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Distressed Debt

Treatment of a Hedge Fund's Claims Against and Other Exposures To a Covered Financial Company Under the Orderly Liquidation Authority Created by the Dodd-Frank Act

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), heralded as the most significant new financial regulation since the Great Depression. Title II of the Dodd-Frank Act creates a framework to prevent the potential meltdown of systemically important U.S. financial businesses. This framework includes a new federal receivership procedure, the so-called orderly liquidation authority ("OLA"), for significant, interconnected non-bank financial companies whose unmanaged collapse could jeopardize the national economy. The OLA will form part of a new regulatory framework intended to improve economic stability, mitigate systemic risk, and end the practice of taxpayer-financed "bailouts." The OLA generally is modeled on the Federal Deposit Insurance Act ("FDIA"), which deals with insured bank insolvencies, and also borrows from the Bankruptcy Code.

Notwithstanding the enactment of Title II, there will be a heavy presumption that companies that otherwise qualify for protection under the Bankruptcy Code will be reorganized or liquidated through a traditional bankruptcy case. If, however, an institution is deemed to warrant the special procedures under the OLA, Title II will apply, even if a bankruptcy case is then pending for such institution. As discussed below, the decision of whether to invoke Title II will be made outside the public view. As a result, hedge funds that have claims and other exposures to financial companies may find the playing field shifting overnight from the relatively predictable confines of the Bankruptcy Code to the novel and untested framework of the OLA.

This article is a general, high-level discussion of how the following types of claims and exposures would be handled in a receivership governed by Title II based on the regulatory rules currently proposed or in effect: (i) secured claims; (ii) general unsecured claims (such as a claim arising out of unsecured bond debt); (iii) contingent claims (such as a claim relating to a guaranty); (iv) revolving lines of credit and other open commitments to fund; and (v) "qualified financial contracts" (i.e., swap agreements, forward contracts, commodity contracts, securities contracts and repurchase agreements).

General Description of OLA

Under the Dodd-Frank Act, five broad categories of "financial companies" are eligible to be placed into receivership under Title II: (i) bank holding companies; (ii) non-bank financial companies that are required by the newly-created Financial Stability Oversight Council to be regulated and supervised by the Board of Governors of the Federal Reserve System; (iii) companies "predominantly" engaged in activities that are "financial in nature"; (iv) subsidiaries of any of the preceding three classes of financial companies (except for insured depository institutions or regulated insurance companies); and (v) registered brokers or dealers. Although insurance companies are ineligible for federal receivership,

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they may be forced into liquidation or rehabilitation pursuant to state insurance laws if the applicable state insurance regulator does not take timely action. This article focuses on the financial companies described in (i) through (iv) above, which, in most instances, would also qualify for protection under the Bankruptcy Code.

Notwithstanding the newly-enacted OLA procedures, the Bankruptcy Code will continue to play a leading role in the restructuring of distressed financial companies. The Senate Banking Committee's report states that "there is a strong presumption that the bankruptcy process will continue to be used to close and unwind failing financial companies."

The Bankruptcy Code is preempted in favor of Title II, however, where certain strict initiation criteria are met. Generally, these criteria include:

- a written recommendation of the Federal Reserve Board of Governors and the Federal Deposit Insurance Corporation ("FDIC") that the failure of the subject institution would create systemic risk; and
- based on that recommendation, the Secretary of the Treasury, in consultation with the President of the United States, must make a series of prescribed determinations, including that (i) an unavoidable systemic risk exists that can be mitigated through a federal receivership and (ii) a resolution under state or federal law (such as under the Bankruptcy Code) would have adverse effects on the financial stability of the United States, and thereby must seek the appointment of the FDIC as receiver of the subject institution.

Following the decision to appoint the FDIC as receiver, the Secretary of the Treasury must notify the FDIC and the financial company. If the management of the financial company consents, the FDIC will be appointed receiver. If, on the other hand, the management does not consent, the Secretary must petition the United States District Court for the District of Columbia for authorization to appoint the FDIC under Title II. The court, in turn, will consider this petition on a strictly confidential basis, and decide whether the Secretary's determination was "arbitrary and capricious," a very deferential standard. The court is given just 24 hours in which to make this decision. Barring an adverse determination from the court within this limited period, a federal receivership under OLA will be commenced with respect to the subject financial company.

