

# FEDERAL DEPOSIT INSURANCE CORPORATION

## 12 CFR Part 380

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

**Agency:** Federal Deposit Insurance Corporation (FDIC).

**Action:** Notice of Proposed Rulemaking.

**SUMMARY:** The FDIC is proposing a rule (“Proposed Rule”), with request for comments, which would implement certain provisions of its authority to resolve covered financial companies under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), Pub. L. 111-203, 12 U.S.C. 5301 et seq. (July 21, 2010). The FDIC’s intent in issuing this Proposed Rule is 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.

**DATES:** Written comments on the Proposed Rule and questions on that rule must be received by the FDIC not later than **[Insert date 30 days after publication in the Federal Register]**. Written responses to the additional questions posed by the FDIC must be received by the FDIC not later than **[Insert date 90 days after publication in the Federal Register]**.

**ADDRESSES:** You may submit comments by any of the following methods:

- *Agency Web Site:* <http://www.fdic.gov/regulations/laws/federal>. Follow instructions for submitting comments on the Agency Web Site.
- *E-mail:* [Comments@FDIC.gov](mailto:Comments@FDIC.gov). Include “Orderly Liquidation” in the subject line of the message.
- *Mail:* Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17<sup>th</sup> Street, NW, Washington, D.C. 20429.
- *Hand Delivery/Courier:* Guard station at the rear of the 550 17<sup>th</sup> Street Building (located on F Street) on business days between 7 a.m. and 5 p.m. (EDT).
- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.
- *Public Inspection:* All comments received will be posted without change to <http://www.fdic.gov/regulations/laws/federal> including any personal information provided. Paper copies of public comments may be ordered from the Public Information Center by telephone at (877) 275-3342 or (703) 562-2200.

**FOR FURTHER INFORMATION CONTACT:**

Michael Krimminger, Office of the Chairman, 202-898-8950; R. Penfield Starke, Legal Division, 703-562-2422; Federal Deposit Insurance Corporation, 550 17<sup>th</sup> Street N.W., Washington, DC 20429.

## **SUPPLEMENTARY INFORMATION:**

### **I. Background**

Prior to the enactment of the Dodd-Frank Act on July 21, 2010, there was no common or adequate statutory scheme for the orderly liquidation of a financial company whose failure could adversely affect the financial stability of the United States. Instead, insured depository institutions were subject to an FDIC-administered receivership under applicable provisions of the Federal Deposit Insurance Act (“FDI Act”), insurance companies were subject to insolvency proceedings under individual State’s laws, registered brokers and dealers were subject to the U.S. Bankruptcy Code and proceedings under the Securities Investor Protection Act, and other companies (including the parent holding company of one or more insured depository institutions or other financial companies) were eligible to be a debtor under the U.S. Bankruptcy Code. These disparate insolvency regimes were found to be inadequate to effectively address the actual or potential failure of a financial company that could adversely affect economic conditions or financial stability in the United States. In such a case, financial support for the company sometimes was the only viable option available for the Federal government to avoid or mitigate serious adverse effects on economic conditions and financial stability that could result from the company’s failure.

With the enactment of the Dodd-Frank Act, Federal regulators have the tools to resolve a failing financial company that poses a significant risk to the financial stability of the United States. The receivership process established under Title II of the Dodd-Frank Act provides for an orderly liquidation of such a “covered financial company” in a way that addresses the concerns and interests of legitimate creditors while also protecting broader economic and taxpayer interests.

#### *Appointment of Receiver*

Title II of the Dodd-Frank Act provides a process for the appointment of the FDIC as receiver of a failing financial company that poses significant risk to the financial stability of the United States (a “covered financial company”). Under this process, certain designated Federal regulatory agencies must recommend to the Secretary of the Treasury (the “Secretary”) that the Secretary, after consultation with the President, make a determination that grounds exist to appoint the FDIC as receiver of the company. The Federal Reserve Board and the Securities and Exchange Commission will make the recommendation if the company or its largest U.S. subsidiary is a broker or a dealer; the Federal Reserve Board and the Director of the Federal Insurance Office will make the recommendation if the company or its largest subsidiary is an insurance company; and the Federal Reserve Board and the FDIC will make the recommendation in all other

cases. This procedure is similar to that which is applied to systemic risk determinations under section 13 of the FDI Act (12 U.S.C. 1823(c)(4)).

