

FDIC ISSUES FINAL RULE ON ORDERLY LIQUIDATION AUTHORITY

On July 6, 2011, the FDIC issued a final rule (the “Final Rule”) to implement certain provisions of its orderly liquidation authority to resolve covered financial companies (including nonbank financial companies) under Title II of the Dodd-Frank Act. The Final Rule is a culmination of the rulemaking process that began with the enactment of the Dodd-Frank Act in July 2010. Several interim phases have been included in the process, including the FDIC’s issuing an interim final rule (the “IFR”) on January 25, 2011 covering the payment of similarly situated creditors and the honoring of personal services contracts, and a proposed rule (the “Proposed Rule”) on March 23, 2011 addressing a variety of matters pertinent to orderly liquidation, including living wills, clawback of executive compensation, priority of claims, the administrative claims process and the treatment of secured claims, among others. The requirement for covered financial companies to prepare “living wills” under Title I of the Dodd-Frank Act is in part designed to facilitate a covered financial company’s rapid and orderly resolution by the FDIC as an alternative to the FDIC’s orderly liquidation authority under Title II.¹

Codified as 12 CFR §§ 380.1 to 380.53, the Final Rule encompasses much of what the FDIC initially proposed in the IFR and the Proposed Rule, but includes a number of key differences. Responding to comments received and following further internal and interagency discussion and consideration, the FDIC incorporated modifications and clarifications in the Final Rule of both a substantive and a technical nature with respect to certain orderly liquidation provisions. These revisions were made in an effort to improve the resolution process’s clarity and transparency for market participants.

Unlike the earlier proposals, the Final Rule codifies the FDIC’s orderly liquidation authority in three subparts. Subpart A covers general and miscellaneous provisions, including definitions, treatment of personal service agreements, subsidiaries of insurance companies, recoupment of compensation of senior executive officers and directors and treatment of fraudulent and preferential transfers.² Subpart B addresses priorities, including administrative expenses of the receiver, amounts owed to the United States, priority for loss of setoff rights, effect of bridge financial companies, and treatment of similarly situated claimants.³ Subpart C covers the receivership administrative claims process, including but not limited to notice requirements, procedures for filing claims, determination of claims, judicial review, contingent claims and secured claims. This memorandum highlights and briefly summarizes the Final Rule’s critical differences from the IFR and the Proposed Rule.

¹ The requirement for covered financial companies to prepare living wills under Title I is subject to a separate and ongoing rulemaking process. The FDIC and Federal Reserve published a notice of proposed rulemaking in the Federal Register on April 22, 2011 addressing in part the timing and substantive requirements of living wills. At the FDIC board meeting on July 6, 2011, FDIC senior staff noted that the FDIC and Federal Reserve are close to issuing final rules.

² 12 CFR §§ 380.1-.19.

³ 12 CFR §§ 380.20-.29.

Key Changes Contained in Subpart A of the Final Rule

- ***Recoupment of compensation from senior executives and directors.*** The Final Rule clarifies that the standard of care for which the FDIC will seek to recoup compensation paid to senior executives and directors is a negligence standard; gross negligence is not required. The FDIC will deem a senior executive or director “substantially responsible” for a covered financial company’s failure if that person failed to conduct his or her responsibilities “with the degree of skill and care an ordinarily prudent person in a like position would exercise under similar circumstances.”⁴
- ***Company predominantly engaged in activities that are financial in nature or incidental thereto.*** The Proposed Rule contained a preliminary definition of a company predominately engaged in activities that are financial in nature.⁵ However, in the preamble accompanying the Final Rule, the FDIC stated that due to its ongoing interagency dialogue with the Federal Reserve and the Federal Reserve’s separate rulemaking process for establishing criteria for the same definition under Title I of the Dodd-Frank Act,⁶ the FDIC would not include such definition or criteria in the Final Rule until that work is completed. It will publish the final criteria in a separate notice published in the Federal Register. Consequently, 12 CFR § 380.8 is reserved in the Final Rule.

Key Changes Contained in Subpart B of the Final Rule

- ***Priority of payments and contractual subordination agreements.*** To make the priority of payments for unsecured creditors more consistent with the Bankruptcy Code, the Final Rule includes an additional provision to provide that contractual subordination agreements will be respected.⁷
- ***Amounts owed to the United States.*** The Final Rule adopts a more refined and less expansive definition of “amounts owed to the United States” to clarify that the term includes only amounts advanced to a covered financial company to promote the company’s orderly resolution or to avoid adverse effects on the financial stability of the United States. Expressly included in the definition of “amounts owed to the United States” are
 - Unsecured amounts owed to the FDIC;
 - Unsecured amounts owed to the U.S. Department of Treasury on account of unsecured tax liabilities;

⁴ 12 CFR § 380.7(a)(1).

