

PROMPT CORRECTIVE ACTION FOR STRICTER STANDARDS COMPANIES AND ENHANCED DISSOLUTION AUTHORITY FOR INTERCONNECTED FINANCIAL COMPANIES IN HOUSE FINANCIAL REFORM LEGISLATION (H.R. 4173)

In an October 20, 2009, client alert we reviewed the Treasury Department's proposed legislation creating a "special resolution" authority for Tier 1 FHCs and any bank holding company. We describe below how the "enhanced dissolution" authority included in the House passed financial reform bill (H.R. 4173) differs from the Treasury proposal. First, however, we describe the House bill's "prompt corrective action" provisions for financial holding companies designated as Stricter Standards Companies. These are presumably the companies most likely to become subject to the dissolution authority that would be created by the House bill.

Prompt Corrective Action for Stricter Standard Companies, but No Mandatory Bankruptcy Code Proceeding

In House hearings concerning the Treasury Department's proposed legislation, the proposal to identify Tier 1 FHCs and to create a special resolution procedure for those companies was attacked for institutionalizing the "too big to fail" doctrine (however defined). The substitution of lengthy "stricter standards" in place of general regulatory directives for Stricter Standards Companies (in place of Tier 1 FHCs) was a partial answer to this criticism.

Treasury had tried to answer the same objection in its proposal by requiring "prompt corrective action" from a troubled Tier 1 FHC and a mandatory Bankruptcy Code filing for such company if it remained critically undercapitalized for 90 days.

The House bill adopts, for Stricter Standards Companies, Treasury's proposed prompt corrective action requirements (which were patterned off the requirements for banks under the Federal Deposit Insurance Act). The House bill, however, does not include the mandatory Bankruptcy Code filing against critically undercapitalized Tier 1 FHCs that was in the Treasury proposal. That proposal was criticized for being inflexible. The proposal, however, did respond to the concern that a Stricter Standards Company should be dealt with quickly and decisively.

In deleting this proposal, the House also did not give the FDIC or any other regulator special authority to require a Bankruptcy Code proceeding for a Stricter Standards Company. This means normal Bankruptcy Code rules would apply, unless federal regulators were to invoke the special dissolution authorities provided in the House bill.

One addition in the House bill related to prompt corrective action is the requirement that a Stricter Standards Company update its "rapid resolution" plan (i.e. living will) whenever a stress test indicates

it could become significantly or critically undercapitalized. The stress test requirements in the House bill were not in the Treasury proposal. They could be viewed as an early warning to avoid the development of a “too big to fail” situation. The requirement for “credible” rapid resolution plans (included in both the Treasury proposal and the House bill) is a more direct attempt to ensure no Stricter Standards Company is “too big to fail.”

House Bill Expands the Types of Companies Eligible for Special Dissolution Rules and Eliminates the Conservatorship Option

Treasury proposed that any Tier 1 FHC and any bank holding company that was not a Tier 1 FHC could be subjected to special resolution rules if the necessary findings of systemic risk were made. The House bill retains Treasury’s proposed procedures for finding systemic risk (i.e. Federal Reserve and FDIC or SEC determinations followed by Treasury Secretary approval (in consultation with the President)) in order to subject a company to special “dissolution” rules.

The House bill differs from Treasury’s proposal in permitting such determination for any company “pre-dominantly engaged” in financial activities (including “incidental” activities, as defined in the BHCA), even if that company is neither a bank holding company nor a Stricter Standards Company. By thereby closing a possible gap in the list of companies potentially subject to special dissolution rules, the House bill would increase the uncertainty as to which companies might be subject to such rules.

The House bill also eliminates the conservatorship option contained in the Treasury proposal, which was patterned off the conservatorship option for banks under the FDIA. Instead, all special dissolution proceedings would be receiverships, with receivership rules very much the same as those that apply to banks, as described in our October 20, 2009, client alert. The notable exception would be the “haircut” for fully secured creditors described below.

Both Fannie Mae and Freddie Mac were placed in conservatorship to stay in business. The ultimate aim of a conservatorship is to return the company to its shareholders. The House bill seeks to prevent that as part of its attack on “too big to fail.” Receiverships would be limited to 1 year unless specific 1 year extensions were granted by the FDIC (and no more than two such extensions could be granted). The receivership would end in a liquidation of the company.

House Bill Adds Limited Optional “Haircut” For Fully Secured Creditors

While the House bill, like Treasury’s proposal, closely follows the receivership rules that apply to banks under the Federal Deposit Insurance Act, it adds a special “haircut” for fully secured creditors. The scope of this haircut was greatly reduced through an amendment adopted in a House Floor vote.

