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Reforming "Too Big to Fail"

The financial reform bill creates a new liquidation process that would allow the FDIC to seize control of large, interconnected financial companies, including broker-dealers, whose imminent failure threatens the stability of the U.S. financial system as a whole.

July 22, 2010

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Wall Street Reform Act), was signed into law by President Obama on July 21. Among the Wall Street Reform Act's many sweeping changes, including provisions addressing consumer protection and executive compensation (both of which are the topics of prior LawFlash Alerts), Title II, titled Orderly Liquidation Authority, creates a new scheme, separate and apart from existing federal bankruptcy and state dissolution laws, through which a financial company can be liquidated.

The Basic Framework

The liquidation process begins when the Secretary of the Treasury (the Secretary), upon the written recommendation of the Board of Governors of the Federal Reserve System (the Board) and the Federal Deposit Insurance Corporation (the FDIC) (in the case of a broker or dealer, the U.S. Securities and Exchange Commission (the SEC); in the case of an insurance company, the Director of the Federal Insurance Office) makes a systemic risk determination, with respect to any company, that, among other factors, fulfills the following criteria:

- Such company is in default or at risk of default
- The failure of such company and its resolution under otherwise applicable federal or state law would have a negative impact on the financial stability of the United States
- Actions pursuant to an orderly liquidation (through the FDIC receivership process) would avoid or mitigate such adverse effects (taking into account, inter alia, the cost to the Treasury and the potential to increase excessive risk)
- The company satisfies the definition of a Financial Company[1] (a Covered Financial Company)

[1] A Financial Company is defined in the Reform Act as any U.S. company (not chartered under and subject to the Farm Credit Act of 1971) that is (i) a bank holding company, (ii) a nonbank financial company supervised by the Board, (iii) predominantly engaged in activities that the Board has determined are financial in nature, or (iv) any subsidiary of any company fitting the preceding descriptions and is itself predominately engaged in activities that the Board has determined are financial in nature.

After making its determination, the Secretary, upon notice to the Covered Financial Company (and upon consent of such company's board of directors or applicable governing body), will appoint the FDIC as receiver for the Covered Financial Company. If the board of directors of the Covered Financial Company does not consent to the appointment of the FDIC as receiver, the Secretary can then petition the U.S. District Court for the District of Columbia (the D.C. Court) for an order authorizing the FDIC's appointment. Following a confidential hearing, any determination by the D.C. Court with respect to such petition is final and appealable, by either the Secretary or the board of directors, within 30 days, to the U.S. Court of Appeals for the Third Circuit,[2] but is not subject to any stay or injunction pending an appeal.

If the Covered Financial Company is a broker or dealer, upon the appointment of the FDIC as receiver, the FDIC then appoints the Securities Investor Protection Corporation (SIPC) as trustee to the Covered Financial Company under the Securities Investor Protection Act of 1970 (SIPA). In such role, SIPC can exercise all of its powers and duties provided by SIPA, but cannot impede certain powers and actions of the FDIC. Likewise, the FDIC is subject to certain limitations in carrying out its receivership duties with respect to a covered broker-dealer—for example, the FDIC may not adversely affect or impair the rights of a customer with respect to payments on account of customer property or customer name securities.

Powers and Duties of the Receiver

Many of the powers and duties of the FDIC as receiver for a Covered Financial Company are similar to the powers and duties provided to a trustee or debtor-in-possession under the U.S. Bankruptcy Code or a receiver under state receivership laws. Basic powers include, without limitation:

- The ability to succeed to all rights, titles, powers, and privileges of the Covered Financial Company, as well as the books, records, and assets with respect to such company

- The ability to operate the Covered Financial Company with all the powers of the members, shareholders, directors, and officers, including the right to collect and pay obligations, and perform all functions in the name of the company

- The ability to enter into contracts with third parties for assistance in fulfilling the receiver's duties and functions

The FDIC as receiver has other important powers, as follows:

Legal Actions

After its appointment, the receiver may request a stay for a period not to exceed 90 days in any noncriminal judicial action or proceeding to which the Covered Financial Company is or becomes a party. To the extent an appealable judgment was rendered prior to its appointment, the receiver (i) has all the rights and remedies available to the Covered Financial Company, including appellate rights, and (ii) is not required to post a bond to pursue such remedies. The FDIC as receiver also has subpoena authority under the applicable section of the Federal Deposit Insurance Act, as if the Covered Financial Company were an insured depository institution.

[2] The decision of the Third Circuit may be appealed to the U.S. Supreme Court within 30 days.

