporate structure that the covered company proposes to undertake to facilitate implementation of the revised plan (including an implementation timeline); and details as to why the covered company believes the revised plan is credible and would result in an orderly resolution.

Should a covered company fail to resubmit a satisfactory plan, or should the Board of Governors and the FDIC jointly determine that the revised plan does not adequately remedy the deficiencies, the Board of Governors and the FDIC may jointly impose "more stringent capital, leverage, or liquidation requirements, or restrictions on the growth, activities, or operations of the [covered] company."[291] If a covered company fails to remedy such deficiencies within two years, the Board of Governors and FDIC may jointly direct the company to divest assets if they jointly determine that divestiture is necessary to facilitate an orderly resolution of the covered company.[292]

While the penalties for non-compliance appear potentially harsh, the commentary to the Dodd Frank Rule makes clear that penalties will not be imposed, at least not with respect to initial plans. In particular, as noted above, the review process will evolve as covered companies gain more experience in preparing their plans, and there is no expectation that initial plans will be found to be deficient.

B. Overview of the FDIC Rule

Pursuant to its authority under the FDIA, the FDIC has issued the FDIC Rule which applies to insured depository institutions with total assets of $50 billion or more (each, a "covered insured depository institution," or "CIDI"). Under the FDIC Rule, a CIDI must prepare a resolution plan that will enable the FDIC, as receiver of the CIDI under the FDIA, to resolve the CIDI pursuant to the bank receivership provisions contained in sections 11 and 13 of the FDIA in a manner that ensures depositors will receive access to their insured deposits within one business day of the CIDI's failure,[293] maximizes the net present value return from the sale or disposition of its assets, and minimizes the amount of losses by the institution's creditors.[294]

The FDIC Rule complements the Dodd Frank Rule. Resolution plans for CIDIs are due on the same timetable as those due under the Dodd Frank Rule,[295] with

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[291] Act § 165(d)(5)(A), 12 U.S.C. § 5365(d)(5)(A); *see also* Resolution Plans Required, 76 Fed. Reg. at 67,339 (to be codified at 12 C.F.R. § 381.6(a)).

[292] Act § 165(d)(5)(B), 12 U.S.C. § 5365(d)(5)(B); *see also* Resolution Plans Required, 76 Fed. Reg. at 67,339 (to be codified at 12 C.F.R. § 381.6(c)).

[293] Two business days if the failure occurs on a day other than Friday.

[294] FDIC Rule, 76 Fed. Reg. at 58,389 (to be codified at 12 C.F.R. § 360.10(a)).

[295] In particular, a CIDI whose parent company has $250 billion or more in non-bank assets (or, in the case of a foreign-based parent company, $250 billion or more in U.S. non-bank assets) is required to submit a resolution plan by July 1, 2012. A CIDI whose parent company has between $100 and $250 billion in non-bank assets (or, in the case of a foreign-based parent company, $100 billion or more in U.S. non-bank assets)

annual plans due every year thereafter. The provisions under the Dodd Frank Rule regarding the obligation to update resolution plans upon the occurrence of material events are mirrored in the FDIC Rule.[296] The Board of Governors and the FDIC anticipate that the resolution plan under the Dodd Frank Rule of a covered company that is a bank holding company will be harmonized with the resolution plan for its corresponding CIDI. In order to facilitate such harmonization, the FDIC Rule provides that a CIDI's plan may incorporate data and other information from a resolution plan filed by its parent company under the Dodd Frank Rule.[297]

The Dodd Frank Rule requires a covered company to provide a strategy that assumes that its CIDI will fail. It also requires a strategy that assumes that all of its insured depository institutions, regardless of whether any qualify as CIDIs, are not the cause of its failure. The Dodd Frank Rule also requires a covered company to set forth how the covered company will ensure that its insured depository institution subsidiaries will be adequately protected from risks arising from the activities of any nonbank subsidiaries of the covered company.[298]

In addition to a strategic analysis, the FDIC Rule requires the inclusion of certain information in a CIDI's resolution plan. Much of the required information mirrors the information required by the Dodd Frank Rule. Thus, the CIDI's resolution plan must include an executive summary, a description of its core business lines, and a description of its practices related to the booking of trading and derivative activities.[299] The CIDI's plan also should include descriptions of any unique aspects of the CIDI's depository base or underlying systems that may create operational complexity for the FDIC, or may result in exceptional resolution expenses.[300]

A CIDI's plan must also identify interconnections between the CIDI and its parent holding company, including how the parent funds the CIDI; the strategy to unwind and separate the CIDI from its parent in a cost-effective and timely fashion; and cross-border elements of the CIDI's structure.[301] It must also provide a strategy for the sale or disposition of its deposit franchise, business lines, and assets.[302] It must describe its processes for assessing its plans, "under idiosyncratic and industry-wide scenarios," for executing any sales, divestitures, restructurings,

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is required to submit a resolution plan by July 1, 2013. A CIDI whose parent company has less than $100 billion in non-bank assets (or, in the case of a foreign-based parent company, less than $100 billion in U.S. non-bank assets) is required to submit a resolution plan by December 31, 2013. *See* FDIC Rule, 76 Fed. Reg. at 58,390 (to be codified at § 360.10(c)).

