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Treasury Issues Report on Dodd-Frank Orderly Liquidation Authority

Treasury Issues Report Recommending Adoption of Reforms to Dodd-Frank Orderly Liquidation Authority and a New Chapter 14 of the Bankruptcy Code for Significantly Systemic Financial Companies

SUMMARY

On February 21, the U.S. Department of the Treasury ("*Treasury*") issued a comprehensive and thoughtful report (the "*Report*")[1] recommending the adoption of a number of reforms to the Orderly Liquidation Authority ("*OLA*") established by Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("*Dodd-Frank*")[2] and a new Chapter 14 of the U.S. Bankruptcy Code (the "*Bankruptcy Code*") to address the resolution of systemically significant financial companies. The Report was issued pursuant to President Trump's Memorandum to the Secretary of the Treasury (the "*Presidential Memorandum*"), released April 21, 2017, which directed the Treasury to review OLA and provide recommendations for improvement in accordance with the Administration's Core Principles for Financial Regulation (the "*Core Principles*") and to determine whether the Bankruptcy Code should be reformed to better enable resolution of financial companies.[3] Significantly, Treasury recommends retaining OLA, with the reforms it recommends, although Treasury characterizes OLA as "an emergency tool for use under only extraordinary circumstances."

The Report's key recommendations are:

- ***Adoption of a new Chapter 14 of the Bankruptcy Code:*** Treasury takes the view that bankruptcy should be the resolution method of first resort for distressed financial firms, in order to reinforce market discipline through a rules-based, predictable, judicially administered allocation of losses from a firm's failure. Because, however, the current Bankruptcy Code "was not designed" for "large, complex financial institutions," Treasury recommends the adoption of significant reforms to the Bankruptcy Code, through the adoption of a new "Chapter 14"[4] based on a reform proposal prepared by the Hoover Institution and legislative proposals for bankruptcy reform. The goal of the Chapter 14

framework according to the Report would be to preserve the key advantage of the existing bankruptcy process (*i.e.*, clear, predictable, impartial adjudication of competing claims) while adding procedural features tailored to the unique challenges posed by large, complex financial institutions. Under the Chapter 14 framework, a "covered financial corporation"[5] filing for bankruptcy would petition the court for approval of a transfer of most of its assets and some of its liabilities to a newly formed bridge company. The recapitalization would occur during the course of a 48-hour stay on actions by qualified financial contracts ("*QFCs*") counterparties. In response to concerns expressed about the effectiveness of a bankruptcy proceeding for a large, internationally active financial institution, the Report includes the following recommendations:

- Statutory provision of standing to U.S. regulators to raise issues and be heard in the Chapter 14 bankruptcy case,[6] and power for a court to grant standing to foreign regulators where relevant.
- Specification by statute that a court should give deference to a Federal Reserve determination as to the financial stability implications of a transfer to a bridge company under the so-called "two-entity" model in Chapter 14.
- The advance designation by the Chief Justice of the United States of a set of bankruptcy judges eligible to preside over any Chapter 14 bankruptcy case, or the alternative approach of designating a set of district court judges (who, the Report notes, would have "broader juridical experience").
- The definition of "capital structure debt," which is, essentially, unsecured long-term debt outstanding at the holding company level, should include all unsecured debt for borrowed money other than QFCs as well as a secured lender's unsecured deficiency claim for an under-secured debt (*i.e.*, the portion of a secured debt in excess of the value of the collateral).
- Treasury recommends against including an asset threshold in defining which financial companies are eligible for Chapter 14, and recommends that the definition of "covered financial corporation" under Chapter 14 be consistent with the definition of "financial company" contained in both Title II and the FDIC implementing regulations.
- Treasury also recommends that U.S. regulators redouble their efforts to establish protocols for cooperation with their foreign counterparts with the aim of giving all parties confidence in the feasibility of the bankruptcy approach.[7]

- ***Limiting and Reforming Orderly Liquidation Authority:*** In addition to the adoption of a new Chapter of the Bankruptcy Code to encourage the use of the bankruptcy process and thereby reduce the need for OLA, Treasury recommends several significant reforms to OLA.[8]
  - Although Treasury recognizes that the FDIC has taken steps to confine its own discretion under Title II, it recommends further commitments by the FDIC, including:
    - *Restrict Potential for* ad hoc *Disparate Treatment* – Restricting the FDIC's authority to treat similarly situated creditors differently on an *ad hoc* basis, and adoption of Bankruptcy Code creditor priority principles.
    - *Provide for Adjudication of Claims by a Bankruptcy Court* – Although the FDIC should manage the transfer and the disposition of the bridge company, a bankruptcy court should be responsible for adjudicating claims to improve the fairness and regularity of the process.
    - *Repeal Tax-Exempt Status of the Bridge Company* – Repeal of the tax-exempt status of the bridge company to ensure that a failed financial firm does not enjoy a government-conferred competitive advantage.
    - *Provide Greater Clarity on Resolution Strategy* – The FDIC should confirm its commitment to use the single-point-of-entry ("*SPOE*") resolution strategy, and identify under what circumstances, if any, SPOE would not be used.
    - *Clarify the Standard for Commencing a Title II Proceeding* – The agencies potentially involved in the commencement of an OLA preceding (Treasury, Federal Reserve, FDIC,

SEC, and Federal Insurance Office ("*FIO*"), as appropriate) should jointly clarify how they will apply the statutory tests for determining when a financial company is in "default or in danger of default" (a condition to being placed into OLA) to specify explicitly that each test must be judged to be met within a specified prospective time period no greater than 90 days from the time of such determination.

