ALERT MEMORANDUM

Treasury Recommends Retaining Orderly Liquidation Authority

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On February 21, 2018, the U.S. Treasury Department released its long-awaited report on the Orderly Liquidation Authority (**OLA**) established under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the **Dodd-Frank Act**).

The report, *Orderly Liquidation Authority and Bankruptcy Reform* (the **Report**), recommends retaining OLA and adopting a new Chapter 14 of the U.S. Bankruptcy Code (the **Code**) to make resorting to OLA proceedings less likely. While there have been many criticisms of OLA in the past, as reflected in the April 21, 2017 Presidential Memorandum instructing the U.S. Department of the Treasury (**Treasury**) to prepare the Report, Treasury ultimately proposed only modest changes to OLA designed to clarify treatment of creditors, tighten the terms for funding from the Orderly Liquidation Fund (**OLF**) line of credit from Treasury, and strengthen judicial review of the decision to initiate OLA.

The new proposed Chapter 14, which has been developed over several years and has been the subject of several legislative proposals, would include many of OLA's powers, such as a bridge company and temporary stays on termination of Qualified Financial Contracts (**QFCs**).

Treasury's recommendations addressed specific criticisms of OLA but did not significantly alter the powers to resolve a systemically important financial institution (**SIFI**). Treasury concluded OLA was necessary as a backstop to bankruptcy in extraordinary cases where private financing is unavailable and to reduce the potential for foreign regulators to ring-fence the foreign operations of SIFIs.

As a preface to the recommendations, the Report lauded the post-Dodd-Frank Act developments, including advances in resolution planning; resolution strategies, particularly the development of the Single Point of Entry (**SPOE**) strategy; and key steps to make resolutions more effective, such as requirements for financial companies to hold Total Loss Absorbing Capacity (**TLAC**) to permit recapitalization. Treasury recognized these developments as enhancing resolvability, while noting other factors – such as the possibility of ring-fencing by foreign regulators – as remaining risks.

Key Takeaways

- **OLA Retention**. Treasury recommended reforms to OLA that leave the resolution authorities intact, while clarifying key elements affecting creditors and claimants in ways that should strengthen market confidence in the transparency of an OLA resolution. In effect, these proposals tighten many of the protections already contained in OLA, but without significantly impairing flexibility.

- **Bankruptcy Reform**. Treasury recommended creating a new Chapter 14 of the Code that could be used to resolve SIFIs, narrowing the scenarios where OLA would need to be used.

  - Chapter 14 would adopt features of OLA such as a 48-hour stay on close-outs of QFCs and the prompt transfer of assets and liabilities (including QFCs) to a bridge financial company.

  - Paralleling OLA, the Report recommends that Chapter 14 be limited to insolvencies of financial companies where necessary "to prevent serious adverse effects on financial stability in the United States."

- **Improvements since the Dodd-Frank Act**. The Report gave regulators and the industry credit for post-Dodd Frank Act developments that have improved the ability to implement a resolution, including:

  - **New Resolution Strategies**. Treasury praised the development of more effective strategies, such as SPOE, to address a number of the most significant challenges in a SIFI resolution – maintaining operations of key subsidiaries both in the U.S. and abroad, restructuring the failed SIFI's balance sheet, and recapitalizing the temporary bridge company to assist its eventual access to market funding and its return to private ownership.

  - **Resolution Planning**. Treasury recognized that resolution planning has led to greater rationalization of legal entity structures, increased liquidity and capital resources, improved avenues for support to operating subsidiaries through intermediate holding companies and contractual frameworks for downstreaming financial resources and more resolution-resilient frameworks to assure continuity of services for operating subsidiaries.

  - **Clean Holding Companies & TLAC**. Treasury noted the significantly greater loss absorbing capacity of SIFIs since the Dodd-Frank Act was enacted. In combination with the higher levels of liquidity and capital now held by SIFIs, the Board of Governors' (**Federal Reserve**) TLAC requirements provide a ready reservoir of bailinable resources to recapitalize a failed SIFI and provide support to its operating subsidiaries. Execution of these steps is enhanced due to the requirement that the top level holding company have only limited liabilities.

  - **Stays on QFC Termination**. OLA incorporates a temporary stay on termination of QFCs as well as authority to stay or override cross-defaults. The Report notes industry efforts to address concerns about the enforceability of stays for QFCs governed by non-US law and to mitigate adverse effects of the exercise of "cross default" rights during resolution (close-out rights triggered by the resolution of an affiliate of a booking entity). It likewise notes the US banking regulators' recent imposition of requirements on SIFIs to amend a wide variety of QFCs to address these concerns.

