October 6, 2010

MEMORANDUM TO: The Board of Directors

FROM: Arthur J. Murton
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Office of Complex Financial Institutions

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SUBJECT: Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act

RECOMMENDATION

Staff recommends that the Board of Directors ("Board") issue a Notice of Proposed Rulemaking (the "Proposed Rule") that would add a new part 380 to title 12 of the Code of Federal Regulations for the purpose of implementing certain orderly liquidation authority provisions of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

EXECUTIVE SUMMARY

Title II of the Dodd-Frank Act provides for the appointment of the FDIC as receiver for a financial company for which a determination has been made that the company's failure would pose a significant risk to the financial stability of the United States (a "covered financial company"). If approved by the Board, the Proposed Rule would be promulgated under section 209,[1] which authorizes the FDIC to prescribe such rules and regulations as the FDIC considers necessary or appropriate to implement the orderly liquidation authority provisions of Title II. The Proposed Rule is intended to

[1] Unless the context requires otherwise, all section references in this memorandum are to the Dodd-Frank Act.

provide greater clarity and certainty about how key components of this authority will be implemented and to ensure that the liquidation process under Title II reflects the Dodd-Frank Act's mandate of transparency in the liquidation of failing systemic financial companies. The Proposed Rule addresses discrete issues within the following broad areas: (1) the priority of payment to creditors (by defining categories of creditors who shall not receive any additional payments under sections 210(b)(4), (d)(4), or (h)(5)(E)); (2) the authority to continue operations by paying for services provided by employees and others (by clarifying the payment for services rendered under personal services contracts); (3) the treatment of creditors (by clarifying the measure of damages for contingent claims); and (4) the application of proceeds from the liquidation of subsidiaries (by reiterating the current treatment under corporate and insolvency law that remaining shareholder value is paid to the shareholders of any subsidiary).

In addition, the preamble to the Proposed Rule will solicit public comments on the Proposed Rule and certain specific questions for a period of 30 days and comments on other key issues involved in the implementation of Title II for a period of 90 days. The comments in response to the questions posed in the preamble will provide valuable information to staff to inform further development of a broader resolution regulation. Title II addresses the powers and responsibilities of the FDIC as receiver and manager of a bridge financial company in the event it is appointed to liquidate a large, complex non-bank financial company. Given the complexities of that process, and the significance of further clarification to financial market participants who may be less conversant with normal FDIC procedures in the resolution of failed insured depository institutions, staff anticipates that it will recommend further regulatory clarification in the future. The preamble to the Proposed Rule is designed, in part, to provide an overview of the powers and different options that the FDIC may use in liquidating a large, complex non-bank financial company. This background information is designed to inform the public and marketplace about the goals of the Proposed Rule and about the questions posed for further comment. Staff recommends deferring adoption of additional resolution regulations until after receipt and analysis of those responses.

The specific provisions of the Proposed Rule are as follows:

Section 380.1 would provide definitions of terms used in the Proposed Rule.

Section 380.2 would provide that the FDIC shall not exercise its authority to provide for more favorable treatment of some creditors over others similarly situated, or to make additional payments to some creditors but not others within a class at the same level of payment priority, in a manner that would result in holders of long-term senior debt, subordinated debt, or equity interests recovering more than others similarly situated at the same level of payment priority established and due under section 210(b)(1), or other priorities of payment specified by law. This section also provides that any other holders of claims shall not receive additional payments unless the FDIC Board of Directors, by a recorded vote, determines that the payments or credits are necessary and meet the requirements of Sections 210(b)(4), (d)(4), or (h)(5)(E), as applicable. The Proposed Rule further provides that the authority of the Board to make this decision cannot be delegated to management or staff of the FDIC. By requiring a vote by the Board, the Proposed Rule will require a decision on the record and ensure that the governing body of the FDIC has made a specific determination that such payments are necessary to the essential operations of the receivership or bridge financial company, to maximize the value of the assets or returns from sale, or to minimize losses. Section 380.2 also confirms that secured creditors will be protected in any liquidation to the extent of their pledged collateral. Of course, to the extent that a secured creditor is under-collateralized the unsecured portion of their claim will be paid along with other unsecured creditors. Section 380.2 confirms that claims that are secured by U.S. government securities will be valued at par value.