The Dodd-Frank Act requires that recommendations to the Secretary include an evaluation of whether the covered financial company is in default or in danger of default, a description of the effect that the company's default would have on the financial stability of the United States, and an evaluation of why a case under the Bankruptcy Code would not be appropriate. In determining whether the FDIC should be appointed as receiver, the Secretary must make specific findings in support, including: that the company is in default or in danger of default; that the failure of the company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States; no viable private sector alternative is available; any effect on the claims or interests of creditors, counterparties, and shareholders is appropriate; any action under the liquidation authority will avoid or mitigate such adverse effects taking into consideration the effectiveness of the action in mitigating the potential adverse effects on the financial system, cost to the general fund of the Treasury, and the potential to increase excessive risk taking; a Federal regulatory agency has ordered the company to convert all of its convertible debt instruments that are subject to regulatory order; and the company satisfies the definition of a financial company under the law.

If the Secretary makes the recommended determination and the board of directors (or similar governing body) of the company acquiesces or consents to the appointment, then the FDIC's appointment as receiver is effective immediately. If the company's governing body does not acquiesce or consent, the Dodd-Frank Act provides for immediate judicial review by the United States District Court for the District of Columbia of whether the Secretary's determinations that the covered financial company is in default or danger of default and that it meets the definition of financial company under Title II are arbitrary and capricious.<sup>1</sup> If the court upholds the Secretary's determination, it will issue an order authorizing the Secretary to appoint the FDIC as receiver.<sup>2</sup> If the court fails to act within twenty-four hours of receiving the petition, then the appointment of the receiver takes effect by operation of law.

### *Orderly Liquidation*

Title II of the Dodd-Frank Act (entitled "Orderly Liquidation Authority") also defines the policy goals of the liquidation proceedings and provides the powers and duties of the FDIC as receiver for a covered financial company. Section 204(a)<sup>3</sup> succinctly summarizes those policy goals as the liquidation of "failing financial companies that pose a significant risk to the financial stability of the United States in a

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<sup>1</sup> The immediate judicial review required by the Dodd-Frank Act contrasts with the analogous provisions in the National Bank Act (12 U.S.C. 191(b)), the Home Owner's Loan Act (12 U.S.C. 1464(c)(2)(B)), and the Federal Deposit Insurance Act (12 U.S.C. 1821(c)(7)). Each of these statutes permits judicial review of the appointment of the receiver, but only after the appointment has taken effect.

<sup>2</sup> If the court overrules the Secretary's determination, the Secretary is provided the opportunity to amend and refile the petition immediately. The Dodd-Frank Act includes appeal provisions, but does not provide for a stay of the actions taken by the receiver after its appointment.

<sup>3</sup> Unless the context requires otherwise, all section references are to the Dodd-Frank Act.

manner that mitigates such risk and minimizes moral hazard.” The statute goes on to say that “creditors and shareholders will bear the losses of the financial company” and the FDIC is instructed to liquidate the covered financial company in a manner that maximizes the value of the company’s assets, minimizes losses, mitigates risk, and minimizes moral hazard. See sections 204(a) and 210(a)(9)(E). Fundamentally, a liquidation under the Dodd-Frank Act is a liquidation of the company that imposes the losses on its creditors and shareholders. Not only is the FDIC prohibited from taking an equity interest in or becoming a shareholder of a covered financial company or any covered subsidiary, but other provisions of the Dodd-Frank Act bar any Federal government bail-out of a covered financial company. See section 210(h)(3)(B). In this way, the statute will prevent any future taxpayer bailout by providing a liquidation process that will prevent a disorderly collapse, while ensuring that taxpayers bear none of the costs.

Similarly, management, directors, and third parties who are responsible for the company’s failing financial condition will be held accountable. The FDIC must remove any management and members of the board of directors of the company who are responsible for the failing condition of the covered financial company. See section 206.

While ensuring that creditors bear the losses of the company’s failure under a specific claims priority, Title II incorporates procedural and other protections for creditors to ensure that they are treated fairly. For example, creditors can file a claim with the receiver and, if dissatisfied with the decision, may file a case in U.S. district court in which no deference is given to the receiver’s decision. See section 210(a)(2)-(4). Once claims are proven, the FDIC has the authority to make interim payments to the creditors, consistent with the priority for payment of their allowed claims, as it does in resolutions of insured depository institutions. This accelerated or advance dividend authority, provided in section 210(a)(7), is a valuable tool to provide payments to creditors and lessen the economic and financial impact of the liquidation. In addition, creditors also are guaranteed that they will receive no less than the amount they would have received if the covered financial company had been liquidated under Chapter 7 of the Bankruptcy Code. See section 210(a)(7)(B) and (d)(2)(B). Shareholders of a covered financial company will not receive payment until after all other claims are fully paid. See section 210(b)(1). This helps ensure that the priority of payments will be enforced.