  - **Subordination of Holding Company Debt**. Treasury noted that SPOE minimized disruption by preserving subsidiary operations, while imposing losses on holding company creditors. The Report noted this could lead to a distortion between holding company and subsidiary creditors, which required further study. While SPOE clearly distinguishes between holding companies and their subsidiaries, this subordination appears consistent with the structural subordination inherent in ownership of the subsidiaries and supportive, rather than corrosive, of market discipline.

  - **International Considerations**. Treasury noted the dangers of ring-fencing by foreign authorities. While much work remains, the Report noted the ongoing coordination efforts along with the challenges to continuity if a bankrupt SIFI lacked sufficient funding to meet foreign requirements. Treasury notes that the existence of OLA, particularly its role in facilitating coordination with foreign regulators, probably enhances the potential effectiveness of the proposed Chapter 14.

- **Political and Policy Reactions**. Reactions to the Report have been generally positive, but outgoing Chairman Jeb Hensarling of the House Financial Services Committee criticized the Report because "it does not recommend repealing OLA" and was, he argued, "inconsistent with the President's core principle" of preventing taxpayer bailouts. It remains unclear whether this view will have any sway or whether the Report will become Administration legislative and regulatory policy.

- **Implementation**. Many of the Report's recommendations can be adopted by regulation, but certain of the OLA recommendations (for judicial review of initiation of OLA and Bankruptcy Court adjudication of claims) and the proposed Chapter 14 require Congressional action.

Background

Orderly Liquidation Authority

Enacted in 2010, the Dodd-Frank Act included OLA as an alternative option to the Code for resolving troubled financial institutions where applying the Code would have "serious adverse effects on financial stability in the United States"[1] and resolution under OLA would mitigate those effects. OLA is largely modeled on the Federal Deposit Insurance Corporation's (**FDIC**) receivership powers under the Federal Deposit Insurance Act, including:

- Authority to take over the failed SIFI and implement a resolution designed to impose losses on its shareholders and creditors, while mitigating the potential systemic consequences. Like the FDIC's powers in bank receiverships, the OLA powers permit the FDIC to operate the failed SIFI, terminate or enforce contracts and take other actions necessary to its resolution goals;

- The power to sell and transfer some or all of the assets and liabilities of the failed institution to a transferee, including a bridge institution;

- A one-business-day stay after appointment of the FDIC as receiver on termination of QFCs to permit their transfer to a bridge financial company;

- The power to prevent exercise of cross-default rights for contracts of the failed institution's affiliates or subsidiaries that are guaranteed by, or "linked to," the failed company (so long as, in the case of guaranteed contracts, the FDIC satisfies certain conditions to preserve the benefit of the guarantee's credit support); and

- Access to a line of credit from Treasury to fund the resolution subject to caps based upon the value of the failed SIFIs assets. The caps are designed to ensure that the line of credit can be repaid from the ultimate disposition of the SIFI or its assets.

Using the OLA framework as a starting point, the FDIC, the Federal Reserve and market participants have developed the SPOE resolution strategy for SIFIs. In an SPOE resolution only the parent holding company would enter Code proceedings, and all material

[1] Dodd-Frank Act § 203(b)(2) (12 U.S.C. § 5383(b)(2)).

operating subsidiaries would continue to operate normally.

The shareholders and creditors of the holding company would bear the losses of the entire group (according to their order of priority), while the remainder of the group's operations would continue as a going concern.

Bankruptcy Code

Scholars and market participants have proposed amendments to the Code to facilitate an SPOE strategy modeled after those contained in OLA. Those proposed amendments include allowing for the rapid transfer of certain assets and liabilities to a new institution to allow for the continuation of operating subsidiaries and the write-down of long-term debt and shareholder claims.[2]

Some critics of OLA have argued that OLA does not afford creditors the same protections as those available under the Code. Others have expressed concern that funds borrowed by the FDIC to facilitate OLA may not be repaid and will thus be borne by taxpayers – despite the multiple layers of statutory prohibitions and mandatory repayment requirements from the sale of the SIFI's assets, recoupment from its responsible officers and directors and authority to assess the industry for any shortfall. These layers effectively ensure that the cost of OLA will not be borne by taxpayers. Nonetheless, it has remained a recurring criticism. Critics have also expressed the view that the FDIC's borrowing ability could create moral hazard – despite the fact that it must be repaid as noted above. The various proposed modifications to the Code are in part a response to such criticisms of OLA.

Presidential Memorandum

Some of these concerns were reflected in the April 21, 2017 Presidential Memorandum. That document noted that OLA "may encourage excessive risk taking by creditors, counterparties, and shareholders of financial companies, because [the FDIC] is authorized to use taxpayer funds to carry out OLA liquidations. While any losses incurred . . . are ultimately supposed to be covered by assessments on other financial companies, taxpayer money may always be at risk." It also noted that it was "important to evaluate the extent to which other legislative solutions, such as changes to [the Code], could fulfill OLA's policy objectives in a more effective manner."

