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Alert Memo

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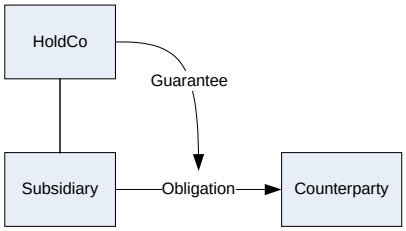
# FDIC Proposes Rules on Nullifying Subsidiary and Affiliate Cross-Defaults Under OLA

On March 20, 2012, the Federal Deposit Insurance Corporation ("FDIC") issued a proposed rule (the "Proposed Rule")[1] to implement section 210(c)(16) of the Orderly Liquidation Authority provisions of the Dodd-Frank Act ("OLA")[2], relating to the treatment of certain subsidiary and affiliate cross-defaults under OLA. The Proposed Rule defines several key terms in the statute and clarifies the protections afforded to counterparties of subsidiaries and affiliates of entities placed into receivership proceedings under OLA.




Section 210(c)(16) and the Proposed Rule are aimed at stabilizing a failing financial group during its resolution and preventing the cascading failures that can occur when one member of a financial group enters insolvency proceedings. The archetypal scenario these provisions are designed to address is where an entity's obligation that is guaranteed by its parent can be accelerated or terminated upon the insolvency of its parent. Absent the power to make such cross-defaults unenforceable, the parent's insolvency allows counterparties of its subsidiary to accelerate or terminate their contracts with the subsidiary, potentially pushing a viable entity into insolvency. Thus, unless such cross-defaults can be nullified, the resulting cascade of failures could require placing multiple entities within a failing financial group into insolvency proceedings, increasing the expense and complexity of such a resolution.

While the power to nullify cross-defaults can help make a resolution more orderly and effective, it deprives creditors of bargained-for protections and has the potential to leave counterparties worse off than if the financial company had been resolved under ordinary insolvency law. The statute and Proposed Rule attempt to strike a balance between these two competing goals by providing certain protections for counterparties to contracts enforced under section 210(c)(16).

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1 Notice of Proposed Rulemaking, Enforcement of Subsidiary and Affiliate Contracts by the FDIC as Receiver of a Covered Financial Company (pre-publication draft available at http://www.fdic.gov/news/board/2012/2012-03-20_notice_no6.pdf).

2 Dodd-Frank Act § 210(c)(16), codified at 12 U.S.C. § 5390(c)(16).

This memorandum begins by providing a high-level overview of section 210(c)(16) and the Proposed Rule. Next, this memorandum analyzes the Proposed Rule by discussing its application first to the enforcement of contracts that are "linked to" a financial company in liquidation proceedings under OLA (a "covered financial company" or "CFC"), then to the enforcement of contracts "supported by" the CFC in the context of a transfer of such support obligations, and finally to the enforcement of contracts "supported by" the CFC in the context of "adequate protection". This memorandum concludes with a discussion of the comments the FDIC has requested in respect of the Proposed Rule and some significant issues that are not addressed by the Proposed Rule.

**Section 210(c)(16) and the Proposed Rule**

Under OLA, the FDIC may be appointed as receiver for a financial company whose failure under otherwise applicable insolvency law would pose significant risks to U.S. financial stability (a covered financial company, or "CFC"), including bank holding companies, broker-dealers, and other non-bank affiliates and subsidiaries. Among other powers, the receiver may transfer assets and liabilities of the CFC to a third party acquirer or a specially chartered bridge institution, notwithstanding any contractual prohibitions or consent requirements. As under the Federal Deposit Insurance Act bank insolvency provisions, on which OLA was based, provisions in contracts with the CFC that allow the counterparty to terminate the contract based on the insolvency of the CFC, so called *ipso facto* clauses, are generally unenforceable.[3] The termination rights of counterparties under certain swaps, repos, securities contracts, forward contracts and commodity contracts ("qualified financial contracts" or "QFCs") are safe harbored from this provision and may be exercised if the QFCs are not transferred to a third party acquirer or bridge institution within one business day after the appointment of the FDIC as receiver for the CFC.[4]

Section 210(c)(16) grants the FDIC, as receiver for a CFC or a subsidiary of a CFC (including an insured depository institution), the power to enforce contracts of subsidiaries or affiliates of the CFC, notwithstanding any contractual rights a counterparty may have to accelerate or terminate such contracts based on the insolvency or financial condition of the CFC. Under the statute, the receiver can enforce these contracts only if all related guarantees or other credit support are transferred to a third party acquirer or bridge institution, or the receiver otherwise provides adequate protection, by 5:00 p.m. on the

[3] Dodd-Frank Act § 210(c)(13)(C), codified at 12 U.S.C. § 5390(c)(13)(C).