[296] *See* FDIC Rule, 76 Fed. Reg. at 58,390 (to be codified at § 360.10(c)).

[297] *See id*. Also as in the Dodd Frank Rule, in preparing its resolution plan, a CIDI must take into account the baseline, adverse and severely adverse economic scenarios developed by the Board of Governors pursuant to Act § 165(i)(1)(B), 12 U.S.C. § 5365(i)(1)(B), but may submit its initial plan assuming the baseline condition only or, if applicable, a reasonable substitute developed by the CIDI.

[298] These are specific statutory requirements set out in the Act. *See* 12 U.S.C. 5365(d)(1)(A) (2006); *see also* Resolution Plans Required, 76 Fed. Reg. at 67,329.

[299] *See* FDIC Rule, 76 Fed. Reg. at 58,390–91 (to be codified at 360.10(c)).

[300] *See id*. at 58,384.

[301] *See id*. at 58,391 (to be codified at 12 C.F.R. 380.10(c)).

[302] *Id.*

recapitalizations, or similar actions contemplated in its plan.[303] Finally, the CIDI must identify its major counterparties, and analyze whether the failure of any of them would likely have an adverse impact on or result in material financial distress or failure of the CIDI.[304]

As with the Dodd Frank Rule, "core business lines" means those business lines, in the view of the CIDI, the failure of which would result in material loss of revenue, profit or franchise value. However, the term "critical services" is not tied to systemic risk, as is the case under the Dodd Frank Rule, but instead is defined as those services and operations, including technology and human resources, that are necessary to continue the day-to-day operations of the CIDI.[305] The FDIC Rule, like the Dodd Frank Rule, provides that the resolution plan should contain both a public portion and a confidential portion, with the same means for protecting confidential information.

The FDIC, in conjunction with certain sister agencies, will review the resolution plan of each CIDI for credibility. A plan is credible if its strategies for resolving the CIDI, and the detailed information that must be included in the plan, are "well-founded and based upon information related to the CIDI that is observable or otherwise verifiable."[306] In particular, projections must be reasonable and based upon current and historic conditions within the broader financial markets. The FDIC will employ the same two-step process employed in the review of resolution plans under the Dodd Frank Rule. A CIDI must provide the FDIC with such information and access to its personnel as the FDIC determines is necessary to assess a resolution plan's credibility, the same with respect to covered financial companies under the Dodd Frank Rule.

IX. AN ASSESSMENT OF THE ORDERLY LIQUIDATION AUTHORITY

As pointed out at the outset of this article, the Act creates a potentially draconian process, including some harsh remedies, that can be implemented swiftly without stakeholder input. The Code also can be harsh. Restructuring professionals experienced with the nuances of the Code know, however, that these provisions often work best when they are not actually implemented, i.e., when they are used instead as a threat to foster consensual solutions, without the intervention of a court.

The Act ostensibly shares this salutary purpose with the Code and, indeed, requires the Board of Governors, the Secretary, and the FDIC to consider private alternatives in deciding whether to recommend and implement receiverships.[307] Indeed, the prospect of a catastrophic liquidation with unpredictable results undoubtedly *compels* thoughtful, value-additive, private solutions that avoid the

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[303] *Id.*
[304] *Id.*
[305] *See id.* at 58,389 (to be codified at 12 C.F.R. 380.10(b)).
[306] *See id.* at 58,392 (to be codified at 12 C.F.R. 380.10(c)).
[307] Act § 203(a)(2)(E), 12 U.S.C. § 5383(a)(2)(E) (Supp. 2010) (requiring receivership recommendation to contain thorough evaluation of private sector alternatives).

need to appoint the FDIC as receiver, or that contemplate its appointment solely to facilitate implementation of a pre-arranged restructuring akin to pre-packaged and pre-arranged restructurings implemented under the Code. This is especially true given the hammer of the FDIC's authority to tax other financial companies after-the-fact for the costs of a receivership.