Parties who are familiar with the liquidation of insured depository institutions under the FDI Act or the liquidation of companies under the Bankruptcy Code will recognize many parallel provisions in Title II. Some provisions are drawn from analogous provisions of the Bankruptcy Code in order to clarify and supplement the authority that the FDIC normally exercises in a bank receivership. The provisions of Title II governing the claims process (including the availability of judicial review of claims disallowed by the receiver), the termination or repudiation of contracts, and the treatment of qualified financial contracts are modeled after the FDI Act, while provisions that empower the FDIC to avoid and recover fraudulent transfers, preferential transfers, and unauthorized transfers of property by the covered financial company are drawn from

Bankruptcy Code provisions. The rules of Title II governing the setoff of mutual debt provide equivalent protections to those under the Bankruptcy Code.

The liquidation rules of Title II are designed to create parity in the treatment of creditors with the Bankruptcy Code and other normally applicable insolvency laws. This is reflected in the direct mandate in section 209 of the Dodd-Frank Act to “to seek to harmonize applicable rules and regulations promulgated under this section with the insolvency laws that would otherwise apply to a covered financial company.” One of the goals of the Proposed Rule would be to begin the implementation of this mandate in certain key areas. Of particular significance is § 380.2 of the Proposed Rule, which clarifies that the authority to make additional payments to certain creditors will never be used to provide additional payments, beyond those appropriate under the defined priority of payments, to shareholders, subordinated debt holders, and bondholders. The FDIC, in this Proposed Rule, is proposing that the creditors of the covered financial company will never meet the statutory criteria for receiving such additional payments.

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). Under the Dodd-Frank Act, the corresponding ability to continue key operations, services, and transactions is accomplished, in part, through authority for the FDIC to charter a bridge financial company. The bridge financial company is a completely new entity that will not be saddled with the shareholders, debt, senior executives or bad assets and operations that contributed to the failure of the covered financial company or that would impede an orderly liquidation. Shareholders, debt holders, and creditors will receive “haircuts” based on a clear priority of payment set out in section 210(b). As in prior bridge banks used in the resolution of large insured depository institutions, however, the bridge financial company authority will allow the FDIC to stabilize the key operations of the covered financial company by continuing valuable, systemically important operations.

This authority is an important tool for the elimination of “too big to fail” because it provides the FDIC with the authority to prevent a disorderly collapse, while ensuring that bail-outs of failing companies will not occur. However, overly broad application of this authority could lead creditors to assume that they will be protected and impair the needed market discipline. For this reason, it is essential that the FDIC clarify that certain categories of creditors will never receive additional payments under this authority, that all unsecured and under-secured creditors of the failed company should expect that they will incur losses, and that the statutory standards for application of this authority will be rigorously applied in the liquidation of a covered financial company.

To emphasize that all unsecured creditors should expect to absorb losses along with other creditors, the Proposed Rule clarifies the narrow circumstances under which

creditors could receive any additional payments or credit amounts under Sections 210(b)(4), (d)(4), or (h)(5)(E). Under the Proposed Rule, such payments or credit amounts could be provided to a creditor only if 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.

Assets and operations that are necessary to maximize the value in the liquidation or prevent a disorderly collapse can be continued seamlessly through the bridge financial company. This is supported by the clear statutory provisions that contracts transferred to the bridge financial company cannot be terminated simply because they are assumed by the bridge financial company. See section 210(c)(10). As in the FDI Act, the FDIC has the authority to require contracting parties to continue to perform under their contracts if the contracts are needed to continue operations transferred to the bridge. Under the Dodd-Frank Act, the contracting parties must continue to perform so long as the bridge company continues to perform. In contrast to the Bankruptcy Code, the FDIC under the Dodd-Frank Act can similarly require parties to financial market contracts to continue to perform so long as statutory notice of the transfer is provided within one business day after the FDIC is appointed as receiver. This is an important tool to allow the FDIC to maximize the value of the failed company's assets and operations and to avoid market destabilization. This authority will help preserve the value of the company by allowing continuation of critical business operations. If financial market contracts are transferred to the bridge company, it also can prevent the immediate and disorderly liquidation of collateral during a period of market distress. This cannot be done under the Bankruptcy Code. The absence of funding for continuing valuable contracts and the rights of counterparties under the Bankruptcy Code to immediately terminate those contracts resulted in a loss of billions of dollars in market value to the bankruptcy estate in the Lehman insolvency.<sup>4</sup>