[4] Dodd-Frank Act § 210(c)(8)–(11), codified at 12 U.S.C. § 5390(c)(8)–(11). See Section III of our July 9, 2010 Alert Memorandum SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (available at http://www.cgsh.com/summary_of_the_dodd-frank_wall_street_reform_and_consumer_protection_act/) or our OUTLINE OF THE TREATMENT OF FINANCIAL CONTRACTS UNDER U.S. INSOLVENCY LAWS (available from your regular Cleary Gottlieb contacts) for more on the OLA safe harbor regime applicable to QFCs.

business day following the appointment of the FDIC as receiver for the CFC (the same deadline for transferring QFCs before counterparties may exercise termination rights).[5]

The Proposed Rule would enforce all contracts of all subsidiaries and affiliates of the CFC that are "linked to" or "supported by" the CFC, in effect exercising by rule the receiver's statutory authority to enforce such contracts.[6] The enforcement of contracts that are "supported by" the CFC would only be effective if the FDIC also transfers the relevant credit support obligations to a "qualified transferee" (a third party acquirer that is not subject to insolvency proceedings or a bridge institution) or provides adequate protection by the statutory deadline. As described below, the Proposed Rule clarifies the scope of contracts that are "linked to" or "supported by" a CFC and defines "adequate protection" for purposes of section 210(c)(16).

**Contracts "Linked to" a CFC Enforced Automatically**

The Proposed Rule enforces all contracts of subsidiaries and affiliates of the CFC that are "linked to" the CFC's insolvency or financial condition. Thus, cross-default rights under contracts that are not otherwise guaranteed or supported by the CFC are made unenforceable without any action on the part of the FDIC. This provision applies to all contracts of subsidiaries and affiliates of the CFC and is not limited to financial contracts.

Under the Proposed Rule, a contract is "linked to" a CFC if it contains a "specified financial condition clause", which is any provision that grants a counterparty the right to close out or take other specified actions under the contract based on certain

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[5] (16) ENFORCEMENT OF CONTRACTS GUARANTEED BY THE COVERED FINANCIAL COMPANY—

(A) IN GENERAL—The Corporation, as receiver for a covered financial company or as receiver for a subsidiary of a covered financial company (including an insured depository institution) shall have the power to enforce contracts of subsidiaries or affiliates of the covered financial company, the obligations under which are guaranteed or otherwise supported by or linked to the covered financial company, notwithstanding any contractual right to cause the termination, liquidation, or acceleration of such contracts based solely on the insolvency, financial condition, or receivership of the covered financial company, if—

(i) such guaranty or other support and all related assets and liabilities are transferred to and assumed by a bridge financial company or a third party (other than a third party for which a conservator, receiver, trustee in bankruptcy, or other legal custodian has been appointed, or which is otherwise the subject of a bankruptcy or insolvency proceeding) within the same period of time as the Corporation is entitled to transfer the qualified financial contracts of such covered financial company; or

(ii) the Corporation, as receiver, otherwise provides adequate protection with respect to such obligations.

Dodd-Frank Act § 210(c)(16), codified at 12 U.S.C. § 5390(c)(16).

[6] The Proposed Rule defines "subsidiary" and "affiliate" by reference to certain prongs of the Bank Holding Company Act definition of "control". This definition includes direct or indirect ownership of, or the power to vote, 25 percent or more of any class of voting securities of a company or the ability to control the election of a majority of the directors of a company.

enumerated conditions related to the insolvency or financial condition of the CFC. The specified actions within the scope of the definition are the rights to:

(a) Terminate, accelerate, liquidate or exercise any other remedy under any contract of the subsidiary or affiliate;

(b) Obtain possession or exercise control over any property of the subsidiary or affiliate; or

(c) Affect any contractual rights of the subsidiary or affiliate.

