

Resolving Resolution: The Insolvency of Important Financial Institutions

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The Obama Administration's proposed Resolution Authority for Large, Interconnected Financial Companies Act of 2009 (the "Resolution Act") is intended to provide more explicit and organized federal authority for intervention in certain financial emergencies, in particular those for which the government felt it had inadequate tools available during the early stages of the present financial crisis. Roughly speaking, the proposed new tools would permit the government to:

- Intervene prior to an institution's insolvency;
- Provide many different types of financial support, including guarantees;
- Delay the settlement of swaps; and
- Exercise a generalized version of the resolution powers currently available to the Federal Deposit Insurance Corporation (the "FDIC") when insured depository institutions fail.

The Resolution Act accomplishes this by defining the business entities subject to the Act, specifying which federal agency is responsible in the various possible cases, and using the existing resolution authority of the FDIC as a template to be modified for broader application.

Significantly, the Resolution Act does not apply automatically when the applicable type of financial institution is in difficulty. The government must first determine that the specific situation warrants application of the Act.

The Entities Subject to the Act

The entities subject to the Resolution Act are referred to as bank holding companies, but include both so-called Tier 1 financial holding companies, as well as ordinary bank holding companies. Despite the potential confusion, both types of companies will be called bank holding companies in this Client Alert. Subsidiaries of both types of companies are also included, other than (i) broker-dealers that are registered with the Securities and Exchange Commission ("SEC") and are members of the Securities Investor Protection Corporation ("SIPC"), and (ii) domestic insurance companies, within the meaning of the Bankruptcy Code. In addition, institutions that are bank holding companies or their subsidiaries for purposes of the Resolution Act must be organized or incorporated

under US state or federal law. Given this set of definitions, even a foreign corporation with most of its activities in the US would not be subject to resolution under the Act, although a US subsidiary of a foreign corporation would, so long as it is neither a domestic insurance company nor a broker-dealer that is a member of SIPC. A foreign subsidiary of a bank holding company being resolved under the Act is apparently affected by the Act to some extent (despite the requirement that entities subject to the Act be incorporated or organized in the US), since Section 1209(a)(1)(M) of the Act requires to "coordinate with the appropriate foreign financial authorities regarding the resolution of subsidiaries of the covered bank holding company that are established in a country other than the United States." However, such a foreign subsidiary may not receive financial assistance under the Act.

Because the Resolution Act excludes domestic insurers only as subsidiaries of bank holding companies and Tier 1 financial holding companies, it is unclear how the Act intends to treat any insurance company that is itself a bank holding company. A similar lack of clarity exists with regard to SIPC members that are themselves bank holding companies or Tier 1 financial holding companies, although the practical likelihood of such a company existing seems quite low.

Responsible Federal Agencies

The FDIC is responsible for carrying out the resolution of any entity covered by the Resolution Act unless the entity or an affiliate of the entity is a broker-dealer registered with the SEC, in which case the SEC is also responsible. Since the FDIC and the SEC can simultaneously be responsible for a resolution, their responsibilities must be allocated more precisely to avoid confusion. One part of that allocation relates to the systemic risk determination that is required before the Resolution Act can even be applied to a specific entity. That determination is discussed below. The other part relates to the administration of the resolution. The FDIC is in all cases responsible for providing financial assistance. Whether the FDIC or the SEC is responsible for the other aspects of administration is determined by the Secretary of the Treasury, who appoints one of the two as conservator or receiver, subject to the requirement that the Secretary choose the FDIC if the largest subsidiary of the bank holding company (measured by assets) is not a broker-dealer.