Accordingly, the Presidential Memorandum directed Treasury to conduct a review examining the potential adverse effects of failing financial companies on U.S. financial stability, whether OLA is consistent with the principles set out in Executive Order 13772, whether invoking OLA could result in a cost to Treasury's general fund, whether the availability or use of OLA could lead to excessive risk taking or otherwise lead market participants to believe that a financial company is "too big to fail" and whether a new chapter in the Code would be a superior method of resolution for financial companies over OLA. The Report fulfils Treasury's obligation to respond to the Presidential Memorandum.

Treasury Report Recommendations

Developments Since the Dodd-Frank Act

As noted above, Treasury recognized the importance of post-Dodd-Frank Act developments to improve resolution, and it effectively sought to further those developments. In fact, it appears that these improvements were significant factors in Treasury's conclusion that a new Chapter 14 of the Code was now a more viable resolution framework for SIFIs even though OLA remained an important backstop in a crisis.

Chapter 14 of the Code

Treasury recommended the creation of a new chapter of the Code, Chapter 14, that would be tailored to the unique challenges of resolving large financial companies. Treasury's recommendations borrowed heavily from Hoover Institution proposals for reforms of the Code to handle SIFI resolution.[3] Treasury argued

[2] *See e.g.*, Financial Institution Bankruptcy Act of 2017, H.R. 1667, 115th Cong. (2017).

[3] Kenneth E. Scott, Thomas H. Jackson, John B. Taylor, eds., Making Failure Feasible: How Bankruptcy Reform Can End "Too Big To Fail" (2015).

that the Chapter 14 framework would more effectively impose market discipline to limit excessive risk taking than OLA alone and that it would preserve what Treasury sees as the key advantage of the existing bankruptcy process: predictable, impartial adjudication of claims between creditors in bankruptcy. Treasury believes that the Code limits moral hazard and improves the rule of law, but that the Code in its current form generally cannot handle the insolvency of a SIFI. The Report accurately notes that the normal Code provisions were not designed to address stress in SIFIs and that reforms are necessary to improve the ability of the Code to handle such an insolvency.

The proposed Chapter 14 would only apply to "financial companies" defined by reference to OLA and the FDIC's implementing regulations and where the use of the Chapter 14 authorities is necessary "to prevent serious adverse effects on financial stability in the United States." Broadly, the proposed Chapter 14 would allow a financial firm to file for bankruptcy and petition the court for approval to transfer within 48 hours most of its assets and certain liabilities to a newly created bridge corporation. A court would permit the transfer if the court determines that the transfer is necessary to prevent the defined effects on U.S. financial stability and the bridge company would likely satisfy obligations under the contracts transferred to it. The transferred assets would include the ownership interests in operating subsidiaries, mitigating an incentive of counterparties to create a run. Liabilities left behind in the debtor financial institution would include shareholder claims and claims of holders of "capital structure debt," which Treasury recommends include all unsecured debt for borrowed money other than QFCs.

Chapter 14 would also provide a temporary 48-hour stay, potentially longer than OLA's 5pm-on-the-next-business-day stay, on the close-out of QFCs by counterparties of the debtor financial institution. This would allow the bankruptcy case to proceed over a "resolution weekend," but give it more flexibility than OLA in the case of a bankruptcy not on a Friday.

As a court would be tasked with reviewing the petition for bankruptcy, Treasury recommended that a set of judges (particularly bankruptcy court judges) be selected in advance to be ready to hear such petitions.

While Treasury noted Chapter 14 would help address some of the Code's deficiencies, Treasury acknowledged that Chapter 14 would not fully address liquidity needs, the need for regulatory involvement and coordination with foreign regulators. To address those deficiencies, Treasury made the following additional recommendations with respect to Chapter 14:

- Congress should make a statutory grant of standing to domestic regulators to raise issues and be heard in any Chapter 14 bankruptcy case.
- Congress should provide that a court may grant standing to foreign regulators.
- Congress should consider providing that a court should give deference to a Federal Reserve determination as to the financial stability implications of a transfer to a bridge company.
- U.S. regulators should redouble their efforts to establish protocols for cooperation with their foreign counterparts to give all parties confidence in the feasibility of bankruptcy.
- Congress should consider designating district court judges, as opposed to bankruptcy court judges, to preside over Chapter 14 cases.
- Congress should not include an asset threshold in defining which financial companies are eligible for Chapter 14.

Treasury's Chapter 14 proposal differs from the proposed amendments to the Code being considered by the Senate and House in a few key ways. For example, unlike the Report, both the House and Senate bills recommend eliminating OLA. Additionally, unlike in the Report, in the Senate bill, the Federal Reserve and FDIC have the ability to commence a Chapter 14 case. Treasury, unlike the House and Senate versions, also recommended defining "capital structure debt" to include the unsecured portions of secured obligations.