Section 380.3 would provide that if the FDIC accepts services from employees during the receivership or any period where some or all of the operations of the covered financial company are continued by a bridge financial company, those employees shall be paid according to the terms and conditions of their personal service agreements and such payments shall be treated as an administrative expense of the receiver. A personal service agreement will not continue to apply to any employee in connection with a sale or transfer of a subsidiary or the sale or transfer of any particular operations or assets of the covered financial company unless the acquiring party expressly agrees to assume the personal service agreement. The provision for payment of employees does not apply to senior executives or directors of the covered financial company, nor does it impair the ability of the receiver to recover compensation previously paid to senior executives or directors.

Section 380.4 would provide that claims based on a contingent obligation in the form of a guarantee, letter of credit, loan commitment, or similar credit obligation may be provable against the receiver, and the damages for repudiation of a contingent guarantee, letter of credit, loan commitment, or similar credit obligation shall be measured based upon the likelihood that such contingent obligation would become fixed and the probable magnitude thereof.

Section 380.5 would provide that where the FDIC acts as receiver for a direct or indirect subsidiary of an insurance company that is not an insurance company itself, the value realized from the liquidation or other resolution of the subsidiary will be distributed according to the order of priorities set forth in the Dodd-Frank Act.

Section 380.6 would provide that the FDIC will avoid taking a lien on some or all of the assets of a covered financial company that is an insurance company, or a covered subsidiary or affiliate of an insurance company, unless it makes a determination, in its sole discretion, that taking such a lien is necessary for the orderly liquidation of such company (or covered subsidiary or affiliate) and will not unduly impede or delay the liquidation or rehabilitation of the insurance company, or the recoveries by its policyholders.

DISCUSSION

The Dodd-Frank Act was enacted on July 21, 2010. Title II of the Dodd-Frank Act provides for the appointment of the FDIC as receiver of a financial company for which a determination has been made that the company's failure would pose a significant risk to the financial stability of the United States (a "covered financial company"). While it is not expected that the FDIC will be appointed as receiver for a covered financial company in the near future, it is important for the FDIC to have rules in place in a timely manner in order to address any uncertainty in the financial system as to how the orderly liquidation process would be implemented. The Proposed Rule would be promulgated under section 209, which authorizes the FDIC, in consultation with the Financial Stability Oversight Council, to prescribe such rules and regulations as the FDIC considers necessary or appropriate to implement Title II. Section 209 also provides that to the extent possible, the FDIC shall seek to harmonize such rules and regulations with the insolvency laws that would otherwise apply to a covered financial company. The Proposed Rule is intended to provide greater clarity and certainty about how key components of this authority will be implemented and to ensure that the liquidation process under Title II reflects the Dodd-Frank Act's mandate of transparency in the liquidation of failing systemic financial companies.

As provided in Section 209, the FDIC consulted with all members of the Financial Stability Oversight Council in developing and finalizing recommendations for the Proposed Rule. Prior to and after enactment of the Dodd-Frank Act, FDIC staff had discussed the regulatory issues presented in the Proposed Rule with the staff of many of the Council members. In order to ensure effective consultation, FDIC staff also discussed the parameters for consultation under Section 209 with senior representatives of the Department of the Treasury, as Council Chair. On September 17th, Chairman Bair distributed a proposed regulation and request for comments to the Council members. Subsequently, the FDIC has discussed the Proposed Rule with all Council members. The final Proposed Rule includes edits and further explanations of the issues that are a product of the valuable insights received from Council members. On September 27th, FDIC staff briefed the Board of Directors on the Proposed Rule.