- Although the Report acknowledges that Title II provides significant protections against taxpayer exposure for losses, it recommends strengthening such protections to eliminate to the greatest possible extent any risk of loss from extensions of credit under the Orderly Liquidation Fund ("*OLF*") (the liquidity facility established under Dodd-Frank that the FDIC may draw upon, subject to terms set by Treasury, to lend to the financial company in receivership). Treasury recommends the following actions, among others:
  - *Use Guarantees and Premium Rate to Encourage Return to Private Credit Markets* – Loan guarantees of private funding should be preferred over direct lending, to enable the bridge company to be reintroduced to private sources of funding more quickly and more promptly resume exclusive reliance on private funding free from OLF support. Further, to incentivize a return to private funding, Treasury should use its authority to set the terms of any OLF advances or guarantees to ensure that the FDIC only lends funds or provides loan guarantees if it charges an interest rate or guarantee fee set at a significant premium to market.
  - *Fully Secure any OLF Loans* – In cases in which it is not possible to limit use of the OLF to loan guarantees, the FDIC should lend on a fully-secured basis, and Treasury should advance funds to the OLF only where this condition is satisfied. The FDIC should seek high-quality assets as collateral, publish a list of assets eligible to serve as collateral for an OLF loan, and only accept a different form of collateral with the approval of the Secretary of the Treasury. Although not suggested in the Report, it would be logical to extend the collateralization requirement to guarantees.
  - *Limit Duration of OLF Loans* – The duration of OLF loans should be limited to a fixed term that is only as long as necessary to meet liquidity needs.
  - *Expedite Industry Backstop Assessment* – Any industry backstop assessment required under Title II in order to recoup losses to the OLF should be imposed and collected as soon as reasonably possible, which Treasury expects would be well in advance of the five-year deadline under Dodd-Frank.
- Treasury further recommends strengthening judicial review of the decision to invoke OLA, while preserving regulators' ability to act swiftly in the event of a financial crisis. Rather than providing for a 24-hour judicial review, limited to two of the seven determinations the Secretary of the Treasury is required to make in order to place a failing financial company into receivership, as is the case under Title II currently, Treasury proposes that the reviewing court should instead be permitted to review the entire seven-point statutory determination under the "arbitrary and capricious" standard. Treasury also recommends that Congress consider either (i) replacing the truncated pre-appointment review procedure with a more robust post-appointment petition to remove the FDIC as receiver, or (ii) strengthening appellate review by permitting *de novo* review of the district court's decision, in light of the speed with which the district court must act.

The combination of the proposed enhancements to the Bankruptcy Code and a preserved yet reformed OLA represents a balanced approach between those who advocate for little or no change and those who advocate for repeal of OLA. The conclusions and recommendations of the Report are appropriately attuned to the need for greater clarity, predictability and certainty regarding the U.S. approach to resolution, assurance against a government bailout, and the continued availability of the unique features of OLA where necessary as a last resort. The Report also reflects a considered weighing of the adverse consequences that OLA repeal would entail for the U.S. economy and financial system, particularly in the international dimension. Importantly, the Report recognizes that such adverse effects on the U.S. economy would not be limited to a future crisis situation, but rather would be immediately felt in the form of heightened foreign ring-fencing and trapping of U.S. financial institution capital and liquidity abroad.

The Report repeatedly expresses sensitivity to the concern that foreign regulatory authorities be comfortable with the U.S. resolution regime. Among the considerations noted by the Report in this regard is that a lack of such confidence could lead to country ring-fencing of the operations of U.S. and other home country banks. The Report stresses that a substantial degree of *ex ante* ring-fencing is likely to reduce economic growth, while *ex post* ring-fencing would be likely to increase loss in the event of a failure. It remains to be seen whether these concerns about the adverse impact of ring-fencing will be expanded into other aspects of regulatory policy.

Although adoption of Chapter 14 would require legislation, many of the recommended revisions to the OLA framework could be implemented by regulatory action. Because of the soundness of these recommendations, we anticipate that the FDIC and Federal Reserve are likely to consider them.

BACKGROUND

A. STATUTORY FRAMEWORK OF ORDERLY LIQUIDATION AUTHORITY

Under Dodd-Frank, Congress adopted OLA as a special resolution regime for large, complex financial companies. As the Report recognizes, the concept of such a specialized resolution regime is consistent with multiple previously established insolvency regimes, including the Federal Deposit Insurance Act ("*FDI Act*"), which applies to insured depository institutions, and the Securities Investor Protection Act, which applies to broker-dealers, as well as state insurance insolvency regimes. OLA can be invoked only in limited circumstances, and requires specific findings and approval by applicable federal regulatory agencies and Treasury. Specifically, the Federal Reserve, by a vote of two-thirds of the Governors then serving, as well as another applicable regulator (the FDIC, SEC or FIO), must make written recommendations for the appointment of the FDIC as receiver of a failing financial company.[9] Following receipt of the required recommendations, the Secretary of the Treasury must also make the determination, in consultation with the President, that appointment of a receiver under OLA is appropriate.[10] These determinations must include a number of findings that severely limit the application of OLA, including that no private sector alternative is available and that resolution of the company under the Bankruptcy Code would have serious adverse effects on U.S. financial stability. Once the Secretary of the Treasury has made the required determination, she or he must notify the board of directors of the financial company and seek its acquiescence or consent to the appointment of the FDIC as receiver, and she or he has the ability to file a petition in district court for such appointment if the company's board of directors does not consent.[11] If such a petition is filed, the court has 24 hours to conduct a two-point review of the Secretary of the Treasury's finding that the financial company is in default or in danger of default and that the company satisfies the definition of “financial company”; if the court does not conclude that either of those findings was arbitrary or capricious, the FDIC will be appointed as receiver.[12]