OLA Recommendations

Consistent with the Dodd-Frank Act, Treasury reiterated that bankruptcy should be the first resort for the failure of a financial institution. However, Treasury recommended that OLA remain in place as an emergency tool for a large, complex, cross-border financial institution, especially if the requisite private financing is unavailable. In addition, Treasury noted that keeping OLA in place will serve to make bankruptcy under the proposed Chapter 14 of the Code more viable by reducing the likelihood of the potential introduction of ring-fencing requirements and interference by non-U.S. authorities, which are already familiar with OLA.

Treasury recommended improvements to regulations implementing OLA to clarify creditor protections and provide greater transparency to creditors, and tighten the terms for OLF funding along with some statutory amendments to facilitate judicial review.

Clarification of the Treatment of "Similarly Situated" Creditors. Treasury recommended clarifying that the FDIC will only treat creditors in the same class differently if it makes the determination that such treatment is necessary to "initiate and continue operations essential to implementation of the receivership or any bridge company."[4] While the FDIC already has regulations in place restricting its own ability to treat similarly-situated creditors differently, Treasury recommended the exception to this standard should be aligned with the Code, which only allows for critical vendors to receive payments before other creditors. Essentially, Treasury recommends that the authority be limited to essential vendors. This is consistent with the FDIC's current regulations, though it would modify those regulations to make the limitation more explicit.

Additionally, Treasury recommended that a bankruptcy court, not the FDIC, decide claims against the FDIC's receivership of a covered financial company.

Tightening the Terms of OLF Funding. Treasury also recommended limiting the duration of advances under the OLF to only as long as necessary to meet the liquidity needs of the bridge company. In addition, Treasury recommended that the OLF use loan guarantees, instead of direct loans, and above-market interest rates on direct loans to discourage their use. The FDIC already favors reliance on guarantees because guarantees without expected losses do not score against the OLF's maximum borrowing thresholds. These direct loans, according to Treasury, should all be secured by high-quality collateral, similar to that accepted by the Federal Reserve discount window. However, it is not entirely clear how this requirement would work in practice; if the covered financial company has enough high-quality collateral to secure their loans from the OLF, it likely would not be in enough trouble to trigger OLA in the first place. Additionally, Treasury recommended accelerating the assessment of the OLF industry-wide backstop in the event OLF loans are not fully repaid.

Modify Role of Judicial Review. Finally, Treasury recommended strengthening judicial review of OLA. Specifically, it recommended expanding the scope of judicial review of the decision to invoke OLA. Currently, the Secretary of the Treasury must make seven statutory findings before petitioning for appointment of a receiver under OLA. However, the district court reviewing such petition can review only two of those findings: (i) that the company is in default or in danger of becoming so and (ii) that the company is a "financial company." Treasury recommended allowing the district court to review all seven findings under the "arbitrary and capricious" standard of the Administrative Procedure Act.

Treasury also recommended that Congress consider revamping the judicial review of the decision to implement OLA through either:

- Replacing the ex ante review process with full judicial review after the appointment of the FDIC as receiver; or

[4] Dodd-Frank Act § 210(b)(4)(A)(ii) (12 U.S.C. § 5390(b)(4)(A)(ii)).

- Retaining pre-appointment review but allowing the circuit court, on appeal, to review the district court's decision de novo on all issues.

Treasury noted that if the judicial review occurred after the appointment of the FDIC as receiver then it might be possible to eliminate the current prohibition on stays or injunctions pending appeal, and give the courts flexibility to grant preliminary relief pending appeal. This recommendation, though noted only in passing, requires clarification and further thought. The mere risk of an injunction against action in an OLA resolution could chill or impair the critical activities designed to mitigate systemic risks. In other countries, injunctions or the threat of injunctions have often proven the major impediment to effective resolutions.

Further Recommendations. Treasury also made the following recommendations with respect to OLA:

- The statutory tests for determining when a financial company is in "default or in danger of default" (a condition to being placed into OLA) should be clarified to require that each test is likely to be met within a specified period, to be no more than 90 days from the determination.
- Congress should repeal the tax-exempt status of the bridge company.
- The FDIC should finalize its notice regarding the SPOE strategy, and if there are any circumstances under which the FDIC does not believe SPOE would be the preferred resolution method, it should make those clear.
- Congress should reform the timing and process of OLA.

Conclusion

Treasury recommended retaining OLA, with reform, as a last resort for the failure of a SIFI. However, it also recommended the creation of a new Chapter 14 of the Code in order to narrow the opportunities for OLA to be employed. These reforms are meant to reduce the possibility of a taxpayer bailout and strengthen market discipline of the largest financial institutions. However, the ultimate political environment for the Report's recommendations, and its progress in Congress and with regulators, remains unresolved. Those considerations will be crucial to the judicious implementation of the Report's recommendations.

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