

**FDIC PROPOSES NEW ORDERLY LIQUIDATION AUTHORITY RULES
ADDRESSING EXECUTIVE COMPENSATION CLAWBACK, PRIORITY OF CLAIMS
AND ADMINISTRATIVE CLAIMS PROCEDURES**

On March 15, 2011, the FDIC released the second in a series of rules it will promulgate to implement its rights and powers as receiver of a failing systemic financial company under the orderly liquidation authority provisions included in Title II of the Dodd-Frank Act.¹ The Notice of Proposed Rulemaking (the “NPR”) introduces, among other things, several new rules in connection with the FDIC’s orderly liquidation authority, including:

- the definition of financial companies potentially subject to the orderly liquidation provisions;
- the framework under which the FDIC could seek recoupment of senior executive and director compensation of a qualifying failed company;
- priorities of claims for unsecured creditors, the treatment of creditors of bridge financial companies and the treatment of fraudulent and preferential transfers; and
- administrative claims and judicial review procedures for both unsecured and secured creditors.

This memorandum highlights and briefly summarizes some of the proposed rules contained in the NPR.

1. “Financial Company” – Predominantly Engaged in Financial Activities.

Section 201(b) of the Dodd-Frank Act requires the FDIC (in consultation with the Secretary of the Treasury) to promulgate regulations establishing standards under which the FDIC will identify nonbank companies that are “predominantly engaged in activities that are financial in nature or incidental thereto.” Companies meeting this criteria may be subject to the orderly liquidation provisions of the Dodd-Frank Act, such that the FDIC will be appointed as receiver for the covered financial company with responsibility for the company’s liquidation, instead of following the traditional bankruptcy process.²

¹ On January 18, 2011, the FDIC released an Interim Final Rule covering, among other things, the payment of similarly situated creditors and the honoring of personal services contracts.

² Note that financial companies subject to the FDIC’s orderly liquidation authority may not be bank holding companies or qualify for Federal Reserve supervision under Title I of the Dodd-Frank Act.

Proposed 12 CFR § 380.8 defines a nonbank company as being “predominantly engaged in financial activities” if (1) at least 85 percent of the total consolidated revenues of the company³ for either of its two most recent fiscal years was derived from activities determined by the Federal Reserve to be financial in nature or incidental thereto under section 4(k) of the Bank Holding Company Act or (2) the FDIC determines, based on all the relevant facts and circumstances, that the nonbank company satisfies the 85 percent consolidated revenue test. Under this test, all of the revenues derived from a company’s equity investment in another company that is not consolidated with the investing company under applicable accounting guidelines would be considered revenues derived from a financial activity (and count toward the 85 percent revenue test) if the investee company itself is predominantly engaged in financial activities under the FDIC’s revenue test. Companies could exclude certain revenues derived from *de minimis* equity investments if the investment and the investee company meet certain requirements under the proposed rule.

2. Clawback of Compensation and Rebuttable Presumption of Responsibility.

Section 210(s) of the Dodd-Frank Act permits the FDIC to recover compensation from any senior executive⁴ or director deemed to be “substantially responsible” for the failure of the covered financial company. The FDIC may clawback all compensation received by the senior executive or director during the two-year period preceding the date on which the FDIC is appointed receiver of the company. This provision does not preclude the FDIC from pursuing additional claims against senior executives and directors. Proposed 12 CFR § 380.1(b)(1) comprehensively defines “compensation” as it applies to recoupment under proposed 12 CFR § 380.7.⁵

Under the NPR, a senior executive or director is “substantially responsible” for the failure of the covered financial company if

- he or she failed to conduct his or her responsibilities with the requisite degree of skill and care required by that position, and
- as a result, individually or collectively, caused a loss to the covered financial company that materially contributed to the failure of the covered financial company.

³ Based on U.S. generally accepted accounting principles and includes revenues derived from ownership or control of a depository institution.

⁴ The FDIC uses the definition of “senior executive” in 12 CFR § 380.3(a)(2) in the Interim Final Rule adopted on January 18, 2011.

⁵ Compensation is defined as “any direct or indirect financial remuneration received from the covered financial company, including, but not limited to, salary; bonuses; incentives; benefits; severance pay; deferred compensation; golden parachute benefits; benefits derived from an employment contract, or other compensation or benefit arrangement; perquisites; stock option plans; post-employment benefits; profits realized from a sale of securities in the covered financial company; or any cash or non-cash payments or benefits granted to or for the benefit of the senior executive or director.”