Title II provides that management responsible for the financial company’s’ failure must be dismissed, and that compensation of any current or former senior executive or director substantially responsible for the failure of the covered financial company shall be clawed back.[13] Title II also mandates that OLA be implemented such that shareholders and creditors will bear the company’s losses,[14] and mandates that the Inspector General of the Federal Reserve or the relevant primary financial regulatory agency would be required to report on the past effectiveness of the agency with respect to the covered financial company, identify acts or omissions of the regulator that helped to cause the failure of the company, and recommend administrative or legislative changes.[15]

B. SINGLE POINT OF ENTRY STRATEGY

In carrying out a resolution of a financial company under Title II, the FDIC has stated that it expects to use a SPOE (single point of entry) strategy in which only the U.S. top-tier parent holding company would be placed into receivership, leaving behind the claims of shareholders and most unsecured creditors, while solvent subsidiaries, such as insured depository institutions, broker-dealers and overseas subsidiaries would continue operating as usual (and paying their obligations when due), thereby avoiding multiple competing insolvencies and minimizing further disruptions to the financial system.[16]

C. PREPARING FOR RESOLUTION: POST-CRISIS DEVELOPMENTS

The Report goes on to detail the many steps that regulators and financial services firms have taken since the financial crisis to improve the resolvability of financial firms. These steps include the following:

- ***Resolution Planning:*** Dodd-Frank requires large bank holding companies (those with $50 billion or more in total consolidated assets) and nonbank financial companies designated by the Financial Stability Oversight Council to prepare resolution plans (or “living wills”) for their rapid and orderly resolution under the Bankruptcy Code and submit them for review by the Federal Reserve and FDIC.[17] These plans have led to significant advances in the resolvability of these firms, including through the rationalization of legal entity structures, installation of measures to ensure provision of adequate capital and liquidity to continue operations through resolution and establishment of contractual arrangements to ensure continued provision of critical internal and external services in resolution. Treasury concludes that these advances have made resolution under the Bankruptcy Code a substantially more feasible option, making the need to resort to OLA less likely.
- ***Total Loss-Absorbing Capacity and Clean Holding Company Requirements:*** Treasury notes that U.S. bank holding companies have greatly enhanced their loss-absorbing capacity in recent years, including as a consequence of the Federal Reserve’s total loss-absorbing capacity (“*TLAC*”) and long-term debt requirements finalized in December 2016.[18] Treasury considers the TLAC requirements essential to the execution of the SPOE resolution strategy contemplated for resolution under both OLA and the proposed Chapter 14 amendments to the Bankruptcy Code, and stresses that the availability of TLAC and the creation of new equity as a result of the conversion of the long-term debt will generate market confidence to help avoid runs on deposits and other liabilities that could otherwise lead to financial contagion.
- ***Stays on Derivatives and Other QFCs in Resolution:*** The terms of QFCs, which include swaps, other derivative contracts, repurchase agreements and securities lending and borrowing agreements,

generally provide that in the event that a party to a QFC or its affiliate enters a bankruptcy or resolution proceeding, its counterparty may terminate the QFC. Although under the Bankruptcy Code creditors are generally subject to an automatic stay, there is a "safe harbor" for QFCs that allows QFC counterparties to exercise their rights against the debtor immediately upon default.[19] Title II provides a one business day stay on QFC contracts following the date of the appointment of the FDIC as receiver (and enables a permanent stay if the QFCs have been transferred to a bridge company or new solvent financial company), but there remains a risk that a foreign court exercising jurisdiction over a covered financial company's counterparty or property may not recognize the stay provisions of U.S. law.[20] To further address the potential for market disruption and uncertainty related to the termination of such QFCs, firms and regulators developed a protocol that contractually binds adhering parties to the temporary stay provisions of special resolution regimes, which many global banks have signed,[21] and U.S. regulators have recently adopted rules that require adoption of these terms, whether by execution of the protocol or using other contractual mechanisms.[22]

- ***Economic Subordination of Holding Company Debt:*** The Report observes that a key advantage of the SPOE strategy is that it is aimed at fostering continued viability at the operating subsidiary level by focusing resolution at the level of the holding company parent. This approach is intended to minimize disruption to the clients and counterparties of the operating subsidiaries that could otherwise spread contagion. The SPOE strategy and the adoption of the TLAC requirements have been designed to effectively subordinate a U.S. Global Systemically Important Bank's holding company creditors to its operating company creditors. The Report notes, however, the theoretical potential that some market participants might in addition develop the expectation that certain classes of operating subsidiary creditors will effectively be shielded in all cases from loss. The Report contends that, if such an expectation were to gain widespread adoption, then the availability of SPOE under OLA could become a potential source of competitive distortion between the operating subsidiaries of firms presumed to be candidates for Title II and those that are not, but that, in such an event, the burden could be shifted to the holding company's creditors. The Report states that continued study of this issue is warranted as observable market data from a range of market and credit cycles becomes available.