The Proposed Rule addresses discrete issues within the following broad areas: (1) the priority of payment to creditors (by defining categories of creditors who shall not receive any additional payments under section 210(b)(4) or (d)(4)); (2) the authority to continue operations by paying for services provided by employees and others (by clarifying the payment for services rendered under personal services contracts); (3) the treatment of creditors (by clarifying the measure of damages for contingent claims); and (4) application of proceeds from the liquidation of subsidiaries (by reiterating the current treatment under corporate and insolvency law that remaining shareholder value is paid to the shareholders of any subsidiary).

Section-by-Section Analysis

Definitions. Section 380.1 of the Proposed Rule would provide that the terms "bridge financial company," "Corporation," "covered financial company," "covered subsidiary," and "insurance company" have the same meanings in the Dodd-Frank Act.

Treatment of Similarly Situated Creditors. Sections 210(b)(4) of the Dodd-Frank Act permits the FDIC to pay certain creditors of a receivership more than similarly situated creditors if it is necessary (1) to "maximize the value of the assets"; (2) to initiate and continue operations "essential to implementation of the receivership and any bridge financial company"; (3) to "maximize the present value return from the sale or other disposition of the assets"; or (4) to "minimize the amount of any loss" on sale or other disposition. In addition, section 210(d)(4) permits the FDIC to make additional payments to certain creditors if it is determined that such payments are necessary or appropriate to minimize losses from the orderly liquidation of the covered financial company. The appropriate comparison for any additional payments received by some, but not all, creditors similarly situated is the amount that the creditors should have received under the priority of expenses and unsecured claims defined in section 210(b) and other applicable law. In addition, the Dodd-Frank Act requires that all creditors of a class must receive no less than what they would have received in a Chapter 7 proceeding under the Bankruptcy Code.

Fundamental to an orderly liquidation of a covered financial company is the ability to continue key operations, services, and transactions that will maximize the value of the firm's assets and avoid a disorderly collapse in the market place. The FDIC has long had authority under the Federal Deposit Insurance Act to continue operations after the closing of failed insured banks if necessary to maximize the value of the assets in order to achieve the "least costly" resolution or to prevent "serious adverse effects on economic conditions or financial stability." 12 U.S.C. 1821(d) and 1823(c). As is well illustrated by comparisons with some liquidations under the Bankruptcy Code, the inability to continue potentially valuable business operations can seriously impair the recoveries of creditors and increase the costs of the insolvency. In bank resolutions under the "least costly" requirement of the Federal Deposit Insurance Act, many institutions purchasing failed bank operations have paid a premium to acquire all deposits because of the recognized value attributable to acquiring ongoing depositor relationships. In those cases, the sale of all deposits to the acquiring institutions has maximized recoveries and minimized losses consistent with the "least costly" requirement.

The ability to maintain valuable operations under the Dodd-Frank Act would be expected to similarly minimize losses and maximize recoveries in any liquidation, while avoiding a disorderly collapse. The ability to maintain essential operations under the Dodd-Frank Act would be expected to similarly minimize losses and maximize recoveries in any liquidation, while avoiding a disorderly collapse. Examples of operations that may be essential to the implementation of the receivership or a bridge financial company include the payment of utility and other service contracts and contracts with companies that provide payments processing services. These and other contracts will allow the bridge company to preserve and maximize the value of the bridge financial company's assets and operations to the benefit of creditors, while preventing a disorderly and more costly collapse.

To clarify the application of these provisions and to ensure that certain categories of creditors cannot expect additional payments under them, § 380.2 of the Proposed Rule would define certain categories of creditors who never satisfy this requirement. Specifically, this section would put creditors of a potential covered financial company on notice that bond holders of such an entity that hold certain unsecured senior debt with a term of more than 360 days will not be given additional payments compared to other general creditors such as general trade creditors or any general or senior liability of the covered financial company, nor will exceptions be made for favorable treatment of holders of subordinated debt, shareholders or other equity holders. The Proposed Rule would focus on long-term unsecured senior debt (i.e., debt maturing more than 360 days after issuance) in order to distinguish bondholders from commercial lenders or other providers of financing who have made lines of credit available to the covered financial company that are essential for its continued operation and orderly liquidation.