However, while the Act purports to create an "orderly" insolvency regime, no one should harbor any illusion that a receivership under the Act will be a clean, tight process that avoids massive ripple effects such as those experienced in the wake of Lehman's collapse. Rather, the failure of a large, systemically-important financial company could be a colossal mess, regardless of what insolvency regime governs. It is doubtful that any insolvency regime, no matter how carefully crafted, can contain all the fallout from the collapse of a company the size of Lehman. The best that can happen is a rapid disposition of the core business that preserves as much value and customer confidence as possible. However, other, inter-connected companies will feel the adverse effects, as "interconnectedness" is one of the defining features of the global financial system. In fact, as noted above, market and other circumstances serious enough to negatively affect one large, systemically important company likely will negatively affect others as well.

The Act, like the FDIA, contains mechanisms for mitigating the disorganized fallout of a financial company's failure—mechanisms that are not available under the Code. Those mechanisms are contained in two short provisions described above:[308] (i) the provision that prohibits derivatives counterparties from terminating their trades until the next business day after the FDIC is appointed receiver, and that prohibits them from terminating their trades permanently if their contracts are assumed by a third-party buyer or a bridge financial company within that time frame;[309] and (ii) the provision that precludes counterparties to derivatives trades with any subsidiaries of covered financial companies from terminating the trades if they are guaranteed by the parent and the guarantee is assumed by a third-party buyer or bridge financial company within the one business day time frame.[310] Derivatives trades, intercorporate guarantees, and contractual cross-default provisions are some of the defining features of the capital structures of large financial institutions.[311] Accordingly, if open derivatives trades of a failing financial company can be transferred to a financially sound successor or bridge company, much of the fallout of the sort that resulted when Lehman collapsed could be avoided.

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[308] *See supra* notes 101, 208–10, & 218–19 and accompanying text (noting existence of safeguard clauses designed to limit fallout).

[309] Act § 210(c)(10)(B)(i), 12 U.S.C. § 5390(c)(10)(B)(i).

[310] Act § 210(c)(16)(A), 12 U.S.C. § 5390(c)(16)(A).

[311] *See, e.g.*, Sean M. Flanagan, *The Rise of a Trade Association: Group Interactions Within the International Swaps and Derivatives Association*, 6 HARV. NEGOT. L. REV. 211, 230, 244 (2001) (noting inclusion of incorporate guarantees in master agreements for derivatives transactions and stating cross-default provisions are "crucial" to commercial banks).

A related point about the difficulty of containing ripple effects from a financial company's failure is that many institutions and individuals will pay for the failure of a financial company under the Act—likely including tax payers. While the Act makes bold statements about the end of "too big to fail" and ostensibly prohibits taxpayer funding of failed financial companies, the FDIC and the Secretary nonetheless have the authority under the Act to utilize public funds to finance resolution of a failed financial company, including by issuing public debt securities.[312] The FDIC is empowered to assess other financial companies for the cost of funding a receivership, but those assessments could be passed on to customers directly or through their owners indirectly in the form of a reduction in equity value caused by the assessments. This underscores the point that failure of a large financial company simply is not an event that easily can be walled-off from the rest of the economy. Massive ripple effects, and the shifting of costs to innocents, are unavoidable, especially considering that economic circumstances serious enough to jeopardize one major financial institution likely will jeopardize many.

Despite the Act's salutary purposes, its enactment begs the question whether there is already in place a comprehensive legal regime that is capable of dealing with the insolvency of a large financial company: the Code. Indeed, under the Act, the Board of Governors is charged with conducting a study regarding the resolution of financial companies under the Code, including the effectiveness of the Code in facilitating the orderly resolution or reorganization of systemic financial companies, and whether amendments to the Code should be adopted to enhance the ability of the Code to resolve financial companies in a manner that minimizes adverse impacts on financial markets.[313] Moreover, as noted above,[314] the proposed rules would, if promulgated, require financial companies to engage in contingency planning under the Code.

For experienced restructuring professionals, no study is needed: the Code is a time-tested tool that arguably can facilitate the resolution or reorganization of systemically-important financial companies. Bankruptcy judges have vast experience with all forms of businesses and capital structures, from the simple and mundane to the highly complex "mega-cases" involving billions of dollars of assets and liabilities. The Code allows a more fragile business, such as a financial company, the ability to effectuate a very rapid sale of its business as a going concern in order to preserve value and jobs.[315] The sale provisions of the Code are not materially different from the orderly liquidation authority which, at its core, also

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[312] Act § 210(n)(5)(B), (E), 12 U.S.C. § 5390(n)(5)(B), (E) (authorizing Secretary to use public debt transactions to purchase obligations from receiver).

