Orderly Liquidation Authority (OLA) – Title II of the Dodd-Frank Act

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Aims for Orderly Liquidation Authority (OLA), Title II of the Dodd-Frank Act

- End “Too Big to Fail”
- End Bailouts
- Manage Systemic Risk
- Provide Federal banking agencies with tools to resolve seriously troubled systemically significant non-bank financial institutions
- Minimize moral hazard.

“The OLA authority of Title II would be a remedy of last resort, to be used only after the remedies available under Title I – including the increased informational and supervisory powers – are unable to stave off a failure. In particular, it is expected that the mere knowledge of the consequences of a Title II resolution, including the knowledge that financial assistance is no longer an option, would encourage a troubled institution to find an acquirer or strategic partner on its own well in advance of failure.”

Tools to Achieve Goals of OLA

- Empower FDIC and other Federal regulators to liquidate systemically significant financial institutions
- Change the incentives and expectations/minimize moral hazard -- require management, equity and unsecured creditors to share in the pain
- Prepare in advance – lever off the “living wills” requirements of Title I; make FDIC presence an ordinary course event

Financial Company Insolvency Regimes

- US Insolvency Regimes Pre-Dodd-Frank
  - Banks with insured deposits: bank insolvency provisions of the Federal Deposit Insurance Act ("FDIA")
    - Created in response to the banking crisis during the Great Depression of the 1930s
    - Designed to reduce systemic risk
    - Failed banks placed into receivership or conservatorship administered by the Federal Deposit Insurance Corporation
  - Broker-dealers: the Securities Investor Protection Act
  - Insurance companies: state insurance insolvency laws
  - All others, including bank holding companies, funds, etc.: the Bankruptcy Code
- New "Orderly Liquidation Authority" regime for financial companies
  - Does not replace existing US insolvency law but creates a special regime with enhanced powers to be used when failure under the Bankruptcy Code or SIPA would pose a systemic risk to the broader US economy
    - Standard insolvency law will apply unless regulators opt for OLA liquidation
  - Modeled on bank insolvency provisions of the FDIA
  - Failing financial companies put into receivership administered by the FDIC
    - Unlike Bankruptcy Code or SIPA, OLA is administrative in nature; limited court review; bilateral rather than multilateral decision-making process

Eligibility and Initiation

- Eligible Entities ("covered financial entities" – CFCs)
  - Applies to all financial companies organized under US law, including bank holding companies, broker-dealers, funds
  - Does not apply to
    - Insured bank (which remain subject to FDIA bank insolvency regime)
    - Insurance companies (which remain subject to state insolvency regimes)
    - Banks and financial companies chartered/organized outside the US
    - US branches of non-US banks
- Initiating an OLA Resolution
  - Trigger: the financial company is in "default or danger of default"
  - Regulators must determine, at the moment, that
    - Failure under otherwise applicable law would pose a systemic risk to the United States and
    - The powers under OLA would mitigate such risks

No Creditor Worse Off

- Creditors Entitled to “Minimum Recovery under OLA
  - As a general principle, creditors in OLA proceedings must receive at least what they would have received had the financial company been liquidated under ordinary Bankruptcy Law
- But, all creditors need not be treated equally
  - Unstated assumption appears to be that value of a CFC will be better preserved in through an OLA receivership than through a Bankruptcy or similar process.
- Enforcement Mechanism Unclear
  - No means provided for enforcing minimum recovery other than *de novo* review of claims after determination by the FDIC
  - No collective process; could result in serial enforcement with differing outcomes

Process for Designating a CFC for Orderly Liquidation

- Recommendation of the Fed & FDIC to the Secretary of the Treasury
- Determination by Secretary of the Treasury
- Notice to CFC
- Acquiescence by CFC or Judicial Approval

Powers of the Receiver

- As receiver, the FDIC would have the power to:
  - Enforce contracts (including contracts to lend) notwithstanding contractual right to terminate based on insolvency of the financial company
  - Repudiate contracts
  - Transfer assets and liabilities to a third-party acquirer or specially chartered bridge financial company
  - Place certain subsidiaries into receivership under specified conditions
  - Make unenforceable certain cross-defaults in contracts of subsidiaries and affiliates guaranteed by the failed financial company
  - Purchase assets from or guaranty obligations of the failed financial company and certain subsidiaries
  - Clawback compensation from executives and directors if responsible for the company's failure
- Treatment of Swaps, Repos, Securities Contracts, etc. ("QFCs")
  - Closeout stayed for 1 business day pending transfer to a third party or bridge
    - If transferred, counterparty cannot closeout
    - If not transferred, counterparty can closeout
  - All QFCs with a counterparty and its affiliates must be transferred together