D. INTERNATIONAL CONSIDERATIONS

Treasury asserts that in the event of the failure of a financial company with significant international operations, cooperation with foreign authorities would be imperative in order to avoid a disorderly resolution that destroys value and causes systemic instability. Although U.S. authorities and their foreign counterparts have worked closely following the financial crisis to improve coordination and to plan for the resolution or bankruptcy of a cross-border financial company, some foreign authorities continue to question whether a traditional U.S. bankruptcy proceeding can adequately address the systemic issues arising from a cross-border financial institution failure and have raised concerns about the ability to coordinate effectively with a bankruptcy judge as opposed to their U.S. regulatory counterparts. Importantly, as discussed above, the Report stresses that the elimination of OLA and reliance on the bankruptcy process exclusively would likely incentivize "ring fencing" by foreign authorities to ensure the maximum amount of funds remain in the host country to ensure local depositors, creditors, and other stakeholders are paid first.

DISCUSSION

Treasury notes that its recommendations in the Report are informed by three overarching policy goals, which are consistent with the Core Principles.

- ***First***, a sound resolution regime should avoid moral hazard arising from the belief that certain classes of equity or debt will likely be "bailed out" or otherwise granted special relief. That belief may arise where rules and procedures for resolution of failed financial companies are not clearly specified in advance.[23]
- ***Second***, shareholders and creditors of a failed firm, not taxpayers, should bear any and all losses.[24]
- ***Third***, a sound resolution regime for financial corporations should minimize adverse effects of the resolution on the financial system. This requires a framework that provides for a source of secured liquidity to continue critical operations during the course of the resolution, limit financial contagion, and guard against potentially destabilizing ring-fencing of foreign affiliates of U.S. financial companies.[25]

A. AN ENHANCED BANKRUPTCY REGIME FOR FINANCIAL COMPANIES

1. New Chapter 14 Bankruptcy Regime

In the Report, Treasury endorses the adoption of bankruptcy reform to address issues specific to the resolution of financial corporations. The Report's recommendations for a new bankruptcy regime build on the House and Senate legislative proposals, which in turn draw on the reform proposal prepared by the Hoover Institution and the FDIC's development of the SPOE model of resolution.[26] The Report refers to the revised bankruptcy process as a "Chapter 14" bankruptcy.

Treasury asserts that by facilitating resolution through the SPOE strategy (what the Report refers to as a "two-entity recapitalization model"), Chapter 14 would enable a more orderly resolution process for even the largest bank holding companies. By making successful bankruptcy possible in a broader set of circumstances without serious adverse effects on U.S. financial stability, Chapter 14 would make it less likely that OLA would be needed.

a. Proposed Chapter 14 Bankruptcy Process

The Chapter 14 bankruptcy process is intended to address deficiencies in the existing provisions of the Bankruptcy Code, which were not designed with the resolution of a large, complex financial corporation in mind.[27]

Under a two-entity recapitalization model, a covered financial corporation (a term which includes bank holding companies and corporations engaged in financial activities), upon filing for bankruptcy, would petition the court for approval of a transfer within 48 hours of most of its assets and some of its liabilities to a newly formed bridge company. The bridge company would be a legally distinct and separate entity from the failing financial corporation. During the 48-hour review period, there would be a temporary stay on actions by QFC counterparties. This temporary stay would allow the Chapter 14 case, similar to the timeline under OLA, to proceed over a "resolution weekend," which would commence on Friday and allow the operating subsidiaries to open for business on Monday with minimal market disruption.

A court would permit the transfer to the bridge company if the court determines that, based on the preponderance of the evidence, the transfer satisfies certain conditions. These conditions include:

- the transfer is necessary to prevent serious adverse effects on financial stability in the United States;
- the bridge company is likely to satisfy the obligations of any debt, executory contract, or QFC transferred to it; and
- the transfer does not provide for the assumption of any capital structure debt (which is, essentially, unsecured long-term debt outstanding at the holding company level) by the bridge company.[28]

Given the financial stability condition for transfers to the bridge company, the Report notes that Chapter 14 would be available to only the largest, most complex financial corporations, as a practical matter.

Treasury states that the Chapter 14 process would provide for a clear, predictable allocation of losses, consistent with its recommendations to reform OLA, to encourage market discipline and risk monitoring by creditors. Chapter 14 would provide, in advance of resolution, that certain obligations of the covered financial corporation would be "left behind" with the debtor rather than transferred to the bridge company. Obligations left behind would include the claims of all shareholders of the covered financial corporation and the claims of holders of capital structure debt.[29]

The bridge company's initial equity securities would be held by a special trustee for the sole benefit of the left-behind shareholders and creditors. The special trustee would only be able to distribute equity securities from the trust in accordance with a confirmed plan or an order from the court overseeing the Chapter 14 bankruptcy case. The special trustee would also be subject to reporting requirements to the debtor.

2. Challenges for Chapter 14 Bankruptcy

The Report outlines challenges that would remain in a Chapter 14 bankruptcy system and seeks to incorporate certain measures to address such challenges into the new bankruptcy regime proposal.

a. Liquidity

According to the Report, liquidity, and, in particular, the possibility that there would be insufficient private liquidity to fund the bridge company, is a significant challenge to the resolution of a financial corporation. Treasury identifies several factors, however, that it believes should mitigate this difficulty.