The bridge financial company arrangement will provide a timely, efficient, and effective means for preserving value in an orderly liquidation and avoiding a destabilizing and disorderly collapse. While the covered financial company's board of directors and the most senior management responsible for its failure will be replaced, as required by section 204(a)(2), operations would be continued by the covered financial company's employees under the strategic direction of the FDIC and contractors employed by the FDIC to help oversee those operations. Section 380.2 of the Proposed Rule addresses the treatment of these employees.

To achieve these goals, the FDIC is given broad authority under the Dodd-Frank Act to operate or liquidate the business, sell the assets, and resolve the liabilities of a

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<sup>4</sup> Examiner's Report, pg. 725, <http://lehmanreport.jenner.com/VOLUME%202.pdf>.

covered financial company immediately after its appointment as receiver or as soon as conditions make this appropriate. This authority will enable the FDIC to act immediately to sell assets of the covered financial company to another entity or, if that is not possible, to an FDIC-created bridge financial company while maintaining critical functions. In receiverships of insured depository institutions, the ability to act quickly and decisively has been found to reduce losses to the deposit insurance funds while maintaining key banking services for depositors and businesses, and it is expected to be equally crucial in resolving non-bank financial firms under the Dodd-Frank Act.

A vital element in a prompt sale to other private sector companies or the continuation of essential operations in the bridge financial company is the availability of funding for those operations. The liquidity available under the Dodd-Frank Act will allow both sales at better value and a more orderly liquidation. The Act provides that the FDIC may borrow funds from the Department of the Treasury to provide liquidity for the operations of the receivership and the bridge financial company. See sections 204(d) and 210(n). The bridge financial company also can access debtor-in-possession financing as needed. Once the new bridge financial company's operations have stabilized as the market recognizes that it has adequate funding and will continue key operations, the FDIC would move as expeditiously as possible to sell operations and assets back into the private sector.

Extensive pre-planning is essential for the effective use of these powers. Advance planning will improve the likelihood that the assets or operations of a failed financial company can be sold immediately or shortly after creation of the bridge financial company to other private sector companies. This should be an expected product of the advance planning mandates of the Dodd-Frank Act. Those mandates will require both regulators and senior management of large, complex financial companies to focus more intently on enhancing the resiliency and resolvability of the companies' operations. This, in turn, will improve the efficiency and speed at which those operations can be transferred to other private companies and both greatly enhance the effectiveness of crisis management and reduce the extent of governmental intervention in the resolution of any future crisis.

Such advance planning, a well-developed resolution plan, and access to the supporting information needed to undertake such planning has been a critical component of the FDIC's ability to smoothly resolve failing banks. This critical issue is addressed in the Dodd-Frank Act in provisions that grant the FDIC back-up examination authority and require the largest companies to submit so-called "living wills" or resolution plans that will facilitate a rapid and orderly resolution of the company under the Bankruptcy Code. See section 165(d). An essential part of such plans will be to describe how this process can be accomplished without posing systemic risk to the public and the financial system. If the company cannot submit a credible resolution plan, the statute permits the FDIC and the Federal Reserve to jointly impose increasingly stringent requirements that, ultimately, can lead to divestiture of assets or operations identified by the FDIC and the Federal Reserve to facilitate an orderly resolution. The FDIC and the Federal Reserve will jointly adopt a rule to implement the resolution plan requirements of the Dodd-Frank Act. The

availability of adequate information and the establishment of feasible resolution plans are all the more critical because the largest covered financial companies operate globally and their liquidation will necessarily involve coordination among regulators around the world.

To strengthen the foundation for effective resolutions, the FDIC also will promulgate other rules and provide additional guidance in consultation with the members of the Financial Stability Oversight Council to ensure a credible liquidation process that realizes the goal of ending “too big to fail” while enhancing market discipline.

