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ONE WAY THAT DODD-FRANK'S LIQUIDATION AUTHORITY COULD ACHIEVE PARITY WITH THE BANKRUPTCY CODE

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On October 19, 2010, the FDIC published a proposed rule governing the implementation of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1] Title II of Dodd-Frank creates an orderly liquidation authority for the resolution of systemically important financial institutions.[2] According to the FDIC's Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, "[t]he liquidation rules of Title II are designed to create parity in the treatment of creditors with the Bankruptcy Code and other normally applicable insolvency laws."[3]

One of the criticisms of Title II, however, is that creditors lack the same degree of certainty with respect to their probable treatment under an FDIC receivership as compared with the bankruptcy process. The FDIC's typical response to this concern is that the statute guarantees creditors no less than the amount they would have received if the covered financial company had been liquidated under chapter 7 of the Bankruptcy Code.[4]

This response is inherently flawed because it assumes that one could state objectively what a creditor's probable recovery would be in a hypothetical chapter 7 case. All judgments of value are subjective, even if based to some extent on objective facts. It is for this reason that valuation disputes are among the most common forms of litigation in Bankruptcy Courts. However, Title II does not appear to provide any recourse to creditors who disagree with the FDIC's

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[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified at 15 U.S.C. § 78o-7).

[2] §§ 201–217.

[3] 75 Fed. Reg. 64,182, 64,175 (proposed Oct. 19, 2010) (to be codified at 12 C.F.R. pt. 380).

[4] *See* §§ 210(a)(7)(B), (d)(2)(B).

determination of value in most contexts. What follow are some examples of how the subjective value determinations of the FDIC may affect creditor treatment under Title II. These examples demonstrate the lack of transparency and creditor rights that is a general issue with FDIC receiverships.

Bifurcation of Secured Claims. To the extent that the FDIC determines that a claim is undersecured, Title II gives the FDIC the authority to bifurcate claims and treat the undersecured portion as an unsecured claim.[5] The FDIC may make payments to a secured creditor pursuant to the disposition of its collateral, but is under no obligation to make any payment with respect to the undersecured portion of the claim.[6] One cannot imagine a more likely scenario for a valuation dispute. If the FDIC cannot dispose of a secured creditor's collateral, then the FDIC will value the underlying security and determine to what extent the security is insufficient, and pay the secured creditor based on that valuation. Moreover, even if the FDIC disposes of a secured creditor's collateral, secured creditors may wish to be involved in the development and administration of the sale process, as well as the determination of the price that the FDIC decides is acceptable. Creditors whose claims are secured by highly illiquid or distressed assets will be particularly disadvantaged, both by the FDIC's absolute discretion in valuing or disposing of such assets and by its relative inexperience in managing such assets.

Transfer of Assets To A Bridge Financial Company. Title II gives the FDIC the ability to organize a "bridge financial company,"[7] and transfer any assets and liabilities of the covered financial company to the bridge financial company without assignment, consent, or obtaining any approval under federal or state law.[8] It is not clear, however, what sort of value a bridge financial company would be required to provide in exchange for such assets. The statute provides that a bridge financial company may either "assume" liabilities, or "purchase" assets of the covered financial company.[9] Presumably, therefore, Congress intended that the bridge financial company would provide some consideration for the transferred assets. But what consideration? This question will be crucial for those unsecured creditors whose liabilities are not assumed by the bridge financial institution, as they will be left to rely on the proceeds of such a transfer in the subsequent distribution of the remaining assets. Title II does not appear to provide any recourse for creditors who believe that the bridge financial institution has not paid fair value.

Adequate Protection for Priming Liens. Title II may also affect secured

[5] *See* § 210(a)(3)(D)(ii).
[6] § 210(a)(2)(D).
[7] *See* § 210(h)(1)(A).
[8] *See* § 210(h)(5)(A), (D).
[9] *See* § 210(h)(1).

claims if the FDIC transfers encumbered assets to a bridge financial company. In these circumstances, the FDIC may authorize the bridge company to issue debt with first priority liens (i.e., "priming liens") on such assets.[10] Fortunately, in such circumstances and unlike for other actions by the FDIC, a hearing is required before a federal district court: the FDIC must demonstrate to the court that secured creditors' preexisting liens are adequately protected.[11] However, the statute does not define the nature of this process, even though it is an area likely to give rise to significant litigation over valuation of the collateral security and what would constitute adequate protection for the secured creditor.

Liquidation Analysis. Under Title II, the FDIC may favor certain creditors over others that are similarly situated, or pay certain creditors before others.[12] Similar results can be obtained in a chapter 11 case, but typically require creditor consent and court approval. Not so under Title II: the FDIC has complete discretion in making this decision. To allay creditor fears, the FDIC cites the statutory "guarantee" that creditors will receive no less, in any event, than they would have received in a chapter 7 liquidation. To ensure that this guarantee is met, however, will require a comparison of the distributions proposed by the FDIC in a Title II liquidation with the probable distributions that would be available to creditors in a chapter 7 liquidation. Who will make this comparison? Who will prepare the liquidation analysis to demonstrate that the FDIC has met its burden? The FDIC should craft rules not only to address these questions, but also to ensure that the liquidation analysis is credible—ideally, performed by an independent third party—and not dependent on the FDIC's subjective view of an institution's liquidation value.

If, through the rulemaking process, value determinations such as the foregoing can be placed in the hands of independent third party arbiters, Title II may yet achieve parity with the Bankruptcy Code. Meaningful dialogue on this subject will require the FDIC, industry executives, investors, and academics to recognize that any potential outcome for creditors under Title II, as it currently stands, depends disproportionately more on the subjective value determinations of a single party—the FDIC receiver—than would ever be the case in a chapter 7 bankruptcy.

[10] *See* § 210(h)(16)(C).
[11] *See* § 210(h)(16)(C)(ii).
[12] *See* § 210(b)(4).