- ***First,*** the various reforms to the structure and operations of large bank holding companies, including heightened capital and liquidity requirements, since the financial crisis, discussed above, have likely reduced the amount of financing that would be necessary.
- ***Second,*** Treasury believes that the 48-hour stay on QFCs would help address liquidity challenges by preventing counterparties from draining the company of liquidity and value before it has had a chance to reorganize.
- ***Third,*** Treasury recommends keeping Title II and its OLF provisions in place, with the reforms it proposes, as an option of last resort in extraordinary circumstances.

b. Role for Regulators

The Report recognizes the challenge of ensuring that financial corporations' regulators have an appropriate role in the bankruptcy regime. Treasury supports the provision in Chapter 14 proposals that would permit the FDIC, Federal Reserve, Office of the Comptroller of the Currency, Commodity Futures Trading Commission, SEC and Secretary of the Treasury to raise and be heard on any issue in the bankruptcy case, which would allow the bankruptcy court to obtain the benefits of the agencies' expertise, including with respect to the implications of the resolution for U.S. financial stability.[30]

The Report also examines the international regulatory coordination challenges associated with resolving a large financial corporation with global operations. As noted, Treasury has recommended providing a clear ability for U.S. regulators to have standing in the bankruptcy case, which should demonstrate to foreign authorities that U.S. regulators will be able to inform the court of the international considerations relevant to the resolution. In addition, the Report suggests providing courts with the ability to grant standing to foreign regulators to promote better coordination in the resolution of a financial corporation with extensive cross-border operations.

In addition, Treasury recommends that Congress adopt a statutory provision specifying that a court should give deference to a Federal Reserve determination as to the financial stability implications of a transfer to the bridge company. This recommendation differs from the approach provided in the proposal prepared by the Hoover Institution and the Senate legislative proposals, which would grant certain regulators the power to commence bankruptcy cases against covered financial corporations if certain conditions are met.

Treasury notes the importance of the Federal Reserve, FDIC and other U.S. financial regulatory agencies coordinating with their foreign counterparts during the pendency of the Chapter 14 process, which the Report states should begin well in advance of any filing. Treasury recommends that the U.S. regulators redouble their efforts to establish protocols for cooperation with their foreign counterparts with the aim of giving all parties confidence in the feasibility of the bankruptcy approach should it ever need to be used.[31]

c. Judicial Expertise

Ensuring that judges have sufficient expertise to preside over financial corporation bankruptcy cases is a challenge for Chapter 14. Acknowledging this, the Report recommends the designation of a set of judges in advance to be available to be assigned to a Chapter 14 case. The Report considers two approaches to designating the pool of eligible judges:

- Both the House and Senate legislative proposals would require the Chief Justice of the United States to designate not fewer than 10 bankruptcy judges to be available to hear a Chapter 14 case.[32]
- Alternatively, the reform proposal prepared by the Hoover Institution suggests a designated set of district court judges. A designated district court judge would preside over the case up to the point of the transfer of assets and liabilities to a bridge company, at which point the judge could then refer the

case to a bankruptcy judge or appoint a bankruptcy judge to assist the district court judge as a special master.

B. REFORM OF ORDERLY LIQUIDATION AUTHORITY

Treasury recommends that Title II remain as an emergency tool for use as an option of last resort in extraordinary circumstances and advances a set of reforms intended to ensure the proper functioning of OLA in accordance with the Core Principles. In particular, Treasury proposes that the OLA framework should:

- provide for clear rules administered with impartiality;
- ensure market discipline and strengthen protection for taxpayers; and
- strengthen judicial review.

1. Providing for Clear Rules Administered with Impartiality

a. Restrict FDIC's Ability to Treat Similarly Situated Creditors Differently

Treasury recommends that the FDIC's latitude to treat similarly situated creditors differently should be narrowed to conform to the bankruptcy standard under which only critical vendors may be given favored treatment if necessary. Title II currently grants the FDIC discretion to treat similarly situated creditors differently without a clearly defined standard to protect disfavored creditors. The statutory standard for different treatment of similarly situated creditors is that such treatment "is necessary to maximize the value of the assets of the covered financial company."[33] Such discretion is subject to the additional statutory limitation that each creditor in an OLA proceeding shall receive no less than the amount that would have been received in a liquidation of the covered financial company under Chapter 7 of the Bankruptcy Code.[34]

Treasury recommends aligning the OLA standard with the better defined bankruptcy standard. The Report recognizes that financial companies required to file resolution plans have made changes to their management of their critical vendors to better ensure continuity of services during a resolution. As a result, the Report observes that this authority described above would be less likely to be needed in a Title II resolution.[35]

b. Provide for the Bankruptcy Court to Adjudicate Claims Against the Receivership

Treasury recommends that a bankruptcy court, rather than the FDIC, adjudicate the claims against the receivership. According to the Report, this could be accomplished by amending Title II to provide that, after the transfer of assets and liabilities to the bridge company, the bankruptcy court would administer the claims of creditors whose liabilities were left in the receivership.[36] Treasury suggests that, although the FDIC has expertise in effecting the transfer of assets and liabilities to the bridge company, managing the bridge company until it or its successors are returned to private ownership and administering the OLF, bankruptcy courts are better positioned to adjudicate claims, which is a process that bankruptcy courts administer every day.

c. Clarification of the Standard for Commencing a Title II Proceeding

As a precondition to appointing the FDIC as receiver for a financial company, the company must be found to be "in default or in danger of default."[37] Treasury recommends clarifying this standard by specifying more clearly when a firm would be considered to be "in danger of default."

Title II currently defines "default or in danger of default" by reference to four tests:

- that a bankruptcy case has been or likely will promptly be commenced;
- that the financial company has incurred or is likely to incur losses that would substantially deplete its capital;
- that the assets of the financial company are, or are likely to be, less than its liabilities; or
- that the company is, or is likely to be unable to, pay its obligations in the normal course of business.[38]

To reduce the potential for regulatory overreach, Treasury recommends defining the term "likely to be", or "likely to incur", which is used in each of the last three tests above, by reference to a particular prospective period—such that the danger of the capital depletion, balance sheet insolvency or illiquidity is imminent. Treasury recommends that any such likelihood determination or recommendation be made by reference to at most the next 90 days.