This highlights another key component of preparedness: the necessity of advance planning with other potentially affected regulators internationally. The Dodd-Frank Act’s framework for an orderly liquidation provides the United States with the vital elements to prevent contagion in any future crisis, while closing the firms and making the creditors and shareholders bear the losses. For this process to work most efficiently, however, it is essential that legal and policy reforms are adopted in key foreign jurisdictions so that the cross-border operations of the covered financial company can be liquidated consistently, cooperatively, and in a manner that maximizes their value and minimizes the costs and negative effects on the financial system. The key reforms involve recognition in the foreign legal and regulatory systems where the FDIC would control the company’s assets and operations; and that the FDIC would have the authority, subject to appropriate assurances that the FDIC will meet ongoing commitments, to continue the covered financial company’s operations to facilitate an orderly wind-down of the company. Through the framework provided by the Dodd-Frank Act, the FDIC is working to facilitate these reforms and is engaged with foreign regulators in the work required to improve cooperation and ensure a much better process is implemented in any future liquidation involving a cross-border company.

## **II. The Proposed Rule**

Section 209 of the Dodd-Frank Act 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 purpose of the Proposed Rule is to provide guidance on certain key issues in order to provide clarity and certainty to the financial industry 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. In this notice of proposed rulemaking, the FDIC also is posing broad and specific questions to solicit public comment on potential additional issues that may require clarification in a broader notice of proposed rulemaking in the future.

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), (d)(4), and (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).

### *Section-by-Section Analysis*

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

*Treatment of Similarly Situated Creditors.* The Dodd-Frank Act permits the FDIC to pay certain creditors of a receivership more than similarly situated creditors if it is necessary to: (1) “maximize the value of the assets”; (2) initiate and continue operations “essential to implementation of the receivership and any bridge financial company”; (3) “maximize the present value return from the sale or other disposition of the assets”; or (4) “minimize the amount of any loss” on sale or other disposition. 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 case under Chapter 7 of the Bankruptcy Code. See section 210(d)(2)(B).

These provisions parallel authority the FDIC has long had 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, § 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 receive 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 rule focuses 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 will be provided with additional payments under sections 210(b)(4), (d)(4) or (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 they may receive additional payments under the Proposed Rule, this will be evaluated on a case-by- case basis and will only occur when such payments meet all of the statutory requirements.

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 agreement 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 these 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. Most importantly, under no circumstances in a Dodd-Frank liquidation will taxpayers ever be exposed to loss.

The Proposed Rule would expressly distinguish between 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 would include, without limitation, collective bargaining agreements. Like other contracts with the covered financial company, a personal services agreement would be 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 would be paid according to the terms and conditions of their personal service agreement and such payments would 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) would not impair the receiver's ability subsequently to repudiate a personal services agreement.<sup>5</sup> The Proposed Rule also would make clear that a personal service agreement would 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 would not be predicated on such assumption. Subparagraph (e) of § 380.3 would make clear that the provision for payment of employees would not apply to senior executives or directors of the covered financial company,<sup>6</sup> nor would 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.

*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)

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<sup>5</sup> 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)).

<sup>6</sup> 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 would expect to 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).

cannot have occurred as of the date of the appointment of the receiver. In addition, the FDIC holds the view 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 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 resolution of the subsidiary will be distributed according to the priority of expenses and unsecured claims 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 is 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 FDIC recognizes that the orderly liquidation of a covered financial company that is a covered subsidiary of, or an affiliate of, an insurance company should not unnecessarily interfere with the liquidation or rehabilitation of the insurance company under applicable state law, and that the interests of the policy holders in the assets of the insurance company should be respected. Accordingly, the FDIC is proposing that it 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. Subsection (b) of § 380.6 makes clear that no restriction on taking a lien on assets of a covered financial company or any covered subsidiary or affiliate would limit or restrict the ability of the FDIC or the receiver to take a lien on 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.

#### **IV. Request for Comments**

The FDIC requests comments on all aspects of the Proposed Rule. All comments and responses to the following questions on the Proposed Rule must be received by the FDIC not later than **[Insert date 30 days after publication in the Federal Register]**. The FDIC specifically requests comments on the following specific questions:

1. Should “long-term senior debt” be defined in reference to a specific term, such as 270 or 360 days or some different term, or should it be defined through a functional definition?
2. Is the description of “partially funded, revolving or other open lines of credit” adequately descriptive? Is there a more effective definition that could be used? If so, what and how is it more effective?
3. Should there be further limits to additional payments or credit amounts that can be provided to shorter term general creditors? Are there further limits that should be applied to ensure that any such payments maximize value, minimize losses, or are to initiate and continue operations essential to the implementation of the receivership or any bridge financial company? If so, what limits should be applied consistent with other applicable provisions of law?