⁵ 12 CFR § 380.8 in the Proposed Rule.

⁶ See the Federal Reserve’s Notice of Proposed Rulemaking, “Definitions of ‘Predominantly Engaged in Financial Activities’ and ‘Significant’ Nonbank Financial Company and Bank Holding Company,” 76 FR 7731 (February 11, 2011).

⁷ 12 CFR § 380.21(c).

- Unsecured amounts paid or payable by the FDIC pursuant to its guarantee of debt issued by the covered financial company under the Temporary Liquidity Guaranty Program (TLGP);
 - The unsecured amount of any debt owed to a Federal Reserve Bank, including loans made through programs or facilities authorized under the Federal Reserve Act; and
 - Any unsecured amount expressly designated in writing by the appropriate United States department, agency or instrumentality as an “amount owed to the United States.”⁸
- ***Priority of claims arising out of loss of setoff rights.*** Unlike the Proposed Rule, the Final Rule includes an express statement that the provisions contained in 12 CFR § 380.24 addressing the priority of claims granted to creditors that have lost setoff rights do not affect the separate provisions in the Dodd-Frank Act that relate to netting rights in connection with qualified financial contracts.

Key Changes Contained in Subpart C of the Final Rule

- ***Scope of receivership administrative claims process.*** The Final Rule clarifies that the receivership claims process does not apply to claims against a bridge financial company, assets or liabilities of a bridge financial company, or extensions of credit from a Federal Reserve Bank or the FDIC to a covered financial company.⁹
- ***Late-filed claims.*** Although the Proposed Rule previously addressed the allowance of late-filed claims, the Final Rule clarifies that claimants that have claims based on the act or omission of the FDIC as receiver due to a breach or repudiation that occurs after the bar date may also submit late-filed claims.¹⁰
- ***Contingent claims.*** Rejecting a suggestion that valuation of a contingent claim be delayed until just before final distribution, the Final Rule clarifies valuation by providing that the receiver will estimate the value of the contingent claim as of the date of appointment of the receiver.¹¹

⁸ 12 CFR § 380.23. In addition to excluding administrative expenses of the receiver that are addressed separately in Subpart B (12 CFR § 380.22) and secured claims addressed in Subpart C (12 CFR §§ 380.50-53), “amounts owed to the United States” expressly excludes amounts incurred by covered financial companies in the ordinary course of business prior to the appointment of the FDIC as receiver, including unsecured amounts owed to Fannie Mae, Freddie Mac and the Federal Home Loan Banks.

⁹ 12 CFR § 380.31.

¹⁰ 12 CFR § 380.35(b)(2)(i).

¹¹ 12 CFR § 380.39.

- **Secured claims.** The Final Rule includes several new provisions in an effort to clarify the rights of secured claimants. Briefly, the Final Rule describes how the fair market value of the property underlying a secured claim will be determined;¹² clarifies that a secured creditor may request the consent of the receiver to dispose of or liquidate the collateral and outlines the process for doing so;¹³ and provides that if the receiver decides to use or sell property subject to a security interest, adequate protection must be provided to secured creditors through cash payments, replacement liens, or any other relief necessary to protect the secured creditor against a decrease in the value of the creditor's security interest.¹⁴
- **Consent to certain actions.** The Final Rule incorporates a provision, similar to the provision added to 12 CFR § 380.24 described above, that expressly acknowledges that holders of qualified financial contracts will not need to seek the consent of the receiver before exercising contractual rights against property of the covered financial company.¹⁵

Until its publication in the Federal Register, the Final Rule is available on the FDIC's website.

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¹² 12 CFR § 380.50. The Final Rule does not specify a particular point in time when property underlying a secured claim will be valued. In the preamble accompanying the Final Rule, the FDIC provides illustrations for the operation of the provision. If a secured claimant requests the receiver's consent to obtain possession of or control over the property securing the claim, the receiver would value the property at the time of the request. If the receiver proposes to sell property subject to a security interest, the property would be valued at the time of sale.

¹³ 12 CFR § 380.51(a)-(d).

¹⁴ 12 CFR § 380.52.

¹⁵ 12 CFR § 380.51(g).