Since the FDIC is required to be the administrator only if the largest subsidiary of the relevant bank holding company is not a broker-dealer, a number of intriguing appointments are theoretically possible: The FDIC could be appointed conservator or receiver if the bank holding company is

itself a broker-dealer (since the appointment provision speaks of a subsidiary of the bank holding company being a broker-dealer), if the broker-dealer is in fact the largest subsidiary (since the statute only says what should happen if the largest subsidiary is not a broker-dealer), if the broker-dealer is not the largest subsidiary, or if the bank holding company has no broker-dealer affiliate whatsoever. Conversely, the SEC is never required to be appointed conservator or receiver, perhaps because a broker-dealer that is a member of SIPC is not subject to the Resolution Act at all, even if the largest subsidiary of the relevant bank holding company is a broker-dealer. Presumably the requirement that the FDIC be appointed if the largest subsidiary is not a broker-dealer suggests that the SEC would be appointed if the largest subsidiary were actually a broker-dealer, but such an appointment does not appear to be required. The SEC could also be appointed if the relevant bank holding company had no subsidiaries (a state of affairs that is at least theoretically possible for a Tier 1 financial holding company, which could be systemically significant without being a holding company), whether or not the bank holding company is a broker-dealer.

Invoking the Resolution Act

The Act does not automatically apply to bank holding companies. Its application must be invoked by the Secretary of the Treasury (in consultation with the President) upon the recommendation of the Federal Reserve Board and either the FDIC or the SEC. The SEC plays this role only if the bank holding company or its largest subsidiary (measured by assets) is a broker-dealer, without any consideration of whether the actual resolution of the holding company or its subsidiary would be excluded from the application of the Resolution Act because the relevant corporation is a member of SIPC. The Secretary is not required to follow any recommendation that is submitted. In addition to considering any recommendation, the Secretary must determine that

- (1) The bank holding company is in default or is in danger of default;
- (2) The failure of the bank holding company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability or economic conditions in the United States; and
- (3) Any action or assistance under [the section relating to financial assistance and the appointment of a conservator or receiver] would avoid or mitigate such adverse effects, taking into consideration the effectiveness of action or assistance in mitigating

potential adverse effects on the financial system or economic conditions, the cost to the general fund of the Treasury, and the potential to increase moral hazard on the part of creditors, counterparties and shareholders in the bank holding company.¹

Several aspects of the required determination are expressive of the fundamental intent of the Resolution Act. For example, the bank holding company does not need to be in default; it suffices for the holding company to be in danger of default. What it means to be in default or in danger of default is defined elsewhere.² The definition includes the commencement of a bankruptcy proceeding, or the likelihood that one will be commenced promptly; critical undercapitalization; the depletion, or likely depletion, of the holding company's capital, coupled with a lack of any reasonable prospect that such depletion can be avoided without assistance; a decline, or the likelihood of a decline, in the holding company's assets to a level below that of its obligations; and the inability, or likely inability, of the holding company to pay its obligations in the normal course.

In effect, it must be determined that the application of any other type of insolvency law will be inadequate, and that utilizing the Resolution Act will alleviate either financial or economic conditions in the US. Although cost must be considered, least cost resolution is not required.

Even though economic conditions must be considered, the Resolution Act would probably not be available to assist an automobile manufacturer near insolvency, unless the manufacturer was a financial company. If other proposals of the Obama Administration are adopted, that would become essentially impossible, since most non-bank bank structures are to be eliminated, requiring the registration of such structures under the Bank Holding Company Act ("BHCA"). Companies registered under the BHCA are limited in their activities to those that are considered financial in nature, as are companies that are determined to be Tier 1 financial holding companies. Conceivably, such companies could hold merchant banking investments in a manufacturer, but that would not resemble the recent situation of General Motors, for example.

The treatment of the commencement of bankruptcy proceedings as a default is particularly interesting, since that would permit the federal government to terminate an ongoing bankruptcy proceeding if, for

¹ Resolution Act, §1203(b).

² As discussed below, this definition of "default or in danger of default" is different from that contained in the sections of the Resolution Act dealing with the treatment of qualified financial contracts.

example, it becomes apparent that the proceeding is not accomplishing its purpose or is endangering the financial or economic system.³ Presumably, the Secretary could terminate such a bankruptcy proceeding even if it had commenced because the Secretary had previously refused to make the determination required for the application of the Resolution Act, or if the Federal Reserve Board had made use of the power contained in the proposed Bank Holding Company Modernization Act of 2009 to force a Tier 1 financial holding company into bankruptcy.⁴

Applying the Resolution Act

The Act contemplates that the powers it grants may be applied in two different ways. Whichever agency (the FDIC or the SEC) acts as conservator or receiver will apply the provisions of the Act to the assets and obligations of the endangered bank holding company (other than its excluded subsidiaries). In addition, the FDIC is independently empowered to provide financial assistance to the bank holding company or in aid of its resolution (i.e., presumably to someone else) by making loans, purchasing debts or assets, assuming or guaranteeing obligations, and contributing equity. This independent power most likely reflects the SEC's lack of financing capabilities.