Principles Governing Orderly Liquidation

- Creditors and shareholders will bear losses
- The CFC will be liquidated in a manner that maximizes trhe value of the company's assets, minimizes losses, mitigates risk and minimizes moral hazard.
- Responsible management will be removed

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Treatment of Derivatives and Other QFCs

- OLA's treatment of QFC counterparties is substantially similar to that under the FDIA.
- The receiver has 1 business day within which to transfer to a third party all QFCs between the failed financial company and a counterparty (and its affiliates), provided that it transfer all such contracts with the counterparty (and its affiliates).
  - Thus, the receiver cannot cherry pick between QFCs with Counterparty A entities, but it can cherry pick between families of counterparties (*e.g.*, transfer all QFCs with Counterparty A entities but not transfer QFCs with Counterparty B entities).
  - Counterparties to transferred QFCs cannot close out based solely on the failure of the insolvency of the failed financial company, appointment of the receiver or transfer of QFCs.
  - The transferee is subject to all of the terms and conditions of the transferred QFCs. Accordingly, transferred counterparties can close out based upon the transferee's performance default (*e.g.*, payment or margin default).
  - Limitations of transferees: cannot be subject to insolvency proceedings; if a non-US company, local insolvency law must treat QFCs substantially similarly to OLA.
- After the 1-business day stay, counterparties to QFCs not transferred may exercise contractual rights to terminate, net, set off and apply collateral held with respect to the QFCs.
- The receiver can make unenforceable cross-defaults in QFCs (<u>and</u> non-QFC financial contracts) with subsidiaries that are guarantied by the company in OLA proceedings (e.g., a parent guaranty of a sub's QFCs or unsecured debt) if the guaranty is transferred within 1 business day or the FDIC otherwise provides "adequate protections".
  - This provision is designed to address situations such as in Lehman, where LBHI's insolvency triggered cross-defaults under QFCs with LB Special Financing, separate from any performance defaults by LBSF.

Tension between "No Bail-outs" and Preventing Systemic Risk

- Goal: End 'Bail-outs'
  - No more 'too big to fail' – shareholders and creditors must bear the losses of the failed financial company
  - Taxpayer funds should never be at risk, nor used to support systemically important financial companies
  - OLA provisions furthering this goal:
    - Failed financial company must be liquidated
    - Government funds can be provided to facilitate resolution, but must be repaid from liquidation proceeds, clawed back from creditors or recouped from industry
- Goal: Protect markets during a crisis
  - Preserve critical functions of failed systemically important financial companies
  - Preserve liquidity in critical markets
  - Prevent contagion
  - OLA provisions furthering this goal:
    - Transfers of liabilities, QFCs
    - Ability to treat similarly situated creditors differently (*e.g.*, make additional payments)
    - Subject to "minimum recovery" provision

OLA and Bail-in

- No power under OLA to force a conversion of debt to equity
- However, bail-in result could be achieved under OLA
  - Transfer assets and all liabilities but subordinated debt to a bridge; then issue equity in the bridge to the left-behind subordinated debt
  - Would likely trigger insolvency cross-defaults
- Recognition of home regulator’s bail-in of non-US bank
  - If based on contractual provisions, generally should be recognized and enforceable
  - Less certainty if debt issued after enactment of home-country bail-in law but without contractual provision
  - Recognition of existing debt, after passage of home-country bail-in law, possible but uncertain
  - Recognition under OLA uncertain

Cross-border Aspects of OLA

- Non-US financial companies may not be liquidated under OLA
- FDIC as receiver is required to "cooperate" with home-country regulators regarding assets and operations outside the United States
  - But no relief or exemption from any of the provisions of OLA
  - No ability to recognize the actions of or defer to home-country insolvency proceedings
    - Bankruptcy Code Chapter 15 provides for recognition of foreign proceedings
    - FDIA does not provide for recognition of foreign proceedings
- Application of power to make unenforceable cross-defaults at subsidiaries
  - Applies to contracts of subsidiaries that are guaranteed by the failed financial company
    - Requires the FDIC to transfer the guarantee or otherwise provide "adequate protection" (undefined) within 1 business day
  - No anti-cherry-picking provisions
  - Extraterritorial by its terms, but enforceability uncertain
    - Contracts of non-US subsidiaries and affiliates?
    - Different for subsidiaries and affiliates?
    - Contracts governed by non-US law?