The Dodd-Frank Act provides the FDIC with a broad range of powers similar to those it is given when resolving insolvent depository institutions under the FDIA. As receiver, the FDIC succeeds to the rights, title, and privileges of the subject financial company. It takes control of all the assets and operates them with every power of the financial company's shareholders, officers, and directors. Accordingly, the FDIC may wind up the company's affairs in any manner it deems appropriate, including through the sale of assets or the transfer of assets to a bridge financial company (as discussed below). In the course of doing so, it must operate the liquidation in order to maximize returns, minimize losses and mitigate adverse effects to the financial system at large.

Among the powers conferred on the FDIC is the authority to allow or disallow claims (subject to ex post judicial review). The FDIC also has the discretion to disaffirm or repudiate contracts or leases regardless of whether a contract or lease

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is "executory" (only executory contract – generally speaking, contracts in which performance remains owing on both sides – are subject to assumption or rejection under the Bankruptcy Code). It can also enforce any contract notwithstanding so-called "*ipso facto*" clauses, which provide for the termination or acceleration of a contract upon the insolvency or financial condition of the subject company.

All of these powers can be exercised with the protection of an automatic stay. The Dodd-Frank Act prohibits courts from taking any action that would prevent the FDIC from exercising its responsibilities as receiver. Further, with certain exceptions discussed below, contract counterparties are prohibited, during the first 90-day period of the receivership, from terminating, accelerating or declaring a default under any contract to which the financial company is party without the consent of the FDIC.

Despite the suggestion implicit in the name "orderly liquidation authority," a receivership under the OLA will not necessarily result in a liquidation of the financial company's business. The FDIC has the authority under Title II to restructure the business (so long as a new legal entity is created in the process) if that would satisfy one of the Dodd-Frank Act's primary objectives – the preservation of value and maximization of creditor recovery. The FDIC may choose to effectuate a restructuring through the sale of the financial company's assets. The FDIC can exercise this power without court approval (which typically is required for non-ordinary course transactions in Chapter 11 proceedings) or input from stakeholders, such as creditors and contract counterparties. Providing this ability to rapidly close transactions was deemed critical by the drafters of the Dodd-Frank Act because financial businesses are grounded in trust and confidence which can quickly erode when a transaction is mired in legal proceedings.

If a transaction with a private party is not readily available, the FDIC has the authority to create a bridge financial company to temporarily assume certain assets and liabilities. Although the authority given to the FDIC to create and utilize a bridge company is broad, the Dodd-Frank Act does place certain limits on the FDIC. For example, except in limited circumstances, the FDIC must treat similarly-situated creditors equally when transferring assets or liabilities to the bridge company. Additionally, the bridge company can have only a limited life (up to a maximum of two years in most cases), as it must serve as a bridge to a permanent, private transaction.

Treatment of Claims and Other Exposures

The Dodd-Frank Act contemplates that a federal receivership under Title II will be administered much like a proceeding under the Bankruptcy Code. Indeed, in prescribing the rules and regulations it deems necessary to implement Title II, the FDIC is directed, to the extent possible, to harmonize such rules and regulations with the Bankruptcy Code.

After an initial notice and comment period, the FDIC issued an Interim Final Rule on January 25, 2011 that, among other things, governs how similarly-situated claimants will be treated in an OLA receivership, and details how claims for contingent obligations of a financial company would be handled. See 12 C.F.R. Part 380. On March 15, 2011, the FDIC issued another proposed rule that expands on the Interim Final Rule and sets forth in detail the priorities of expenses and unsecured claims. The notice and comment period on this latest proposed rule ends May 23, 2011.

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Although both the Interim Final Rule and the newly-proposed rule remain subject to revision – the FDIC requested another round of comments on the Interim Final Rule which were to be submitted by March 28, 2011 – they nevertheless provide useful insight into how claims against and other exposures to a covered financial company would be handled under Title II of the Dodd-Frank Act.

The Dodd-Frank Act and the accompanying rules provide that distributions on account of claims and interests must be made in the following order of priority:

- Secured claims;
- Claims related to unsecured debt incurred by the FDIC as receiver for the covered financial company;
- Administrative claims incurred by the FDIC as receiver;
- Claims for any amounts owing to the United States;
- Claims for certain wages, salaries or commissions owed to primarily rank and file employees;
- Claims for certain contributions owed to employee benefit plans;
- Claims for loss of setoff rights (discussed in greater detail below);
- General unsecured claims;
- Subordinated claims;
- Claims for wages, salaries and commissions owed to senior executives and directors of the covered financial company;
- Prescribed level of post-insolvency interest to be paid in the above-described order of priority; and
- Anything remaining in the estate of the covered financial company will be distributed to shareholders, members, general partners, limited partners and others with interests in the company.