The treatment of long-term unsecured senior debt under the Proposed Rule is consistent with the existing treatment of such debt in bank receiverships. The FDIC has long had the authority to make additional payments to certain creditors after the closing of an insured bank under the Federal Deposit Insurance Act, 12 U.S.C. 1821(i)(3), where it will maximize recoveries and is consistent with the "least costly" resolution requirement or is necessary to prevent "serious adverse effects on economic conditions or financial stability." 12 U.S.C. 1821(d) and 1823(c). In applying this authority, the FDIC has not made additional payments to shareholders, subordinated debt, or long-term senior debt holders of banks placed into receivership because such payments would not have helped maximize recoveries or contribute to the orderly liquidation of the failed banks. This experience supports the conclusion that the Proposed Rule appropriately clarifies that shareholders, subordinated debt, or long-term senior debt holders of future non-bank financial institutions resolved under the Dodd-Frank Act should never receive additional payments under the authority of Sections 210(b)(4), (d)(4), or (h)(5)(E).

While the Proposed Rule would distinguish between long-term unsecured senior debt and shorter term unsecured debt, this distinction does not mean that shorter term debt would be provided with additional payments under sections 210(b)(4), (d)(4), or 210(h)(5)(E) of the Dodd-Frank Act. As general creditors, such debt holders normally will receive the amount established and due under section 210(b)(1), or other priorities of payment specified by law. While holders of shorter term debt may receive additional payments, this will be evaluated on a case-by- case basis and will only occur when such payments meet all of the statutory requirements. Under the Proposed Rule, the Board must specifically determine that additional payments or credit amounts to such holders are necessary and meet all of the requirements under 12 U.S.C. 5390(b)(4), (d)(4), or (h)(5)(E), as applicable. The Board's authority to make this decision cannot be delegated to management or staff of the FDIC.

A major driver of the financial crisis and the panic experienced by the market in 2008 was in part due to an overreliance by many market participants on funding through short-term, secured transactions in the repurchase market using volatile, illiquid collateral, such as mortgage-backed securities. In applying its powers under the Dodd-Frank Act, the FDIC must exercise a great deal of caution in valuing such collateral and will review the transaction to ensure it is not under-collateralized. Under applicable law, if the creditor is under-secured due to a drop in the value of such collateral, the unsecured portion of the claim will be paid as a general creditor claim. In contrast, if the collateral consists of U.S. Treasury securities or other government securities as collateral, the FDIC will value the obligations at par.

This provision must also be considered in concert with the express provisions of section 203(c)(3)(A)(vi). This subsection requires a report to Congress not later than 60 days after appointment of the FDIC as receiver for a covered financial company specifying "the identity of any claimant that is treated in a manner different from other similarly situated claimants," the amount of any payments and the reason for such action. In addition, the FDIC must post this information on a web site maintained by the FDIC. These reports must be updated "on a timely basis" and no less frequently than quarterly. This information will provide other creditors with full information about such payments in a timely fashion that will permit them to file a claim asserting any challenges to the payments. The Dodd-Frank Act also includes the power to "claw-back" or recoup some or all of any additional payments made to creditors if the proceeds of the sale of the covered financial company's are insufficient to repay any monies drawn by the FDIC from Treasury during the liquidation. 12 U.S.C. 5390(o)(1)(D). This provision underscores the importance of a strict application of the authority provided in sections 210(b)(4), (d)(4), and (h)(5)(E) of the Dodd-Frank Act and will help ensure that if there is any shortfall in proceeds of sale of the assets the institution's creditors will be assessed before the industry as a whole. Mos t importantly, under no circumstances in a Dodd-Frank liquidation will taxpayers ever be exposed to loss.

