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## The Impact of Financial Reform: Framework Established for Liquidating Failed Financial Companies

The *Dodd-Frank Wall Street Reform and Consumer Protection Act* establishes a framework to provide for the orderly liquidation of financial companies that are determined to be systemically significant (“Covered Companies”). Under the legislation, after determination by federal regulators that a Covered Company is in danger of default, the FDIC will step in as receiver to liquidate the company.

### Covered Financial Companies Determined in Hindsight

Once the receivership begins, a Covered Company will be liquidated. But creditors and counterparties may not know whether a financial company is a Covered Company until the company nears default.

The company must first be a “financial company.” This means that 85% of its revenues must derive from financial activities, broadly defined to include activities such as lending or safeguarding money or securities, providing insurance, providing investment advice (including advising an investment company), or engaging in other activity incidental to banking.

Then the Secretary of the Treasury, along with two thirds of the board members of each of the Federal Reserve System and the FDIC, must determine, among other things, that (1) the company’s failure would have “serious adverse effects on financial stability in the United States,” rendering it a Covered Company, and (2) the company is in danger of default (broadly defined as likely to file bankruptcy or become insolvent).

If these criteria are met, the Secretary must appoint the FDIC as receiver of the Covered Company. If the company contests the receivership, the Secretary can petition the United States District Court for the District of Columbia to review the Secretary’s findings under the deferential “arbitrary and capricious” standard within 24 hours, with an expedited appeal process from there on.

Relatively few financial firms are expected to be Covered Companies. The legislation provides that other failed financial companies will be dealt with by the Bankruptcy Code (or the appropriate insolvency regime). Covered Companies, on the other hand, cannot file for bankruptcy once receivership begins.

### Impact on Derivatives Counterparties

The financial reform legislation leaves intact special exemptions in the Bankruptcy Code and current FDIC rules for derivative transactions for Covered Companies as well as all other companies. The legislation applies the FDIC derivatives rules that now cover failed banks to Covered Companies. In particular, counterparties will be stayed from terminating derivatives until 5 p.m. on the business day after the FDIC is appointed as receiver. During this period the FDIC may transfer all derivatives contracts with a counterparty wholesale, although the FDIC is forbidden from “cherry picking” profitable derivatives transactions and terminating unprofitable ones.

## Impact on Creditors

The powers provided to the FDIC and the rights of creditors of Covered Companies are generally analogous to those provided under the Bankruptcy Code. The new rules promise an accelerated determination of creditor rights compared to the pace of such determinations in conventional bankruptcies, but they reduce certainty for unsecured creditors.

The financial reform legislation will speed up the process and reduce delays. There is relatively little court oversight or approval necessary for the receiver to take action, and the FDIC, not company, manages the liquidation. Creditors must submit claims within 90 days of receivership and the FDIC must allow or disallow those claims within 180 days of submission (with further expediting for cause). The entire proceeding cannot last more than three years, or up to five years for cause.

The law provides a priority scheme for unsecured creditors, as in the Bankruptcy Code, but gives the FDIC the power to alter priorities to “maximize the value of the assets of the covered financial company, ... or to minimize the amount of any loss realized upon the sale or other disposition of the assets of the covered financial company.” The only limit on FDIC power to re-order priorities is that unsecured creditors may not receive less than they would in a liquidation under chapter 7 of the Bankruptcy Code. Secured creditors are unaffected by this power.

The priority scheme for unsecured creditors is as follows:

1. Expenses of administering the estate
2. Obligations owed to the United States
3. Unpaid compensation and benefit plan contributions to employees other than senior executives and directors of up to approximately \$12,000 (inflation-adjusted) per employee
4. General or senior unsecured claims
5. Claims subordinated to general unsecured claims
6. Unpaid compensation of senior executives and directors
7. Equity

The legislation also requires a study on the impact of secured creditor haircuts. The legislation prescribes guidelines that must be considered when undertaking this study and requires a report to Congress within a year of enactment.

## Management Liability Imposed

The legislation encourages the FDIC to take legal action against senior management and boards of Covered Companies “consistent with their responsibility” for the failure. It provides that, in addition to other available remedies, the FDIC may recoup up to two years of compensation from culpable senior executives and directors (or compensation over an unlimited period in case of fraud). The legislation further provides that senior executives and directors may be barred from the financial services industry for no less than two years if they are determined to have violated laws or regulations, breached fiduciary duties, or engaged in unsafe or unsound practices.

We continue to evaluate the impact of financial reform legislation, especially those changes that may affect the investment management, banking, hedge and private investment fund, private equity, and derivatives businesses. If you have questions concerning *Financial Reform Matters*, please contact any of the attorneys listed below or the Ropes & Gray attorneys with whom you regularly work:

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