Although the Dodd-Frank Act generally requires that similarly-situated claims be administered in a like manner, it permits the FDIC to provide disparate treatment in exceptional circumstances, namely circumstances in which the following criteria are met: the FDIC determines that making additional payments is necessary to:

- Maximize the value of the assets of the covered financial company;
- Initiate and continue operations essential to implementation of the receivership or any bridge financial company;
- Maximize the present value return from the sale or other disposition of the assets of the covered financial company; or
- Minimize the amount of any loss realized upon the sale or other disposition of the assets of the covered financial company.

This determination must be made on the record by the affirmative vote of a majority of the FDIC's board members. Details regarding any such extraordinary treatment must also be posted on the FDIC's website "on a timely basis" and no less frequently than quarterly in order to permit any creditor of the covered financial company to raise any challenges. Moreover, in the event that any claimant receives additional payment under this authority given to the FDIC, all other claimants that rank equally in the priority waterfall with such a claimant must recover at least as much they would have received in a liquidation under chapter 7 of the Bankruptcy Code.

The commentary relating to the Interim Final Rule makes clear that the above-described standards are intended to be onerous and therefore additional payments to creditors will

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be extremely rare. Some claims that are identified in the commentary as possible candidates for special treatment in an OLA receivership are claims for payment under utility and other service contracts and claims under contracts with companies that provide payments processing services – each related to operations that may be essential to the orderly liquidation of the covered financial company. (In that respect, this type of extraordinary treatment is similar to "first day" relief typically granted in reorganization cases under Chapter 11 of the Bankruptcy Code for payment of outstanding utility claims, among other things.)

The following is a discussion of how claims and exposures that may be of particular interest to hedge funds would be treated in an OLA receivership:

Secured Claims

Hedge funds may become secured creditors of a covered financial company in various ways, including as lenders under a secured credit facility in which the company is borrower. Just as in a typical bankruptcy case, secured claims would be accorded the highest level of priority in an OLA receivership. The Dodd-Frank Act and the accompanying rules provide that claims secured by a valid and enforceable security interest in any property or asset of the covered financial company will be paid in full to the extent of the collateral. Any portion of such claim that exceeds the amount equal to the fair market value of the collateral will be treated as a general unsecured claim in accordance with the above-described priority distribution provisions. Under the Interim Final Rule, the fair market value of the collateral will be determined as of the date the FDIC is appointed receiver under Title II. (The FDIC has sought comment on the question of whether, in times of great market volatility, it may be more appropriate to determine the worth of the collateral based on values existing on the day prior to the appointment of the receiver.)

The following hypothetical illustrates how secured claims would be treated in an OLA receivership: A covered financial company is a borrower under a $500 million credit facility which is secured by collateral consisting of substantially all assets of the company. As of the date of the FDIC's appointment as receiver, the fair market value of the collateral package is determined to be $300 million. Under this scenario, as the FDIC liquidates the financial company's assets (through sale transactions with third parties, for example), the first $300 million in proceeds would be distributed for the benefit of the secured lenders. The deficiency claim of $200 million would be treated as a general unsecured claim.

General Unsecured Claims

Hedge funds may hold unsecured bonds issued by a covered financial company, or may be lenders under an unsecured credit facility in which the company is borrower. Claims relating to such exposure would constitute general unsecured claims against the covered financial company, and will receive distribution only after all prior claims are paid in full.

Notwithstanding this otherwise clear principle, the FDIC's authority to treat similarly-situated creditors differently in certain extraordinary situations (as discussed above) gave rise to speculation as to what types of general unsecured claims could possibly warrant additional payment. The Interim Final Rule provides some additional guidance in this respect by establishing that the following types of claims and interests will never qualify for extraordinary relief:

- Claims related to "long-term senior debt," defined as senior debt issued by the covered financial company to

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bondholders or other creditors that has a term of more than 360 days (this does not include revolving or other open lines of credit);
- Claims for obligations "subordinated to general creditors" (presumably as determined by applicable non-insolvency law); and
- Ownership interests of shareholders, members, general partners, limited partners or others.