Any of the actions above that are premised, directly or indirectly, on the occurrence of any of the following conditions fall within the scope of the Proposed Rule:

(i) Changes in the financial condition or insolvency of the CFC;

(ii) The appointment of the FDIC as receiver for the CFC or regulators' recommendation that such appointment be made;

(iii) The exercise by the FDIC as receiver of powers under OLA;

(iv) The transfer of assets or liabilities of the CFC to a qualified transferee;

(v) Other actions taken by the FDIC as receiver to liquidate the CFC; or

(vi) Actions taken by the FDIC as receiver to operate and terminate a bridge institution, including merging or dissolving the bridge institution.

The preamble explains that "specified financial condition clause" is defined broadly in order to encompass occurrences that often accompany insolvency to prevent a counterparty from relying on such factors, rather than the insolvency itself, to justify the exercise of cross-default rights and thus frustrate the purpose of the statute. Further, the definition is intended to address indirect linkages to the CFC—rights triggered by the default of another entity within the corporate structure may also be "linked to" the CFC if the change in financial condition or insolvency of the CFC was the "ultimate triggering event" giving rise to such right. Despite its breadth, the Proposed Rule does not interfere with a counterparty's right to exercise contractual rights premised on the CFC's payment or performance defaults.

The ability to enforce contracts "linked to", but not "supported by", the CFC without providing adequate protection may not be entirely consistent with section 210(c)(16), which, by its terms, requires the transfer of related credit support or the

provision of adequate protection in order to enforce any contract of a subsidiary or affiliate. In the preamble, the FDIC argues in effect that contracts merely linked to the CFC do not gain any benefit from such linkage that requires protection.

Further, the definition of "specified financial condition clause" expands the FDIC's powers under section 210(c)(16). First, the rights of counterparties affected by the Proposed Rules go beyond those specifically addressed by the statute, and the preamble encourages that the scope of such rights be "read expansively". Section 210(c)(16) only specifically addresses rights to terminate, liquidate or accelerate contracts while the Proposed Rule is drafted to apply to all rights under contracts premised on the enumerated conditions. In particular, the preamble notes that margin calls against a subsidiary or affiliate premised on the insolvency or financial condition (including ratings downgrade) of the CFC would be unenforceable. The FDIC acknowledges that the Proposed Rule goes beyond the literal scope of the statute, but argues that the actions described under the statute are not meant to be exclusive and that this broad definition is necessary to implement the purpose of the statute.

Second, the linkages to the CFC under the Proposed Rule go beyond those identified in the statute. Section 210(c)(16) only addresses actions that are premised on the "insolvency, financial condition, or receivership" of the CFC. However, the preamble explains that the Proposed Rule broadens this list to include, among other things, a termination right triggered by a "change of control" of the CFC.

**Enforcing Contracts "Supported by" a CFC by Transfers to a Qualified Transferee**

A contract is "supported by" a CFC if the CFC undertakes any of the following for the purpose of supporting the obligations of a subsidiary or affiliate for the benefit of its creditors:

- To "guarantee, indemnify, undertake to make any loan or advance to or on behalf of the subsidiary or affiliate";
- To "undertake to make capital contributions to the subsidiary or affiliate"; or
- To "be contractually obligated to provide any other financial assistance to the subsidiary or affiliate."

The preamble clarifies that non-financial support, such as an undertaking to conduct specific performance, does not constitute "support" under the Proposed Rule.

In order to enforce contracts of a subsidiary or affiliate of a CFC that are "supported by" the CFC, the receiver must either transfer all such credit support to a qualified transferee or otherwise provide "adequate protection" by the statutory deadline.

Such credit support obligations must be transferred together with all "related assets and liabilities", including all related collateral, rights of offset, and master netting agreements. The preamble states that, with respect to unsecured guarantees, the transfer of the guarantee alone is sufficient. The Proposed Rule requires that the FDIC must provide notice by the statutory deadline to counterparties of its intent to enforce contracts "supported by" the CFC, which notice may be made by a posting on the FDIC's website or the website of the CFC.