[313] Act § 216(a), 12 U.S.C. § 1296(a). In fulfillment of this obligation, the Board of Governors published the *Study on the Resolution of Financial Companies Under the Bankruptcy Code* (July 2011) *available at* http://www.federalreserve.gov/publications/other-reports/files/bankruptcy-financial-study-201107.pdf.

[314] *See supra* note 26 and accompanying text.

[315] 11 U.S.C. § 363 (2006) (allowing trustee to sell assets free and clear of interest if non-bankruptcy law permits sale).

is designed to facilitate a rapid sale or other disposition of a covered financial company.

While there are procedural differences between the Code and the Act—the Code requires notice to stakeholders and allows their input, whereas the Act dispenses altogether with stakeholder input[316]—the Code nonetheless could be flexible enough to allow a bankruptcy court to expedite matters and limit notice in order to facilitate a rapid, going-concern sale of the core business. The Lehman case provides an example of this. As noted above,[317] Lehman filed its bankruptcy petitions on a Sunday, and by the following Friday, the bankruptcy court had entered an order approving the sale of the core operating business. The remaining bankruptcy estate has continued, spawning litigation over derivatives trades and related matters that undoubtedly will continue for years. But this does not necessarily represent a failing of the Code. Rather, this is a likely unavoidable consequence of the failure of any very large financial institution.

There are other examples of successful transactions involving financial companies under the Code. The next biggest failure of a financial company behind Lehman was Refco, the largest commodity broker ever to file bankruptcy.[318] As with Lehman, the estate conducted a rapid sale of its core operating business, and then later proposed and obtained confirmation of a largely consensual plan of liquidation.[319] As pointed out above, CIT was able to reorganize its affairs, without a sale and without any protracted fall-out, by pursuing and obtaining confirmation of a pre-packaged chapter 11 plan of reorganization that limited the company's stay in bankruptcy to a mere 40 days.[320]

More recently, bank holding companies that own troubled banks have avoided FDIC receiverships of their wholly-owned banks under the FDIA by commencing proceedings under chapter 11 that entailed rapid sales of the stock of those banks to third-parties who simultaneously agreed to infuse capital into the bank.[321] This avoids the cost to taxpayers of a failed bank and, indeed, preserves the enterprise value of the bank and jobs for its employees. Lastly, the government was able to participate effectively in the rapid, chapter 11 restructurings of other large, non-

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[316] *Compare* FED. R. BANKR. P. 2002 (requiring notice to interested parties of commencement of bankruptcy proceedings, proposed sale or use of assets, and any order for relief), *and* 11 U.S.C. § 1126 (giving claim holders power to accept or reject plans), *with* Act § 210(a)(1)(G), 12 U.S.C. § 5390(a)(1)(G) (allowing FDIC as receiver to merge or transfer any asset or liability of covered financial company without consent from any claim holders or interested parties).

[317] *See supra* Part 4 (acknowledging Lehman's speedy bankruptcy while complying with required standards).

[318] *See* Charles M. Oellermann & Mark G. Douglas, *The Year in Bankruptcy: Part II*, 7 J. BANKR. L. 344, 383 (2011) (listing Refco as largest brokerage firm to file for bankruptcy in past thirty years).

[319] *See In re* Refco Inc., 336 B.R. 187, 191 (Bankr. S.D.N.Y. 2006) (describing Refco's immediate sale of its largest assets and eventual plan of orderly liquidation under chapter 11).

[320] *See supra* Part 2.b (discussing CIT's reorganization plan under chapter 11).

[321] *See, e.g.*, *In re* AmericanWest Bancorporation, No. 10-06097, 2011 WL 2346706 (Bankr. E.D. Wash. July 7, 2011) (describing filing of AmericanWest Bancorporation under chapter 11 in 2010 and sale of its subsidiary, AmericanWest Bank, under section 363 of the Bankruptcy Code).

financial companies, including General Motors and Chrysler, that also were generally considered "too big to fail."[322]

On the other hand, significant aspects of the process under the Code could limit its effectiveness in resolving a large financial company. One is the inability of a bankruptcy judge to issue a moratorium on the close-out of derivatives trades with financial companies or their subsidiaries.[323] Another is the inability of a bankruptcy judge to create a bridge entity to hold assets and related liabilities pending a more deliberative sale process to a third party. Even if bankruptcy judges were afforded this authority, however, another aspect of the bankruptcy process that likely would not work well in a national economic crisis is its dispersal of decision-making authority among a debtor's board, the debtor's numerous creditors and other stockholders, and the bankruptcy judge, with no explicit authority granted regulators to control the process.