It is clear from the commentary accompanying the Interim Final Rule that the specific mention of "long-term debt" in this context during the notice and comment phase led some commenters to infer that claims related to short-term debt are likely to receive additional payments. The Interim Final Rule commentary dispels this notion in the strongest possible terms:

> Short-term debt holders (including, without limitation, holders of commercial paper and derivatives counterparties) are highly unlikely to meet the criteria set forth in the statute for permitting payment of additional amounts. In virtually all cases, creditors with shorter-term claims on the covered financial company will receive the same pro rata share of their claim that is being provided to the long-term debt holders. Accordingly, a potential credit provider to a company subject to the Dodd-Frank resolution process should have no expectation of treatment that differs depending upon whether it lends for a period of over 360 days or for a shorter term.

For illustrative purposes, the commentary identifies contract claims that are tied to performance bonds or credit support agreements needed for the covered financial company to qualify to continue other valuable contracts, as being possible candidates for additional payment.

Given the onerous standards and the pronouncements contained in the rules, it is likely that most general unsecured claims, including short-term debt, will only be eligible for ordinary treatment in accordance with the priority waterfall.

Contingent Claims

Claims that hedge funds may have against a covered financial company may be contingent in nature. A claim is "contingent" if actual damages would arise only upon the occurrence of a future event. If, for example, a covered financial company is a holding company that guaranteed the debt obligations of an operational subsidiary (for which an OLA receivership was not commenced), and the subsidiary had not defaulted on such obligations at the time of the FDIC's appointment as receiver, the beneficiaries of the guarantee would have contingent claims against the receivership which would become fixed claims if and only if the non-debtor subsidiary eventually were to default. (This hypothetical assumes for the sake of simplicity that the insolvency event of the guarantor is not an event of default that permits the debt of the operating company to be accelerated, as is commonly the case.)

Contingent claims would be estimated and allowed under Title II, just as they would under the Bankruptcy Code. The proposed rule that preceded the Interim Final Rule strongly suggested that only certain types of contingent claims (such as for guarantees) would be allowed under Title II. The FDIC changed course after the notice and comment phase, and the Interim Final Rule now makes clear that any contingent claim will receive recovery in OLA receiverships based on the value of such claim as determined by the FDIC after taking into account the likelihood that the underlying contingency will occur. In addition, the Interim Final Rule specifically states

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that if the FDIC were to repudiate a contingent obligation of a covered financial company consisting of a guarantee, letter of credit, loan commitment, or similar credit obligation, the resulting claim for damages will be no less than the estimated value of such claim as of the date of the FDIC's appointment.

Revolving Lines of Credit and Open Commitments to Fund

Hedge funds may be lenders under a revolving credit facility of a covered financial company at the time it is placed into an OLA receivership. The treatment of contracts to extend credit under Title II represents a significant departure from the Bankruptcy Code. Although ipso facto provisions generally are unenforceable in insolvency situations (under both the Bankruptcy Code and Title II), the Bankruptcy Code provides an exception to this rule for any "contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor" (generally referred to as contracts of "financial accommodation"). As a result, a revolving line of credit may be terminated upon the borrower's bankruptcy filing to prevent the debtor from incurring additional borrowings.

In contrast, Title II of the Dodd-Frank Act expressly permits the receiver to enforce financial accommodation contracts in an OLA receivership. The FDIC therefore has the ability to require lenders under a revolving credit facility to continue funding draw-downs even after a receivership has been commenced with respect to the borrower. In exchange, the revolving credit lenders would have administrative expense claims entitled to priority treatment against the receivership for any amounts that they were required to fund post-insolvency.

Qualified Financial Contracts

Hedge funds may be counterparties with covered financial companies under a special category of contracts referred to under Title II as "qualified financial contracts" ("QFCs"). QFCs include a variety of hedging and investment instruments popular amongst hedge funds and other financial institutions, such as "swap agreements" (e.g., credit derivatives, interest rate swaps and currency swaps), "forward contracts," "commodity contracts," "securities contracts" and "repurchase agreements." (The reader should refer to the precise definitions provided for these terms under Title II of the Dodd-Frank Act.)