The interactions of section 210(c)(16) powers and the provisions governing the treatment of QFCs can be quite complex. As noted in the preamble, credit support obligations with respect to QFCs are themselves QFCs. Thus, guarantees of QFCs are subject to anti-cherry picking rules, which require that all QFCs between the CFC and a counterparty (and all of the counterparty's affiliates) be transferred to a qualified transferee or no such QFCs be transferred. As applied in the context of section 210(c)(16), if the FDIC transfers, e.g., the guarantee of a QFC with Counterparty X to a bridge institution, it must also transfer to the same bridge institution all QFCs between the CFC and Counterparty X and all QFCs between the CFC and any affiliate of Counterparty X.

**Enforcing Contracts "Supported by" a CFC by Providing "Adequate Protection"**

Contracts "supported by" a CFC may also be enforced by providing "adequate protection", either in the alternative to transferring any related support or in combination with a partial transfer of such support. Under the Proposed Rule, "adequate protection" includes any of the following:

- Making payment or periodic payments to counterparties to the extent of any losses caused by the failure to transfer the CFC's guarantee or other support;
- Provision by the FDIC as receiver of a guarantee of the subsidiary or affiliate's obligations; or
- Provision of relief that will result in realization by the counterparty of the "indubitable equivalent" of the CFC's support.

The preamble describes this definition as consistent with the definition of "adequate protection" under Section 361 of the Bankruptcy Code and notes in particular that "indubitable equivalent" should be read as having a meaning consistent with its use and application under the Bankruptcy Code. However, under the Bankruptcy Code, these terms are applied in the context of secured obligations, whereas here they are applied in the context of potentially unsecured credit support obligations. Thus, any guidance on the application of these terms may come by analogy to, rather than direct application of, Bankruptcy Code precedents. Further, treatment of these terms varies from jurisdiction to

jurisdiction and from case to case, leaving the ultimate scope of these terms somewhat ambiguous.

Also unclear is the functional difference between the first and second prongs of the definition of "adequate protection". The commitment by the FDIC to make a payment or periodic payments in respect of an obligation would appear to be the functional equivalent of a guarantee. To the extent the intent of this construction is to provide protection that falls short of that which would be provided by a guarantee, creditors may be harmed by the nullification of their cross-default rights.

**Request for Comment**

A request for comments accompanied the Proposed Rule. Of particular note, the FDIC sought input on the scope of "adequate protection" as well as which contractual provisions should trigger the applicability of section 210(c)(16). Comments are due 60 days after the Proposed Rule is published in the Federal Register.

**Significant Issues Yet to be Addressed**

Procedures for "Adequate Protection" Determinations: The Proposed Rule does not address who will make the determination that a counterparty of a subsidiary or affiliate of a CFC has received "adequate protection", or how such a determination will be made. More guidance from the FDIC, particularly in how it will make the subjective determination of "indubitable equivalence", would give the operation of these powers more predictability. Further, it is unclear whether or how a counterparty whose contract with a subsidiary or affiliate of a CFC has been enforced may challenge such enforcement or a determination that "adequate protection" has been provided. In the context of other OLA rules relating to adequate protection of secured creditors of a CFC, the FDIC has indicated that the avenue for challenging determinations of the FDIC as receiver is by judicial appeal of the FDIC's final determination of a claim.

Complexity in the Application of these Powers: The application of section 210(c)(16) powers under the Proposed Rule in the context of a complex group of financial companies raises a number of potential concerns for creditors. In particular, little guidance is provided on the circumstances under which the FDIC would choose to exercise its power to nullify cross-defaults. Further, there is no limitation under either the statute or the Proposed Rule on the FDIC's ability to selectively apply this power to "cherry pick" entities, obligations or counterparties. Consideration should be given to the impact on counterparties and markets of the selective application of this power to enforce some contracts of a subsidiary or affiliate but not others or to enforce the contracts of some counterparties of a subsidiary or affiliate but not the contracts of other counterparties of the subsidiary or affiliate. These issues are made all the more complex when the power to enforce contracts is exercised in respect of QFCs and the all-or-none anti-cherry picking rules must be applied with respect to the CFC. At the very least, it might be appropriate to apply the same all-or-

none anti-cherry picking rules to the enforcement of QFCs of subsidiaries or affiliates of the CFC in cases where some QFCs are "supported by" the CFC but others are merely "linked to" the CFC.

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Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Banking and Financial Institutions or Bankruptcy and Restructuring in the "Practices" section of our website (http://www.cgsh.com) if you have any questions.

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