As a procedural matter, OLA could be invoked as an initial resolution response for a financial company that is "in default or in danger of default" or could be invoked after a bankruptcy proceeding has been initiated, where the relevant authorities then decide that use of OLA is necessary to address systemic concerns.

d. Repealing Tax-Exempt Status of Bridge

The Report states that the Title II provision exempting a bridge company from all federal, state and local taxes[39] is without any policy or legal basis and would give the bridge an "enormous advantage" over the bridge's private-sector competitors. Accordingly, Treasury recommends that Congress repeal this provision.

e. Confirmation of the FDIC SPOE Notice

Treasury recommends that the FDIC finalize the notice issued in December 2013 that describes the SPOE strategy as the proposed method by which the FDIC would execute an OLA proceeding with respect to U.S. Global Systemically Important Banks.[40] By taking this step, the FDIC would make more certain the expectations of counterparties of financial companies and market participants and permit them to better price the risks of their exposures. In addition, such action could help address concerns that the FDIC still retains too much discretion under Title II and that this discretion leads to too much unpredictability as to how a resolution would be conducted. Finally, Treasury recommends that, if there are any circumstances under which the FDIC does not believe SPOE would be the preferred resolution method, then the FDIC should clearly identify those circumstances.

2. Ensuring Market Discipline and Strengthening Protection for Taxpayers

a. Limiting the Duration of Advances to the OLF

With respect to the use of the OLF, Treasury recommends that the duration of any advances under the OLF should be limited to a short, fixed term that is only as long as necessary to meet demonstrated liquidity needs.[41] The initial Title II funding authorized for a bridge company must be sufficient to prevent runs on short-term funding at its operating subsidiaries and bring stability to the company, but, after the company has been initially stabilized, Treasury believes that it is probable that the private sector would be able to provide financing to the bridge company, even in the midst of a significant financial crisis. If, at the borrowing maturity date, the bridge company continues to need liquidity in excess of what is available in the private markets to maintain confidence in the operation of the bridge company, Treasury would consider an FDIC advance request for additional funding.

b. Using Guarantees and Premium Interest Rates to Encourage Return to Private Credit Markets

Treasury recommends that loan guarantees should be preferred over direct lending and that loans and guarantees should only be extended if a premium interest rate or guarantee fee is charged.[42]

According to the Report, in some circumstances private-sector funding may be available in sufficient amounts to fund the bridge company, but either initial uncertainty regarding the bridge company's financial condition or volatility in the financial markets generally may prevent private lenders from making commitments to the bridge company without such a guarantee. As compared to direct OLF loans, Treasury believes that use of loan guarantees could enable the bridge company to be reintroduced to private sources of funding more quickly and to more promptly resume exclusive reliance on private funding free from OLF support.

c. Secured Lending Only

According to the Report, the FDIC should lend only on a secured basis to ensure that taxpayers are protected. In addition, the FDIC should seek high-quality assets as collateral and should publish a list of collateral it deems eligible to secure OLF loans.[43] If the FDIC proposes to accept as security for an OLF loan any collateral of a type not previously identified by the FDIC as being eligible, such proposed collateral should be approved by the Secretary of the Treasury on a case-by-case basis. According to the Report, lending on these terms will protect taxpayers and reduce the potential for moral hazard.

d. Expedite OLF Industry-Wide Backstop Assessment

Treasury recommends charging any OLF industry-wide backstop assessment on large financial companies as soon as reasonably possible, and well in advance of the five-year deadline imposed by Dodd-Frank.[44] Although the reforms proposed by the Report are intended to minimize the risk that that the bridge company would be unable to repay OLF loans, the assessments would eliminate the potential for taxpayer exposure to losses in the event the OLF loans are not fully repaid by the bridge.

3. Strengthening Judicial Review

Treasury recommends strengthening the judicial review provisions of Title II to provide a more robust check on the decision to invoke OLA.

First, Treasury recommends statutory change to allow a court to review all seven of the Secretary of the Treasury's required findings (rather than two, as currently permitted) under the "arbitrary and capricious" standard set forth in the Administrative Procedure Act.[45]

Second, Treasury suggests consideration of reforms regarding the timing and process for judicial review with respect to the placement of a financial company into an OLA receivership. As currently constituted, Title II affords judicial review to financial companies before a receiver is appointed, if the board of the financial institution does not consent to the appointment, while at the same time truncating that review so regulators may act quickly to meet the demands of a financial crisis. But the cost of this trade-off, according to the Report, is a judicial review process that may not allow adequate time for full judicial deliberation. Potentially to address this problem, the Report describes the following alternatives to consider:

- The current *ex ante* truncated judicial review could be replaced with a full judicial review after the appointment of the FDIC as receiver. This approach would align Title II with the *ex post* review procedure afforded to failed insured depository institutions under the FDI Act.[46] The existing *ex ante* review procedure would be replaced by full judicial review on a more typical schedule after the appointment is made. The financial company, not later than 30 days after the appointment of the FDIC as receiver, could bring an action in federal district court to remove the FDIC as receiver. There would be no statutory time limit for the court to issue a decision. Judicial review would instead operate under the normal rules of federal procedure, which give courts flexibility to act as quickly as they deem appropriate and to grant preliminary relief pending appeal.
- Alternatively, the judicial review process could be reformed without eliminating the 24-hour period of judicial review before the FDIC is appointed as receiver. Although a court may have difficulty conducting a full review in 24 hours, it may be preferable to retain some pre-appointment review than to have none at all. If Title II's 24-hour period of pre-appointment review were retained, Treasury recommends combining it with a more robust appellate process. Title II could be amended to make clear that, in the event of an appeal, the district court's decision is to be reviewed by the circuit court *de novo* on all issues and without regard to the arguments made in the district court.