FDIC report re: “The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act

(http://www.fdic.gov/bank/analytical/quarterly/2011_vol5_2/lehman.pdf)

- “The keys to an orderly resolution of a systemically important financial company that preserves financial stability are the ability to plan for the resolution and liquidation, provide liquidity to maintain key assets and operations, and conduct an open bidding process to sell the company and its assets and operations to the private sector as quickly as practicable.”

- “The report concludes that the powers provided to the FDIC under the Dodd-Frank Act to act decisively to preserve asset value and structure a transaction to sell Lehman’s valuable operations to interested buyers . . . could have **promoted systemic stability** and **made the shareholders and creditors, not taxpayers, bear the losses**.” (emphasis added)

- “The report also concludes that, due to the powers to preserve valuable assets and operations in the Dodd-Frank Act, the FDIC liquidation of Lehman **would recover substantially more for creditors** than the bankruptcy proceedings -- and **at no cost to taxpayers**.” (emphasis added)

Key FDIC powers under OLA

- **Advance resolution planning:** The resolution plans, or living wills, mandated under Title I of the Dodd-Frank Act would have required Lehman to analyze and take action to improve its resolvability and would have permitted the FDIC, working with its fellow regulators, to collect and analyze information for resolution planning purposes in advance of Lehman's impending failure.

- **Domestic and International Pre-planning:** The Lehman resolution plan would have helped the FDIC and other domestic regulators better understand Lehman's business and how it could be resolved. This would have laid the groundwork for continuing development of improved Lehman-specific cross-border planning with foreign regulators to reduce impediments to crisis coordination.

- **Source of Liquidity:** A vital element in preserving continuity of systemically important operations is the availability of funding for those operations. The FDIC could have provided liquidity necessary to fund Lehman's critical operations to promote stability and preserve valuable assets and operations pending the consummation of a sale. These funds are to be repaid from the receivership estate with the shareholders and creditors bearing any loss. By law, taxpayers will not bear any risk of loss.

- **Speed of Execution:** The FDIC would conduct due diligence, identify potential acquirer and troubled assets, determine a transaction structure and conduct sealed bidding -- all before Lehman ever failed and was put into receivership under Title II. A suitable acquirer would be ready to complete the acquisition at the time of Lehman's failure. A critical element in quickly completing a transaction is the power, provided by the Dodd-Frank Act, to require contract parties to continue to perform under contracts with the failed financial company so long as the receiver continues to perform. This is particularly critical to avoid the lost value, as exemplified in the Lehman bankruptcy, when counterparties immediately terminate and net financial contracts and liquidate valuable collateral.

- **Flexible transactions:** The FDIC's bidding structure would provide potential acquirers with the flexibility to bid on troubled assets (e.g., questionable real estate loans) or leave them behind in the receivership. Similarly, creditors could receive advance dividends (i.e., partial payment on their claims) to help move money back out into the market and further promote financial stability. Advance dividends would not be provided if they would expose the receivership to loss.

Illustrative Timeline for an OLA Resolution of LBHI

- **March-July, Due Diligence and Structuring the Resolution**
  - Discussions with Lehman
  - Due Diligence
  - Valuation and Identification of Problem Assets
  - Structuring the Resolution
- **August, Begin Marketing Lehman**
  - Option A: whole company purchase and assumption with partial loss share (loss-sharing P&A)
  - Option B: modified purchase and assumption without loss share, which excludes certain identified problem assets (modified P&A, similar to good bank-bad bank resolution strategy)
- **Early September, Closing**

- Will OLA achieve its goals?
- Will individuals, institutions and the markets behave as intended?

References

- Title II, Dodd-Frank Act (http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/hr4173_enrolledbill.pdf starting at page 67)
- The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act (http://www.fdic.gov/bank/analytical/quarterly/2011_vol5_2/lehman.pdf)
- Many thanks to Cleary, Gottlieb, Steen & Hamilton for providing the core of many of the foregoing slides.