No mechanical procedures are established for coordinating any financing by the FDIC with any administrative acts by the SEC. It is therefore unclear who would have the authority to resolve disputes between the two agencies, unless the Secretary of the Treasury has such power *ex officio*. Both the SEC and the FDIC, however, would have the power to arrange priority funding from third parties for bridge bank holding companies that may be established in the course of resolving the financial problems of a bank holding company.⁵

Although the Resolution Act contains provisions, discussed above, regarding the appointment of the FDIC or the SEC as either conservator or receiver, it lacks specific provisions governing the decision to convert a conservatorship into a receivership, nor does it make any cross-reference

³ Section 1207 of the Resolution Act provides that the inception of a conservatorship or receivership automatically terminates a bankruptcy proceeding. It does this without formally amending the Bankruptcy Code.

⁴ The Bank Holding Company Modernization Act of 2009, proposed new Section 6A(h) of the BHCA. Proposed Section 6A also contains numerous other prompt corrective action steps that the Federal Reserve would be authorized to take outside (prior to) any application of the Resolution Act.

⁵ Such bridge bank holding companies would have a federal charter but would be treated as being subject to Delaware corporate law. If the bridge bank holding company provisions are adopted, it would be useful to specify how such companies are to be treated under Article 9 of the Uniform Commercial Code.

to such provisions in the Federal Deposit Insurance Act ("FDIA"). Whether that power would be considered to be inherent in the power of a conservator is unclear.

Most of the remaining provisions of the Resolution Act take the related provisions of the FDIA and generalize them so that they can effectively apply to entities that are not insured depository institutions or so that they are somewhat more flexible. Three fundamental aspects of the existing and the generalized provisions are (i) their respect for perfected security interests, (ii) their generally favorable treatment of swaps, securities contracts and other qualified financial contracts, and (iii) the ability of the relevant conservator to delay the resolution of qualified financial contracts in order to reduce the immediate financial pressure on the failed or failing entity.

A few of the changes from the FDIA model that are made in the Resolution Act may, however, be worth mentioning briefly. The administrative review procedures in the FDIA have not been carried over into the Resolution Act.⁶ Section 1209(a)(4)(D) provides that the conservator or receiver may disallow any claim that is not proved to its satisfaction. No such disallowance may affect extensions of credit to the affected bank holding company by any Federal Reserve Bank or the Treasury, nor may it affect any portion of a claim that is covered by a legally enforceable or perfected security interest. Section 1209(a)(4)(E) provides that disavowals cannot be challenged in court. Despite that, Section 1209(a)(5) establishes a procedure for challenging a disavowal by the receiver in the federal court of the district in which the bank holding company has its principal place of business or in the District of Columbia. It is unclear whether this provision for judicial challenge is an unintentional result of the failure to carry over an administrative review procedure or whether judicial challenges are available after notices of disavowal have been delivered but before some final determination by the receiver.

To be valid, pre-failure agreements against the interest of the conservator or receiver would only need to be in a writing executed by an authorized officer or representative of the bank holding company, and would no longer need to be approved by that company's board of directors.

For obvious reasons, there is no depositor preference; instead, there is a list of priorities for **unsecured** claims, namely:

- Administrative expenses of the receiver;

⁶ However, one clause of the claims determination section is still written as if such review would be available.