Treasury does not endorse either of these approaches in the Report.

If either approach, and particularly the first, were to be implemented, it could in theory raise questions regarding how to unwind a resolution that has commenced under Title II in the event a court determines *ex post* that the FDIC had been inappropriately appointed as receiver. As a practical matter, however, such judicial review would occur only if the board refused to consent to the appointment of a receiver, and such a refusal is unlikely to occur in light of the fact that Title II immunizes directors from any liability for consenting to an OLA proceeding whereas a decision to refuse entry into OLA is not similarly insulated.[47] Moreover, as a further practical matter, once a Title II proceeding has commenced any prospect of reversal would seem remote. Accordingly, any concerns on the part of foreign regulatory authorities or counterparties of the bridge company and its operating subsidiaries about the uncertainty of a judicial outcome should be substantially alleviated.

*   *   *

ENDNOTES

1 U.S. Department of Treasury, *Orderly Liquidation Authority and Bankruptcy Reform* (Feb. 21, 2018), *available at* https://home.treasury.gov/sites/default/files/2018-02/OLA_REPORT.pdf.

2 Dodd-Frank §§ 201-217 (12 U.S.C. Subchapter II).

3 Administration of Donald J. Trump, *Memorandum on Orderly Liquidation Authority* (Apr. 21, 2017), *available at* https://www.gpo.gov/fdsys/pkg/DCPD-201700266/pdf/DCPD-201700266.pdf.

4 The Report refers to the new bankruptcy regime as "Chapter 14," following the reform proposal prepared by the Hoover Institution and the Senate legislative proposals. The House legislative proposals, however, have proposed the new bankruptcy regime as a subchapter of Chapter 11 of the Bankruptcy Code.

5 Treasury recommends that the definition of "covered financial corporation" under Chapter 14 be consistent with the definition of "financial company" contained in both Title II and the FDIC implementing regulations. Under Title II, the definition of "financial company" includes companies that are predominantly engaged in activities that the Federal Reserve has determined are financial in nature or incidental thereto; provided that, to be considered "predominantly engaged," at least 85 percent of the financial company's revenues must be derived from such activities. 12 U.S.C. §§ 5381(a)(11)(B)(iii), 5381(b).

6 Some commentators have suggested a more direct and formal role for U.S. bank regulators, such as appointing the Federal Reserve or the Federal Deposit Insurance Corporation ("*FDIC*") as a special master. As discussed below, non-U.S. resolution authorities have expressed considerable concerns about the effectiveness of resolution under the Bankruptcy Code.

7 Report at 29.

8 A number of these recommendations are similar to those proposed in an article authored by two Sullivan & Cromwell partners. *See* H. Rodgin Cohen & Michael M. Wiseman, *Resolving Resolution: A Path to End "Too Big to Fail" and Taxpayer Exposure*, Brookings (Mar. 15, 2017), https://www.brookings.edu/research/resolving-resolution-a-path-to-end-too-big-to-fail-and-taxpayer-exposure/.

9 Dodd-Frank § 203(a) (12 U.S.C. § 5383(a)).

10 *Id.* § 203(b) (12 U.S.C. § 5383(b)). In the event the FDIC is appointed receiver of a broker-dealer, the FDIC would in turn appoint the Securities Investor Protection Corporation to act as trustee of the broker-dealer. Dodd-Frank § 205(a)(1) (12 U.S.C. § 5385(a)(1)), and an insurance company is to be resolved as provided under state law governing insurance company insolvencies. Dodd-Frank § 203(e) (12 U.S.C. § 5383(e)).

11 Dodd-Frank § 202(a)(1)(A)(i) (12 U.S.C. § 5382(a)(1)(A)(i)).

12 Dodd-Frank § 202(a)(1)(A)(iii) (12 U.S.C. § 5382(a)(1)(A)(iii)).

13 Dodd-Frank § 204(a)(2) (12 U.S.C. § 5384(a)(2)); Dodd-Frank § 210(s) (12 U.S.C. § 5390(s)); 12 C.F.R. § 380.7.

14 Dodd-Frank § 204(a)(1) (12 U.S.C. § 5384(a)(1)).

15 Dodd-Frank § 211(f) (12 U.S.C. § 5391(f)).

16 *See* Notice: Request for Comments, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614 (Dec. 18, 2013).

17 Dodd-Frank § 165(d) (12 U.S.C. § 5365(d)).

18 *See* Department of the Treasury, *A Financial System That Creates Economic Opportunities: Banks and Credit Unions* (June 2017) at 37-43, *available at* https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf; Federal Reserve System,

ENDNOTES (CONTINUED)

Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements, 82 Fed. Reg. 8266 (Jan. 24, 2017). The Report indicates that the increase in effective loss-absorbing capacity, in terms of the percentage of risk-weighted assets, has been about 500% since 2009.

19 11 U.S.C. §§ 362(b)(6), (7), (17), (27).