The Proposed Rule would expressly distinguish ongoing credit relationships with lenders who have provided lines of credit that are necessary for maintaining ongoing operations. Under section 210(c)(13)(D) of the Dodd-Frank Act, the FDIC can enforce lines of credit to the covered financial company and agree to repay the lender under the credit agreement. In some cases, such lines of credit may be an integral part of key operations and be essential to help the FDIC maximize the value of the failed company's assets and operations. In such cases, it may be more efficient to continue such lines of credit and, if appropriate, reduce the demands for funding from the Orderly Liquidation Fund.

Personal Services Agreements. Section 380.3 of the Proposed Rule concerns personal services agreements, which may include, without limitation, collective bargaining agreements. Like other contracts with the covered financial company, a personal services agreement is subject to repudiation by the receiver if the agreement is determined to be burdensome and its repudiation would promote the orderly liquidation of the company. Prior to determining whether to repudiate, however, the FDIC as receiver may need to utilize the services of employees who have a personal services agreement with the covered financial company. The Proposed Rule would provide that if the FDIC accepts services from employees during the receivership or any period where some or all of the operations of the covered financial company are continued by a bridge financial company, those employees shall be paid according to the terms and conditions of their personal service agreement and such payments shall be treated as an administrative expense of the receiver. The acceptance of services from the employees by the FDIC as receiver (or by a bridge financial company) does not impair the receiver's ability subsequently to repudiate a personal services agreement.[2] The Proposed Rule also would clarify that a personal service agreement will not continue to apply to employees in connection with a sale or transfer of a subsidiary or the transfer of certain operations or assets of the covered financial company unless the acquiring party expressly agrees to assume the personal service agreement. Likewise, the transfer will not be predicated on such assumption. Subparagraph (e) of § 380.3 would clarify that the provision for payment of employees does not apply to senior executives or directors of the covered financial company,[3] nor does it impair the ability of the receiver to recover compensation previously paid to senior executives or directors under section 210(s) of the Dodd-Frank Act. The definition of "senior executive" in this section substantially follows the definition of "executive officer" in Regulation O of the Board of Governors of the Federal Reserve System (12 C.F.R. 215.2). This definition is commonly understood and accepted.

[2] In this regard, the Proposed Rule is consistent with the Federal Deposit Insurance Act regarding the treatment of personal service contracts (see 12 U.S.C. 1821(e)(7)).

[3] Section 213(d) of the Dodd-Frank Act requires the FDIC and the Board of Governors of the Federal Reserve System, after consultation with the Financial Stability Oversight Council, to prescribe, *inter alia,* "rules, regulations, or guidelines to further define the term "senior executive" for the purposes of that section, relating to the imposition of prohibitions on the participation of certain persons in the conduct of the affairs of a financial company. In the future, the FDIC will conform the definition of "senior executive" in § 380.1 of the Proposed Rule to the definition that is adopted in the regulation that is adopted pursuant to section 213(d).

Contingent Obligations. Section 380.4 of the Proposed Rule would recognize that contingent obligations are provable under the Dodd-Frank Act. See section 201(a)(4), defining the term “claim” to include a right of payment that is contingent, and section 210(c)(3)(E), providing for damages for repudiation of a contingent obligation in the form of a guarantee, letter of credit, loan commitment, or similar credit obligation. The Proposed Rule would apply to contingent obligations consisting of a guarantee, letter of credit, loan commitment, or similar credit obligation that becomes due and payable upon the occurrence of a specified future event. For an obligation to be considered contingent, the future event (i) cannot occur by the mere passage of time (i.e., the arrival of a certain date on the calendar); (ii) cannot be made to occur (or not) by either party; and (iii) cannot have occurred as of the date of the appointment of the receiver. In addition, the preamble to the Proposed Rule expresses the view of the FDIC that an obligation in the form of a guarantee or letter of credit is no longer contingent if the principal obligor (i.e., the party whose obligation is backed by the guarantee or letter of credit) becomes insolvent or is the subject of insolvency proceedings.