4. Under the Proposed Rule, the FDIC's Board of Directors must determine to make additional payments or credit amounts available to shorter term general creditors only if such payments or credits meet the standards specified in 12 U.S.C. 5390(b)(4), (d)(4), and (h)(5)(E). Should additional requirements be imposed on this decision-making process for the Board? Should a super-majority be required?
5. Under the Dodd-Frank Act, secured creditors will be paid in full up to the extent of the pledged collateral and the proposed rule specifies that direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States shall be valued for such purposes at par value. How should other collateral be valued in determining whether a creditor is fully secured or partially secured?
6. During periods of market disruption, the liquidation value of collateral may decline precipitously. Since creditors are normally held to a duty of commercially reasonable disposition of collateral [Uniform Commercial Code], should the FDIC adopt a rule governing valuation of collateral other than United States or agency collateral? Would a valuation based on a rolling average prices, weighted by the volume of sales during the month preceding the appointment of the receiver, provide more certainty to valuation of other collateral? Would that help reduce the incentives to quickly liquidate collateral in a crisis?
7. Are changes necessary to the provisions of proposed Section 380.3 through 380.6? What other specific issues addressed in these sections should be addressed in the proposed rule or in future proposed rules?

In addition, the FDIC specifically requests responses to the following questions. Written responses to the specific questions posed by the FDIC must be received by the FDIC not later than **[Insert date 90 days after publication in the Federal Register]**.

1. What other specific areas relating to the FDIC's orderly liquidation authority under Title II would benefit from additional rulemaking?
2. Section 209 of the Dodd-Frank Act requires the FDIC, "[t]o the extent possible," "to harmonize applicable rules and regulations promulgated under this section with the insolvency laws that would otherwise apply to a covered financial company." What are the key areas of Title II that may require additional rules or regulations in order to harmonize them with otherwise applicable insolvency laws? In your answer, please specify the source of insolvency laws to which you are making reference.
3. With the exception of the special provisions governing the liquidation of covered brokers and dealers (see section 205), are there different types of

covered financial companies that require different rules and regulations in the application of the FDIC's powers and duties?

4. Section 210 specifies the powers and duties of the FDIC acting as receiver under Title II. Are regulations necessary to define how these specific powers should be applied in the liquidation of a covered company?
5. Should the FDIC adopt regulations to define how claims against the covered financial company and the receiver are determined under section 210(a)(2)? What specific elements of this process require clarification?
6. Should the FDIC adopt regulations governing the avoidable transfer provisions of section 210(a)(11)? What are the most important issues to address for the fraudulent transfer provisions? What are the most important issues to address for the preferential transfers provisions? How should these issues be addressed?
7. What are the key issues that should be addressed to clarify the application of the setoff provisions in section 210(a)(12)? How should these issues be addressed?
8. Do the provisions governing the priority of payments of expenses and claims in section 210(b) and other sections require clarification? If so, what are the key issues to clarify in any regulation?
9. Section 210(b)(4), (d)(4), and (h)(5)(E) address potential payments to creditors "similarly situated" that are addressed in this Proposed Rule. Are there additional issues on the application of this provision, or related provisions, that require clarification in a regulation?
10. Section 210(h) provides the FDIC with authority to charter a bridge financial company to facilitate the liquidation of a covered financial company. What issues surrounding the chartering, operation, and termination of a bridge company would benefit from a regulation? How should those issues be addressed?
11. Regarding actual direct compensatory damages for the repudiation of a contingent obligation in the form of a guarantee, letter of credit, loan commitment, or similar credit obligation, should the Proposed Rule be amended to specifically provide a method for determining the estimated value of the claim? In addition to the statutory considerations in valuation, including the likelihood that the contingent claim would become fixed and its probable magnitude, what other factors are appropriate? If so, what methods for determining such estimated value

would be appropriate? Should the regulation provide more detail on when a claim is contingent?

12. Are the provisions of the Dodd-Frank Act relating to the classification of claims as administrative expenses of the receiver sufficiently clear, or is additional rulemaking necessary to clarify such classification?
13. Should the Proposed Rule's definition of "long-term senior debt" be clarified or amended?

## **V. Regulatory Analysis and Procedure**

### *A. Paperwork Reduction Act*

The Proposed Rule would establish internal rules and procedures for the liquidation of a failed systemically important financial company. It would not involve any new collections of information pursuant to the Paperwork Reduction Act (44 U.S.C. 3501 et seq.). Consequently, no information collection has been submitted to the Office of Management and Budget for review.