While the requirement of input and control from these numerous sources tends to work well in the context of most private enterprises reorganizing under chapter 11, the concentration of authority in the hands of a single authority—the FDIC—arguably may be a more practicable course with respect to a massive financial company whose collapse would have very public consequences that threaten the economy as a whole. That concentration of authority in the FDIC arguably must include the ability to act unilaterally, with more limited stakeholder input and ability to later challenge FDIC decisions in court.

This last point highlights the single biggest difference between the fundamental purposes underlying the insolvency of almost all other private businesses, on the one hand, and the insolvency of a large financial company that is deemed systemically important to the financial stability of the United States, on the other hand. In the former scenario, the overriding purpose is to maximize the value of the enterprise for the benefit of stakeholders. In the latter scenario, however, there is a much larger, overriding purpose: the stability of the financial system and the United States economy as a whole.

While the orderly liquidation authority is designed to preserve value, that aim is subordinate to the liquidation authority's ultimate objective of preserving systemic stability.[324] There may be circumstances in which the achievement of this objective should not be left solely to private creditors and other stakeholders, and in which the responsibility for this goal should not be foisted upon a single government official, i.e., a bankruptcy judge who may be unfamiliar with the intricacies of

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[322] *See In re* General Motors Corp., 407 B.R. 463, 477, 484 (Bankr. S.D.N.Y. 2009) (describing U.S. Government's assistance and "need for speed" in reaching deal); *In re* Chrysler LLC, 405 B.R. 84, 91, 109 (Bankr. S.D.N.Y. 2009) (detailing U.S. Government's involvement in Chrysler's reorganization and necessity of expedited procedures).

[323] *See, e.g.*, 11 U.S.C. § 555 (2006) (stating contractual rights of financial institution shall not be limited by any court order).

[324] The Act specifically states that in taking action, the FDIC shall "determine that such action is necessary for purposes of the financial stability of the United States, and *not* for the purpose of preserving the covered financial company." Dodd-Frank Wall Street Reform and Consumer Protection Act § 206(1), 12 U.S.C. § 5386(1) (Supp. 2010) (emphasis added).

financial companies and who will be afforded limited time to make a thoughtful decision. Under such circumstances, authority to pursue this public objective may need to be vested in the national government, through those agencies—the FDIC, the Federal Reserve, and the Treasury—most well-equipped to make rapid, informed decisions designed to maintain stability during a time of national economic crisis.

One significant qualification to this line of reasoning, however, is that preservation of value and systemic stability need not be viewed as mutually exclusive concepts. The economic aims of private stakeholders can be—and often are—effective guarantors of systemic stability, as illustrated by cases like Long Term Capital. Moreover, involvement of private stakeholders does not preclude effective involvement by government authorities, as illustrated by cases like Chrysler[325] and General Motors.[326] And it does not follow from the need for speed that stakeholders should be completely denied notice and the opportunity for input on a course of action, as illustrated by cases like Lehman Brothers,[327] CIT,[328] and Refco.[329] Put simply, with advance planning, the Code, perhaps with some modifications, can afford the government and stakeholders with a basic framework of time-tested tools for resolving major financial issues rapidly, tools that, in some cases, may be more effective than a solution that completely disenfranchises private stakeholders who bear the brunt of the insolvency process.

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[325] *See In re* Chrysler, 405 B.R. 84, 96–97 (Bankr. S.D.N.Y. 2009), *aff'd*, 576 F.3d 108 (2d Cir. 2009), *vacated as moot*, 130 S.Ct. 1510 (2009) (noting use of government funding to complete transaction).

[326] *See In re* Gen. Motors Corp., 407 B.R. 463, 494 (Bankr. S.D.N.Y. 2009) (discussing government involvement in § 363 sale).

[327] *See In re* Lehman Brothers Holdings Inc., No. 08–13555, 2008 WL 4902179, at *1 (Bankr. S.D.N.Y. Nov. 5, 2008) (issuing order of sale under § 363 of Code and noting notice procedural requirements had been met).

[328] *See In re* CIT Group Inc., No. 09-16565, 2009 WL 4824498, at *3 (Bankr. S.D.N.Y. Dec. 8, 2009) (acknowledging debtor compliance with notice and disclosure requirements of Code before sale finalized).

[329] *See In re* Refco Inc., 336 B.R. 187, 199 (Bankr. S.D.N.Y. 2006) (holding notice of sale was adequate to provide adequate opportunity to be heard).