As originally proposed and adopted by the House Financial Services Committee, the provision would have permitted the FDIC to reduce by up to 20% the claim of any fully secured creditor of a company covered by the receivership. As adopted by the House, the potential haircut was reduced to 10%. Also, the FDIC could only apply the haircut to secured claims arising under “qualified financial contracts” (i.e. swaps, repos, other securities contracts, and other trading arrangements) with an original term of 30 days or less. As an important protection for the repo market, the provision would not apply to government or agency security collateral.

FDIC Chair Sheila Bair argued in an October 4, 2009, speech that a haircut for secured creditors of financial companies could ensure those creditors actively monitor the creditworthiness of their debtor financial company. She was concerned there were too many secured creditors, particularly short term creditors, that relied on the value of pledged assets rather than the creditworthiness of their counterparty. She also complained that creditors of large financial companies generally relied on “too big to fail” to protect them from losses. Those would seem to be two different groups of creditors. Yet, in Chairperson Bair’s view, at the start of a receivership for a financial company it would be good to take assets from the secured creditors (who she thought relied unduly on collateral values and therefore, one would think, not on “too big to fail”) and give those assets to unsecured short term creditors (who presumably were more likely to rely on “too big to fail”) in order to provide unsecured creditors “substantially greater advance payments to stem any systemic risks.”

Chairperson Bair’s speech, available at this link <<http://www.fdic.gov/news/news/speeches/chairman/spoct0409.html>>, and her October 29 testimony to the House Financial Services Committee, available at this link <http://www.house.gov/apps/list/hearing/financialsvcs_dem/bair.pdf>, are clear statements of her influential views on proper dissolution authorities and on financial regulatory reform in general. She prevailed in expanding the scope of companies that could be subject to the new special dissolution authority, but not in permitting the FDIC to dissolve any bank holding company under that authority without the need for a systemic risk determination. Similarly, she prevailed in having the House bill include language that general “systemic liquidity” programs provided by the FDIC (such as the Temporary Liquidity Guarantee Program) could only be provided to solvent companies in response to a general liquidity crisis, but not in her actual goal of eliminating the “emergency stabilization” authority for banks (under existing law) and for systemically important financial companies (as proposed by Treasury and included in the House bill’s dissolution authority). Perhaps Chairperson Bair’s most significant suggestion related to resolution authority would be to apply the “sister bank guarantee” to all affiliates of a financial company. This proposal, not included in the House bill, could mean that any affiliate of any financial company would have a subordinate obligation to pay the unpaid obligations of its insolvent affiliates.

Because the secured party haircut included in the House bill only applies to non-government/agency collateral for repos and other QFCs, if it became law it would seem more likely to ensure such collateral is used for those transactions (or that such transactions are restructured to fall outside the 30 day limit) than to affect counterparty monitoring of the creditworthiness of financial company borrowers in those transactions.

Special Prefunded Dissolution Fund For Any Emergency Stabilization Actions

The House bill would adopt the “emergency stabilization” provisions proposed by Treasury that were patterned off the provisions for the FDIC to take certain actions (e.g. loans, asset purchases, guarantees) to stabilize a systemically important bank. The House bill added restrictions (i.e. “mandatory terms and conditions for all stabilization actions”) that would require the assisted company’s board and management be removed, its unsecured creditors suffer losses, and other actions. As noted above, the House bill, therefore, did not follow Chairperson Bair’s recommendation to eliminate this power. As in the case of banks, however, the power could only be used by the FDIC in its discretion. The Treasury Secretary would need to approve, but could not direct, “emergency stabilization” action.

The House bill also added a requirement that a “dissolution fund” of up to \$150 billion be funded through risk based assessments on financial companies. Through convoluted language the House bill suggests such assessments could only be made on financial companies with assets of more than \$50 billion and hedge funds that manage more than \$10 billion in assets. The dissolution fund could be used to provide emergency stabilization funding, but also to recoup any losses the FDIC might incur in any receivership under the dissolution authority.

Treasury opposed a prefunded stabilization fund on the grounds it suggested emergency stabilization would be provided. Chairperson Bair and other critics complained such a fund was necessary to protect taxpayers.

The FDIC would not be limited to funds in the dissolution fund to pay for stabilization actions. It could borrow from the US Treasury to fund such assistance. The FDIC would then be required to use assessments on financial companies for the dissolution fund to repay such borrowings to the extent stabilization funding in the amount of such borrowing was not otherwise recovered.

The House bill, however, requires Congressional approval of any loan from Treasury that would provide for more than \$150 billion in assistance to an individual company and, even with such approval, caps the loan amount at \$50 billion. This suggests the House intended to limit assistance to any single company to \$200 billion. In some circumstances that limit might not be reached or might be exceeded, depending on the balance in the dissolution fund at the time of the borrowing request. That balance could be less than \$150 billion or could exceed that through earnings.

If you would like to discuss any of the issues addressed in this Client Update or would simply like to find out more about Chapman, please contact Bob Lockner at lockner@chapman.com or Tim Mohan at mohan@chapman.com.

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