Paragraph (b) of § 380.4 would recognize that contingent claims may be provable against the receiver. Thus, for example, where a guarantee or letter of credit becomes due and payable after the appointment of the receiver, the receiver will not disallow a claim solely because the obligation was contingent as of the date of the appointment of the receiver.

Paragraph (c) of § 380.4 would implement section 210(c)(3)(E), which authorizes the FDIC to promulgate rules and regulations providing that damages for repudiation of a contingent guarantee, letter of credit, loan commitment, or similar credit obligation shall be no less than the estimated value of the claim as of the date of the appointment of the FDIC as receiver, as such value is measured based upon the likelihood that such contingent obligation would become fixed and the probable magnitude of the claim.

Insurance Company Subsidiaries. Section 380.5 of the Proposed Rule would provide that where the FDIC acts as receiver for a direct or indirect subsidiary of an insurance company that is not an insured depository institution or an insurance company itself, the value realized from the liquidation or other liquidation of the subsidiary will be distributed according to the order of priorities set forth in section 210(b)(1) of the Dodd-Frank Act. In order to clarify that such value will be available to the policyholders of the parent insurance company to the extent required by the applicable State laws and regulations, the Proposed Rule would expressly recognize the requirement that the receiver remit all proceeds due to the parent insurance company in accordance with the order of priority set forth in section 210(b)(1).

Liens on Insurance Company Assets. Section 380.6 of the Proposed Rule would limit the ability of the FDIC to take liens on insurance company assets and assets of the insurance company's covered subsidiaries, under certain circumstances after the FDIC has been appointed receiver. Section 204 of the Dodd-Frank Act permits the FDIC to provide funding for the orderly liquidation of covered financial companies and covered subsidiaries that the FDIC determines, in its discretion, are necessary or appropriate by, among other things, making loans, acquiring debt, purchasing assets or guaranteeing them against loss, assuming or guaranteeing obligations, making payments, or entering into certain transactions. In particular, pursuant to section 204(d)(4), the FDIC is authorized to take liens "on any or all assets of the covered financial company or any covered subsidiary, including a first priority lien on all unencumbered assets of the covered financial company or any covered subsidiary to secure repayment of any transactions conducted under this subsection."

Section 203(e) provides that, in general, if an insurance company if a covered financial company, the liquidation or rehabilitation of such insurance company shall be conducted as provided under the laws and requirements of the State, either by the appropriate State regulatory agency, or by the FDIC if such regulatory agency has not filed the appropriate judicial action in the appropriate State court within sixty (60) days of the date of the determination that such insurance company satisfied the requirements for appointment of a receiver under section 202(a). However, a subsidiary or affiliate (including a parent entity) of an insurance company, where such subsidiary or affiliate is not itself an insurance company, will be subject to orderly liquidation under Title II without regard to State law.

The Proposed Rule would recognize that the orderly liquidation of such a covered affiliate or subsidiary should not unnecessarily interfere with the liquidation or rehabilitation of the insurance company, and that the interests of the policy holders in the assets of the insurance company should be respected. Accordingly, the Proposed Rule would provide that the FDIC will avoid taking a lien on some or all of the assets of a covered financial company that is an insurance company or a covered subsidiary or affiliate of an insurance company unless it makes a determination, in its sole discretion, that taking such a lien is necessary for the orderly liquidation of the company (or subsidiary or affiliate) and will not unduly impede or delay the liquidation or rehabilitation of such insurance company, or the recoveries by its policyholders. The final paragraph of § 380.6 would make clear that no restriction on taking a lien on assets of a covered financial company or any covered subsidiary or affiliate will limit or restrict the ability of the FDIC or the receiver to take a lien on in such assets in connection with the sale of such entities or any of their assets on a financed basis to secure any financing being provided in connection with such sale.

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