20 Dodd-Frank § 210(c)(10)(B)(i)(I) (12 U.S.C. § 5390(c)(10)(B)(i)(I)).

21 Press Release, International Swaps and Derivatives Association, *Major Banks Sign Relaunched ISDA Resolution Stay Protocol* (Nov. 12, 2015), *available at* http://www2.isda.org/attachment/ODAwNQ==/Resolution%20Stay%20Protocol%20relaunch%20FINAL.pdf.

22 Restrictions on Qualified Financial Contracts, 82 Fed. Reg. 42882 (Sept. 12, 2017) (Federal Reserve rule); Restrictions on Qualified Financial Contracts of Certain FDIC-Supervised Institutions, 82 Fed. Reg. 50228 (Oct. 30, 2017) (FDIC rule); Mandatory Contractual Stay Requirements for Qualified Financial Contracts, 82 FR 56630 (Nov. 29, 2017) (OCC rule).

23 *See* Core Principle 1(c).

24 *See* Core Principle 1(b).

25 *See* Core Principles 1(d) and 1(e).

26 As noted in the Report, the reform proposal prepared by the Hoover Institution was first set forth in Kenneth E. Scott and John B. Taylor, eds., Bankruptcy Not Bailout: A Special Chapter 14 (2012). The Hoover Institution has since refined its proposed new Bankruptcy Code chapter, in part to incorporate some of the concepts introduced by the FDIC in its SPOE strategy for executing an OLA strategy under Title II of Dodd-Frank. *See* Thomas H. Jackson, Building on Bankruptcy: A Revised Chapter 14 Proposal in Making Failure Feasible, at 15-58.

27 For example, the Report notes that the Bankruptcy Code was not designed to address the financial distress of a debtor engaged in significant derivatives activities and short-term borrowing. These activities are at the core of the intermediation services that financial institutions provide but also make them vulnerable to swift market reactions and destabilizing runs.

28 *See, e.g.*, 2017 FIBA, § 3 (proposed 11 U.S.C. § 1185(c)); Financial CHOICE Act, § 122 (proposed 11 U.S.C. § 1185(c)).

29 As mentioned above, Treasury recommends that the definition of “capital structure debt” include all unsecured debt for borrowed money other than QFCs as well as a secured lender’s unsecured deficiency claim for an under-secured debt (*i.e.*, the portion of a debt secured by collateral in excess of the value of the collateral). This recommendation differs from the most recent House and Senate bills, which do not include the latter in the definition of “capital structure debt.”

30 *See, e.g.*, 2017 FIBA, § 3 (proposed 11 U.S.C. § 1184).

31 Report at 29.

32 2015 TPRRA, § 4 (proposed 28 U.S.C. § 298); 2017 FIBA, § 4 (proposed 28 U.S.C. § 298); Financial CHOICE Act, § 123 (proposed 28 U.S.C. § 298).

33 Dodd-Frank § 210(b)(4)(A) (12 U.S.C. § 5390(b)(4)(A)). The FDIC’s authority to treat certain creditors in the same class more favorably pertains both to the transfer of assets and liabilities from the covered financial company to the bridge company and the post-transfer process of determining final payment of claims against the estate of the failed company.

34 Dodd-Frank § 210(a)(7)(B) (12 U.S.C. § 5390(a)(7)(B)).

35 As noted in the Report, the FDIC has indicated that, in practice, the only types of unsecured creditors that might receive preferential treatment are essential vendors, i.e., those that provide services essential to the continued operation of the receivership or the bridge company such as

utility service providers or payment processors. *See* Orderly Liquidation Authority, 76 Fed. Reg. 4207, 4211 (Jan. 25, 2011).

36 *See* Cohen & Wiseman, *supra* note 8.

37 Dodd-Frank § 203(b)(1) (12 U.S.C. § 5383(b)(1)).

38 Dodd-Frank § 203(c) (12 U.S.C. § 5383(c)).

39 Dodd-Frank § 210(h)(10) (12 U.S.C. § 5390(h)(10)).

40 *Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy*, 78 Fed. Reg. 76614 (Dec. 18, 2013).

41 *Cf.* Cohen and Wiseman, *supra* note 8 (proposing a six-month repayment requirement).

42 As described in the Report, Dodd-Frank provides that the Secretary of the Treasury shall determine the rate of return of any lending to the FDIC and requires the Secretary to take into consideration the current average yield on outstanding Treasury securities of comparable maturity plus an interest rate surcharge to be determined by the Secretary. Dodd-Frank § 210(n)(5)(C) (12 U.S.C. § 5390(n)(5)(C)). The statute further requires that such surcharge "shall be greater than the difference between (i) the current average rate on an index of corporate obligations of comparable maturity and (ii) the current average rate on outstanding marketable obligations of the United States of comparable maturity." *Id*. This spread represents the floor of the interest rate surcharge to be imposed by Treasury. The Report recommends that the interest rate surcharge charged to the FDIC (and thus to the bridge company) should include any further premium needed to sufficiently encourage the bridge to return to private market funding as soon as possible.

43 The Report notes that the collateral acceptable to Federal Reserve Banks for discount window lending provides a helpful starting point for identifying acceptable collateral. *See* Federal Reserve Collateral Guidelines (May 30, 2017), *available at* https://www.newyorkfed.org/banking/collateral_pledging.html.

44 Dodd-Frank § 210(o)(1) (12 U.S.C. § 5390(o)(1)). *Cf.* Cohen & Wiseman, *supra* note 8 (suggesting acceleration of assessments).

45 5 U.S.C. § 706.

46 *See* 12 U.S.C. § 1821(c)(7).

47 Dodd-Frank § 207 (12 U.S.C. § 5387).

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