### *B. Regulatory Flexibility Act*

The Regulatory Flexibility Act requires an agency that is issuing a final rule to prepare and make available a regulatory flexibility analysis that describes the impact of the final rule on small entities. (5 U.S.C. 603(a)). The Regulatory Flexibility Act provides that an agency is not required to prepare and publish a regulatory flexibility analysis if the agency certifies that the final rule will not have a significant impact on a substantial number of small entities.

Pursuant to section 605(b) of the Regulatory Flexibility Act, the FDIC certifies that the Proposed Rule will not have a significant impact on a substantial number of small entities. The Proposed Rule would clarify rules and procedures for the liquidation of a failed systemically important financial company, which will provide internal guidance to FDIC personnel performing the liquidation of such a company and will address any uncertainty in the financial system as to how the orderly liquidation of such a company would operate. As such, the Proposed Rule would not impose a regulatory burden on entities of any size and does not significantly impact small entities.

### *C. The Treasury and General Government Appropriations Act, 1999--Assessment of Federal Regulations and Policies on Families*

The FDIC has determined that the Proposed Rule will not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, enacted as part of the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999 (Public Law 105-277, 112 Stat. 2681).

### *E. Plain Language*

Section 722 of the Gramm-Leach-Bliley Act (Pub. L. 106-102, 113 Stat. 1338, 1471), requires the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. The FDIC has sought to present the Proposed Rule in a simple and straightforward manner. The FDIC invites comments on whether the Proposed Rule is clearly stated and effectively organized and how the FDIC might make the final rule on this subject matter easier to understand.

### **List of Subjects in 12 C.F.R. Part 380**

Holding companies, Insurance companies

■ For the reasons stated above, the Board of Directors of the Federal Deposit Insurance Corporation proposes to amend title 12 of the Code of Federal Regulations by adding new part 380 as follows:

#### **§ 380.1 Definitions**

As used in this part, the terms “bridge financial company,” “Corporation,” “covered financial company,” “covered subsidiary,” “insurance company,” and “subsidiary” have the same meanings as in the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5301 et. seq.)

#### **§380.2 Treatment of similarly situated claimants**

(a) For the purposes of this section, the term “long-term senior debt” means senior debt issued by the covered financial company to bondholders or other creditors that has a term of more than 360 days. It does not include partially funded, revolving or other open lines of credit that are necessary to continuing operations essential to the receivership or any bridge financial company, nor to any contracts to extend credit enforced by the receiver under 12 U.S.C. 5390(c)(13)(D).

(b) In applying any provision of the Act permitting the Corporation to exercise its discretion, upon appropriate determination, to make payments or credit amounts, pursuant to 12 U.S.C. 5390(b)(4), (d)(4), or (h)(5)(E) to or for some creditors but not others similarly situated at the same level of payment priority, the Corporation shall not exercise such authority in a manner that would result in the following recovering more than the amount established and due under 12 U.S.C. 5390(b)(1), or other priorities of payment specified by law:

- (1) holders of long-term senior debt who have a claim entitled to priority of payment at the level set out under 12 U.S.C. 5390(b)(1)(E);
- (2) holders of subordinated debt who have a claim entitled to priority of payment at the level set out under 12 U.S.C. 5390(b)(1)(F);
- (3) shareholders, members, general partners, limited partners, or other persons who have a claim entitled to priority of payment at the level set out under 12 U.S.C. 5390 (b)(1)(H); or
- (4) other holders of claims entitled to priority of payment at the level set out under 12 U.S.C. 5390(b)(1)(E) unless the Corporation, through a vote of the members of the Board of Directors then serving and in its sole discretion,

specifically determines 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 authority of the Board to make the foregoing determination cannot be delegated.

(c) Proven claims secured by a legally valid and enforceable or perfected security interest or security entitlement in any property or other assets of the covered financial company shall be paid or satisfied in full to the extent of such collateral, but any portion of such claim which exceeds an amount equal to the fair market value of such property or other assets shall be treated as an unsecured claim and paid in accordance with the priorities established in 12 U.S.C. 5390(b) and otherwise applicable provisions. Proven claims secured by such security interests or security entitlements in securities that are direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States shall be valued for such purposes at par value.