QFCs are entitled to certain special protections under both the Bankruptcy Code and Title II. Notwithstanding the stay that automatically arises upon the commencement of a formal insolvency under either regime – which generally prohibits the exercise of contractual remedies against the insolvent party – QFCs may be terminated through the exercise of bankruptcy/insolvency-based termination provisions (which otherwise constitute unenforceable ipso facto provisions, as discussed above), and, generally speaking, collateral that is posted in connection with the underlying transactions can be used to setoff amounts that may be owing by the insolvent counterparty. These so-called "safe harbor" protections were designed to permit non-defaulting counterparties to QFCs to limit and manage their financial exposure to the underlying contracts upon their counterparties' insolvency.

Although the safe harbor protections under Title II are similar to those contained in the Bankruptcy Code, there is one significant difference between the two. Unlike the Bankruptcy Code safe harbors, which allow eligible non-

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defaulting counterparties to exercise their bankruptcy/insolvency-based termination rights as soon as they are contractually permitted, Title II imposes a one business-day stay on the ability to exercise such rights. This temporary restriction is designed to enable the FDIC to preserve QFCs that may constitute valuable assets of the covered financial company by assigning such contracts to third parties or, if third party purchasers cannot immediately be found, to a bridge financial company. If the FDIC elects to assign a QFC, the non-defaulting counterparty loses the ability to terminate the contract based on the covered financial company's insolvency event, and must resume the contractual relationship with the assignee (whether it is a third party or the bridge financial company) who will take the place of the covered financial company. Under Title II, the FDIC's ability to sell off favorable QFCs is limited by the fact that it must assign all or none of a particular counterparty's QFCs with the covered financial company. For example, if the covered financial company's swap agreements with a particular counterparty are "in the money" for the receivership but the securities contracts transacted between the two parties yield a net loss, the FDIC will need to decide whether the assignment of all such swap agreements and securities contracts would benefit the receivership or whether the contracts should instead all remain with the covered financial company, in which case the non-defaulting party will be free to terminate them.

The assignment of one or more QFCs to a third party or bridge financial company may also affect the non-defaulting party's substantive rights in another notable way. Both the Bankruptcy Code and Title II preserve any rights a creditor may have to setoff any payables the creditor has to the debtor against its receivables from the debtor. This right of setoff can only exist in situations where the same two parties both owe and are owed money to/from each other. An assignment of a QFC to a third party or bridge financial company would cause this requirement of "mutuality" to be violated with respect to the amounts relating to the QFC. To illustrate, assume that Party A, a covered financial company in an OLA receivership, and Party B, the non-defaulting counterparty, are parties to a swap agreement under which Party A is owed $10 million in premium payments as of the date of the FDIC's appointment as receiver. Also assume that Party A owes Party B $20 million under a promissory note. If the swap agreement were to remain with the covered financial company, Party B's claim of $20 million on account of the promissory note could be setoff (subject to delay due to the stay) against the $10 million payable under the swap agreement (assuming that a valid right of setoff exists under applicable non-insolvency law), resulting in a net claim against the receivership of $10 million. If, on the other hand, the receiver were to exercise its right to assign the swap agreement to a third party, Party B's obligations under that contract (including to pay make the $10 million premium payment) would remain in place as it continues to transact under the agreement with the third party assignee. Meanwhile, Party B's claim against the receivership in the amount of $20 million would remain undiminished.

In order to mitigate the prejudicial effects that an assignment of assets can have to creditors like Party B, the Dodd-Frank Act and the newly-proposed rules provide that creditors who have lost setoff rights as the result of actions taken by the receiver will have claims that have priority over general unsecured claims. As a result, under the above hypothetical, Party B's $20 million claim on account of the promissory note presumably would be bifurcated into two claims, one

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general unsecured claim in the amount of $10 million and one higher priority claim for a lost setoff right in the amount of $10 million. Thus, assuming that the liquidation of Party A's assets in the OLA receivership produces sufficient proceeds to allow general unsecured claimants to receive any recovery, Party B would not have been prejudiced as a result of the receiver's assignment of its swap agreement to a third party assignee (because the priority claim of $10 million for the loss of setoff rights would have received full recovery before any distributions were made for the benefit of general unsecured claims).

Summary

The enactment of the Dodd-Frank Act gives rise to the possibility that a company that otherwise qualifies for protection under the Bankruptcy Code may become subject, without any advance notice, to the novel and untested insolvency regime governed by Title II. Although an OLA receivership is designed to function much like a traditional bankruptcy, as discussed above, there are important differences that hedge funds should be cognizant of in dealing with institutions that potentially could be considered "systemically important."

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