In any action brought by the receiver, the applicable statute of limitations period is (i) in the case of a contract claim, the longer of six years from the date such claim accrues, or the applicable state law period, and (ii) in the case of a tort claim, the longer of three years from the date such claim accrues, or the applicable state law period. However, if the applicable state law statute of limitations with respect to a tort claim expired less than five years before the receiver's appointment, then the receiver may bring suit on such claim regardless of the expiration of such period.

Avoidable Transfers
The Wall Street Reform Act authorizes the receiver to avoid fraudulent and preferential transfers of any interest in property of, or obligation incurred by, the Covered Financial Company, pursuant to provisions similar to those in the U.S. Bankruptcy Code. In fact, the statute references the same definitions for the terms "insider" and "insolvent" and provides that a transferee or obligee subject to the receiver's avoidance powers has the same defenses as a transferee or obligee under sections 547, 548, and 549 of the Bankruptcy Code.

Claims Determination
The receiver must promptly publish and mail notice to the Covered Financial Company's creditors of a specified date by which to present claims, which date is not less than 90 days after the publication of such notice. A claim filed after the specified deadline will be disallowed unless (i) the claimant did not receive notice of the appointment of the receiver and (ii) the claim was filed in time to permit payment.

Under routine procedures, the receiver must decide within 180 days (which may be extended) after a claim is filed whether to allow such claim, and provide notice of its determination. A claimant may seek judicial determination of its claim by filing (or continuing) suit in the U.S. District Court for the District of Columbia or the district in which the company's principal place of business is located before the end of 60 days following the earlier of (i) the end of the 180-day period (or longer if extended) or (ii) the date of any notice of disallowance.

Under an expedited process for any claimant who (i) holds or controls a legally valid and enforceable perfected security interest in property or a specific asset of the Covered Financial Company and (ii) will suffer irreparable injury if the routine claims procedure is followed, the receiver must make its determination to allow or disallow (and provide notice of its decision) within 90 days following the date such claim is filed. A judicial review of such claim may be initiated following the end of the 90-day period.

Payments and Priorities
The receiver may pay on creditor claims in such manner and amounts as are authorized under the statute. Unsecured claims against the Covered Financial Company, or the FDIC as receiver for it, have priority in the following order:

- (i) Administrative expenses of the receiver
- (ii) Amounts owed to the United States (unless the United States agrees otherwise)
- (iii) Wages, salaries, or commissions of individuals (excluding senior executives and directors) earned not later than 180 days before the receiver's appointment, up to $11,725 (as adjusted for inflation)
- (iv) Contributions to employee benefit plans (from services rendered not later than 180 days prior to the receiver's appointment)
- (v) Other general or senior liabilities of the Covered Financial Company
- (vi) Any obligation subordinated to general creditors

(vii) Wages, salaries, or commissions owed to senior executives and directors of the Covered Financial Company
(viii) Equity interests

As part of its incidental powers, the receiver may obtain credit or incur debt on the part of the Covered Financial Company, which debt has priority over all administrative expenses.

The receiver may also, with the approval of the Secretary, make additional payments or credit additional amounts to any claimant if the receiver believes that such payments or credits are necessary or appropriate to (i) minimize losses to the receiver from the resolution of the Covered Financial Company, or (ii) prevent or mitigate serious adverse effects to the financial stability or economy of the United States.

Leases and Contracts
The receiver may generally enforce, assign, or disaffirm and repudiate any contract or lease.[3] Any liability resulting from the disaffirmance or repudiation of any contract is (i) limited to actual, direct compensatory damages (which are separately set forth by type of contract) and (ii) determined as of the date of the appointment of the receiver, or in the case of Qualified Financial Contracts, as of the date of the disaffirmance or repudiation of such contract. With respect to a contract for services, if the receiver accepts performance by the counterparty prior to repudiation, such counterparty is to be paid under the terms of the contract for the services performed and such payment is treated as an administrative expense.

In the case of a lease where the Covered Financial Company is the lessee, the lessor: (i) is entitled to the contractual rent accruing before the later of (a) notice of disaffirmance or repudiation or (b) the effective date of disaffirmance or repudiation, unless the lessor is in default of the terms of the lease; (ii) has no claim for damages under any acceleration clause or penalty provisions; and (iii) has a claim for any unpaid rent, due as of the date of the receiver's appointment, less any setoffs and defenses.

Where the Covered Financial Company is the lessor, and the receiver repudiates such lease (and the lessee is not in default as of the date of such repudiation), the lessee may (i) treat the lease as terminated by such repudiation or (ii) remain in possession of the leasehold interest for the balance of the term of the lease, in which case the lessee (a) must continue to pay the contractual rent and (b) may offset any rent against damages due to the nonperformance of any obligation by the Covered Financial Company.