### **§ 380.3 Treatment of personal service agreements**

#### **(a) Definitions.**

(1) The term “personal service agreement” means a written agreement between an employee and a covered financial company, covered subsidiary or a bridge financial company setting forth the terms of employment. This term also includes an agreement between any group or class of employees and a covered financial company, covered subsidiary or a bridge financial company, including, without limitation, a collective bargaining agreement.

(2) The term “senior executive” means for purposes of this section, any person who participates or has authority to participate (other than in the capacity of a director) in major policymaking functions of the company, whether or not: the person has an official title; the title designates the officer an assistant; or the person is serving without salary or other compensation. The chairman of the board, the president, every vice president, the secretary, and the treasurer or chief financial officer, general partner and manager of a company are considered executive officers, unless the person is excluded, by liquidation of the board of directors, the bylaws, the operating agreement or the partnership agreement of the company, from participation (other than in the capacity of a director) in major policymaking functions of the company, and the person does not actually participate therein.

(b) (1) If before repudiation or disaffirmance of a personal service agreement, the Corporation as receiver of a covered financial company, or the Corporation as receiver of a bridge financial company accepts performance of services rendered under such agreement, then:

(i) the terms and conditions of such agreement shall apply to the performance of such services; and

(ii) any payments for the services accepted by the Corporation as receiver shall be treated as an administrative expense of the receiver.

(2) If a bridge financial company accepts performance of services rendered under such agreement, then the terms and conditions of such agreement shall apply to the performance of such services.

(c) No party acquiring a covered financial company or any operational unit, subsidiary or assets thereof from the Corporation as receiver or from any bridge financial company shall be bound by a personal service agreement unless the acquiring party expressly assumes the personal services agreement.

(d) The acceptance by the Corporation as receiver for a covered financial company, by any bridge financial company or the Corporation as receiver of a bridge financial company of services subject to a personal service agreement shall not limit or impair the authority of the Corporation as receiver to disaffirm or repudiate any personal service agreement in the manner provided for the disaffirmance or repudiation of any agreement under 12 U.S.C. 5390.

(e) Subparagraph (b) of this section shall not apply to any personal service agreement with any senior executive or director of the covered financial company or covered subsidiary, nor shall it in any way limit or impair the ability of the receiver to recover compensation from any senior executive or director of a failed financial company under 12 U.S.C. 5390.

#### **§ 380.4 Provability of claims based on contingent obligations**

(a) This section only applies to contingent obligations of the covered financial company 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 (other than the mere passage of time), which

(1) is not under the control of either the covered financial company or the party to whom the obligation is owed and

(2) has not occurred as of the date of the appointment of the receiver.

(b) A claim based on a contingent obligation of the covered financial company may be provable against the receiver notwithstanding the obligation not having become due and payable as of the date of the appointment of the receiver.

(c) If the receiver repudiates a guarantee, letter of credit, loan commitment, or similar credit obligation that is contingent as of the date of the receiver's appointment, the actual direct compensatory damages for repudiation shall be no less than the estimated value of the claim as of the date the Corporation was appointed receiver of the covered financial company, as such value is measured based upon the likelihood that such contingent claim would become fixed and the probable magnitude thereof.

**§ 380.5 Treatment of covered financial companies that are subsidiaries of insurance companies**

The Corporation shall distribute the value realized from the liquidation, transfer, sale or other disposition of the direct or indirect subsidiaries of an insurance company, that are not themselves insurance companies, solely in accordance with the order of priorities set forth in 12 U.S.C. 5390(b)(1).

**§ 380.6 Limitation on liens on assets of covered financial companies that are insurance companies or covered subsidiaries of insurance companies**

(a) In the event that the Corporation makes funds available to a covered financial company that is an insurance company or is a covered subsidiary or affiliate of an insurance company or enters into any other transaction with respect to such covered entity under 12 U.S.C. 5384(d), the Corporation will exercise its right to take liens on some or all assets of such covered entities to secure repayment of any such transactions only when the Corporation, in its sole discretion, determines that:

- (1) taking such lien is necessary for the orderly liquidation of the entity;
- and
- (2) taking such lien will not either unduly impede or delay the liquidation or rehabilitation of such insurance company, or the recovery by its policyholders.

(b) This section shall not be construed to restrict or impair the ability of the Corporation to take a lien on any or all of the assets of any covered financial company or covered subsidiary or affiliate in order to secure financing provided by the Corporation or the receiver in connection with the sale or transfer of the covered financial company or covered subsidiary or affiliate or any or all of the assets of such covered entity.