The FDIC will apply a rebuttable presumption to certain senior executives and directors under which such individuals would be automatically considered substantially responsible for the failure of the company unless the individual could prove that he or she (1) performed his or her duties with the requisite degree of skill and care required by the position or (2) was hired by the financial company within the two years preceding the failure for the purpose of improving the company's financial condition and avoiding its failure. The rebuttable presumption would be applied to any senior executive or director serving as the chairman of the board of directors, chief executive officer, president or chief financial officer, or in any similar role, regardless of his or her actual title if that individual had strategic, policymaking or company-wide decision-making authority prior to the date the company was placed into receivership.⁶ At the FDIC Board meeting adopting the NPR, the FDIC General Counsel acknowledged that neither the statute nor the proposed rule contains a specific standard under which the presumption will be applied. Instead, the FDIC will likely conduct a "factored analysis" which will consider an individual's specific facts and circumstances, including their participation in certain activities and transactions, and their actual role in directing the company's strategic and other activities.

3. Priorities of Claims, Creditors of Bridge Financial Companies and Fraudulent and Preferential Transfers.

The FDIC aims to provide greater clarity to unsecured creditors of covered financial companies by establishing a detailed priority of payments that includes eleven classes of claims.⁷ In addition, the NPR separately defines "administrative expenses of the receiver"⁸ and "amounts owed to the United States,"⁹ both of which are included as priority classes ranking numbers two and three, respectively, within the priority of payments. Under the framework, each class will be paid in full before payment of the next priority, and if funds are insufficient to pay all creditors within the same class, the funds will be allocated *pro rata* among the creditors in that class.

To alleviate concerns regarding how the FDIC would treat creditors of a bridge financial company, and to ensure that a bridge financial company will be able to continue operating effectively, the NPR provides that the purchase of any asset or the assumption of any liability or contract by the bridge financial company will become the obligation of the bridge financial company. The bridge company will be required to observe, perform, pay and enforce any such obligation in accordance with its applicable terms and provisions. As a result, such obligations will not be subject to the general creditor claims process.

⁶ The presumption would also apply in cases where the senior executive officer is found to be liable by a court or tribunal for having breached his or her duty of loyalty to the covered financial company, or if the FDIC removed the senior executive or director from the management or the board of directors, as applicable, of the covered financial company.

⁷ See proposed 12 CFR § 380.21 in the NPR.

⁸ See proposed 12 CFR § 380.22 in the NPR.

⁹ See proposed 12 CFR § 380.23 in the NPR.

The NPR also contains proposed rules for the application of the receiver's powers to avoid fraudulent or preferential transfers. These rules are of substantial significance to participants in the securitization market, and in response to concerns raised by those participants, the FDIC has proposed rules regarding such transfers that conform to similar powers under the Bankruptcy Code.¹⁰

4. Administrative Claims and Judicial Review.

In drafting the NPR, the FDIC recognized that many market participants are not familiar with its administrative claims process, developed over time through its resolution of numerous failed depository institutions, and that the market desires clarification as to the interplay between the FDIC's powers under the orderly liquidation authority and the Bankruptcy Code. The NPR details an administrative claims and judicial review framework to provide current and potential creditors clarity with respect to the claims process relating to covered financial institutions. Proposed 12 CFR §§ 380.30-38 provide detailed procedural guidelines covering administrative claims, including information regarding the claims bar date, applicable notice requirements, procedures for filing a claim, the FDIC's determination of claims, the FDIC's decision period rules, notification of the FDIC's claims determination, and procedures for seeking a judicial determination of a disallowed claim in federal court. Future NPRs will address the termination of receiverships, records retention requirements and various other matters relating to the orderly liquidation authority.

The NPR separately addresses the treatment of secured claims under proposed 12 CFR §§ 380.50-55. As stipulated in Section 210(b)(5) of the Dodd-Frank Act, and discussed in the FDIC's prior releases regarding the orderly liquidation authority, a secured claim may be separated into secured and unsecured components if the fair market value of the collateral does not equal the amount of the claim. This framework would prohibit secured creditors from taking certain actions against the collateral without FDIC consent within 90 days of the FDIC's being appointed receiver, clarifies the effect on a secured party's claim by the receiver's repudiation of a contract, and establishes that a secured party may seek expedited relief outside of the standard administrative claims process upon satisfaction of certain conditions. Lastly, the proposed rules permit the receiver (1) to sell the collateral to a third party free and clear of any security interest, the proceeds of which sale must be paid to the creditor within a reasonable time, or (2) to pay the secured creditor the fair market value of the property serving as the collateral.

The NPR includes a number of specific questions on which the FDIC requests comment. All comments on the questions and the proposed rules are due within 60 days of publication of the NPR in the Federal Register. Until publication in the Federal Register, the NPR is available on the FDIC's website.

¹⁰ See proposed 12 CFR § 380.9 in the NPR.

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