Similarly, where the receiver repudiates a contract for the sale of real property (and the purchaser is not in default), the purchaser may (i) treat the contract as terminated by the repudiation or (ii) remain in possession of such real property, in which case the purchaser (a) must continue making payments under such contract after repudiation and (b) may offset payments against any damages due to the nonperformance of the Covered Financial Company.

Bridge Financial Companies
The receiver may create, by charter, a bridge financial company as a vehicle in liquidating the Covered Financial Company. Such bridge financial company can (i) assume the rights, powers, and privileges;

[3] There are special provisions limiting the receiver's powers with respect to Qualified Financial Contracts, which are defined under the Wall Street Reform Act as any securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements and other similar agreements.

(ii) acquire liabilities and assets (which may include any trust or custody business and fiduciary appointments); and (iii) perform any other temporary function, of the Covered Financial Company.

Subject to certain limitations and restrictions, the receiver may transfer the assets and liabilities of, or merge a Covered Financial Company into, a bridge financial company without the need for approval under applicable federal or state law. Any judicial action to which a bridge financial company becomes a party, by virtue of its acquisition of any assets or assumption of any liabilities of a Covered Financial Company, is stayed for a period up to 45 days at the request of the bridge financial company.

A bridge financial company may also obtain credit and issue debt. Such debt may be secured by liens authorized by the FDIC, after notice and hearing, only if (i) the bridge financial company is otherwise unable to obtain such credit or issue such debt and (ii) there is adequate protection of the interest of any other holder of a lien on property with respect to which the proposed lien is to be granted.

A bridge financial company terminates at the end of the two-year period (which may be extended for three additional one-year periods at the discretion of the FDIC) following the date it was granted a charter, unless otherwise terminated upon the earliest of (i) the merger or consolidation of the bridge financial company with another company; (ii) at the election of the FDIC, the sale of a majority of the capital stock of the bridge financial company to another company; (iii) the sale of 80% or more of the capital of the bridge financial company; (iv) at the election of the FDIC, the assumption of all or substantially all of the assets of the bridge financial company by another company; or (v) the dissolution of the bridge financial company.

Liquidation Funding
Under the Wall Street Reform Act, an Orderly Liquidation Fund (the Liquidation Fund) will be established in the U.S. Treasury, which fund is available to the FDIC to cover its costs as receiver in carrying out the orderly liquidation of a Covered Financial Company. The Liquidation Fund will be funded by, among other sources, investments, and proceeds of obligations issued by the FDIC to the Secretary (the Fund Obligations).

In addition, the FDIC may impose graduated risk-based assessments as is necessary to repay the Fund Obligations within five years following the issuance of such Fund Obligations, on any claimant that received additional payments from the receiver to recover the difference between what such claimant received and what the claimant would have been entitled to receive solely from the liquidation of the Covered Financial Company, and, if the cumulative recoveries from such claimants are insufficient to repay the Fund Obligations, Financial Companies with total consolidated assets equal to or greater than $50 billion and nonbank financial companies supervised by the Board.

Ban Against Certain Individuals
In addition to the authority and mechanics of an orderly liquidation of a Covered Financial Company through a receivership under the FDIC, section 213 of Title II sets forth a ban against certain senior executives or directors from participating in the affairs of any Covered Financial Company.

Specifically, if the Board or FDIC, as applicable, determines that (i) a senior executive or director of a Covered Financial Company has (a) violated any law or regulation, or any order or condition of a federal agency, (b) engaged in any unsafe or unsound practice (in connection with any Financial Company), and (c) breached such executive's fiduciary duties; (ii) that such senior executive or director received financial gain and contributed to the failure of the company by reason of the violation, breach or practice; and that (iii) such violation, practice or breach involves personal

dishonesty, or demonstrates willful disregard for the safety and soundness of the company, then such senior executive or director may be prohibited from any participation in the conduct of the affairs of any Financial Company for a period of not less than two years.

We will continue to monitor the ongoing developments of Financial Regulatory Reform. If you have any questions or would like more information on the issues discussed in this LawFlash, please contact the authors, **Howard S. Beltzer** (212.309.6976; hbeltzer@morganlewis.com) and **Annie C. Wells** (212.309.6976; awells@morganlewis.com), or any of the following Morgan Lewis attorneys:

New York

Howard S. Beltzer	212.309.6976	hbeltzer@morganlewis.com
Annie C. Wells	212.309.6976	awells@morganlewis.com

Washington, D.C.

Kathleen W. Collins	202.739.5642	kcollins@morganlewis.com

In addition, Morgan Lewis's multidisciplinary Financial Regulatory Reform resource team is available to assist with a wide range of issues and areas of concern related to the reform effort. You can access a complete collection of the firm's updates and alerts on the subject on our website's Financial Regulatory Reform page.

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