- Amounts owed to the United States;
- Any other general or senior liability of the applicable bank holding company;
- Subordinated liabilities; and
- Equity interests.⁷

Administrative expenses include the cost of preserving assets and liquidating and otherwise resolving the affairs of the relevant bank holding company, as well as any obligations that the receiver "determines are necessary and appropriate to facilitate the smooth and orderly liquidation or other resolution"⁸ of that bank holding company. This presumably includes all ordinary operating expenses of the holding company, although, as in the FDIA, there are special provisions for the repudiation of contracts and for determinations regarding real-estate-related matters and service contracts.

The factors that the conservator or receiver may consider when dealing with the assets and obligations of the failed or failing company have been expanded slightly, both by adding some additional considerations and by removing the requirement that the availability and affordability of residential real property be taken into account.

The definitions relating to qualified financial contracts have been taken largely unchanged from the FDIA.⁹ Consequently, the definitions relating to swaps do not match the definitions found in the proposed Over-the-Counter Derivatives Markets Act of 2009 ("OTC Act"). Since the purposes of the two sets of definitions are different, it is unclear whether this discrepancy would have a significant effect in any resolution, especially since the FDIA definition refers to agreements and transactions that in the future become "the subject of recurrent dealings in the swap or other derivatives markets."¹⁰ One standard that could cause difficulty if the OTC Act is adopted requires that all qualified financial contracts between one person and the failed bank holding company be transferred to a single person, if transferred at all. Since the value of many credit default swaps can be high, and many of them may well be standardized, traded and cleared through a clearing organization, and since the clearing organization is one person with whom the failed company will by

⁷ Resolution Act, §1209(b)(1). The reference to equity interests as unsecured claims is unusual terminologically, but is found in the statute.

⁸ Resolution Act, §1209(b)(4).

⁹ One exception is the insertion of special definitions for "default" and "in danger of default." §1209(c)(8)(D)(vii).

¹⁰ Resolution Act, §1209(c)(8)(D)(vi)(II)

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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hypothesis have (novated) contracts, it may be hard to find a single person who wants to assume all the failed company's contracts with the clearing organization. Unless other countries enact something like the OTC Act, it may also be difficult to satisfy the requirement that qualified financial contracts be transferred to a foreign institution only if its local law makes provision for netting, security agreements, etc., similar to those set forth in the Resolution Act, which could be thought to include those of the OTC Act by implication.

The Need for the Resolution Act

The ways in which the Resolution Act tries to deal with problems seen as crucial or difficult during the most dynamic stages of the current financial crisis have been discussed above. The mechanisms that are articulated in the Act appear on their face to deal with those problems. Whether those mechanisms will be sufficient is difficult to guess. One possible global issue is whether the assessment provisions in the Resolution Act, together with the other available funding mechanisms, will be sufficient to enable the FDIC to be solely responsible for the funding needs of large resolution proceedings,¹¹ or whether the Federal Reserve System might still need to be involved.

In addition, the extent to which protecting the financial system needs to rely on more generalized resolution procedures remains unclear. If the views expressed by papers such as "Leverage Causes Fat Tails and Clustered Volatility"¹² prove to be largely correct, much of the burden could or should fall on constraining highly leveraged secured transactions that roll over daily or otherwise in very short intervals, since such arrangements apparently cause highly non-linear (crash-like) feedback situations. If the burden falls on the regulators of financial institutions to establish such constraints and they succeed, then the proposed resolution mechanism may just be a precaution. If not, it may be a vital necessity.

For more information, please contact George Williams jr. at +1 212 259 8064 or gwilliams@dl.com, or your Dewey & LeBoeuf relationship attorney.

¹¹ Assessments would be one source of funds for the Bank Holding Company Fund proposed in Section 1209(n) of the Resolution Act. The Fund would be available to cover the cost of resolving bank holding companies. Other sources of funds include the Secretary of the Treasury. Assessments would be imposed on bank holding companies (presumably within the meaning of that term in the Resolution Act). Calculations would take risk into account and would take as a starting point the difference between (i) an institution's total liabilities and (ii) the sum of \$10 billion plus any applicable deposit insurance assessment base. Payments to insurance guaranty funds would be deducted from any assessment.

¹² By Stefan Thurner, J. Dooyne Farmer and John Geanakoplos (Santa Fe Institute Working Papers, Paper No. 09-08-031, August 3, 2009).