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Dodd-Frank and Bankruptcy Law[1]

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Dodd-Frank contains over 2,000 pages and deals with numerous areas of federal regulation including legal guidelines for financial and non-financial companies, instructions to various existing federal agencies to develop regulations to enforce provisions of Dodd-Frank and procedures for federal regulators to intercede when state regulators fail to act with regard to specified liquidation and rehabilitation protocols. Dodd-Frank became law on July 21, 2010.

Troubled Financial Companies—Title II

Title II of Dodd-Frank provides for the systematic liquidation or reorganization of those specific financial companies that are in danger of default. Dodd-Frank defines a financial company as one incorporated or organized under any provisions of State or Federal law and is a bank holding company as defined under the Bank Holding Company Act of 1956, a nonbank financial company supervised by the Board of Governors of the Federal Reserve System (the ''Fed''), a company that is predominantly engaged in activities determined by the Fed to be financial in nature or incidental thereto, including insurance companies, brokers or dealers and investment advisors, among others, or a subsidiary of such companies that is predominantly engaged in activities the Fed has determined are financial in nature or incidental thereto, with certain exceptions.

Title II of Dodd-Frank applies to financial entities whose failure sufficiently threatens market stability, commonly referred to as ''too big to fail'' financial institutions. Section 165 of Dodd-Frank requires that these systemically important financial institutions develop prepackaged reorganization plans, akin to a ''living will,'' to facilitate their ''rapid and orderly resolution, in the event of a material financial distress or failure.'' The irony of this provision is that absent periodic review and revision, these living wills will quickly become outdated as the financial institutions and markets rapidly change.

In the event that a financial institution covered under Dodd-Frank does fail, it may become the subject of an

[1] This article is the second in a series discussing the Dodd-Frank Wall Street Reform and Consumer Protection Act (''Dodd-Frank''). The first, entitled, *Banker Beware: Bank Practices Under Increased Scrutiny as Dodd-Frank Implementation Begins*, written by Jeffrey Kirschenbaum appeared in the Winter 2012 edition of Buchalter Nemer's quarterly newsletter *Points & Authorities*. This article provides an overview of Title II and Title X of the Dodd-Frank as their provisions relate to bankruptcy law and issues.

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FDIC receivership. The recommendation that an FDIC receivership be initiated must contain very specific findings, including an evaluation of whether the subject company is in default or in danger of default, a description of the effect of a default on financial stability in the United States, a description of the effect that the default would have on economic conditions or financial stability for low income, minority, or underserved communities, a recommendation of actions to be taken, and an evaluation of why a case under the Bankruptcy Code, 11 U.S.C. § 101 *et seq*., is not appropriate.

After determining that an FDIC receivership is appropriate, the Secretary of the Treasury must consult with the President and they must arrive at various conclusions including that:

- the company is in default or in danger of default,
- the failure of the company would have serious adverse effects on financial stability in the United States,
- no private sector alternative is available to prevent default, and
- action taken under Dodd-Frank would avoid or mitigate those adverse effects.

If the appropriate conclusions are reached, the company can agree to the appointment of the FDIC as receiver, or, if it does not agree, an action can be initiated in the District Court for the District of Columbia to have the FDIC appointed as receiver to proceed with the Orderly Liquidation Authority which operates under the principles drawn from the receivership provisions of the Federal Deposit Insurance Act. Only by the Board of Directors of the company can contest this provision, and the scope of review is very narrow. It is limited to assessing whether ''the determination of the Secretary that the covered financial company is in default or in danger of default and satisfies the definition of a financial company under [Dodd-Frank] is arbitrary and capricious.'' Dodd-Frank, § 202(a)(1)(A)(iii). Further, the District Court must act within 24 hours and the proceedings take place in secret so as to avoid any market disruptions. Dodd Frank, § 202(a) (1)(A)(v). Whether this provision will pass constitutional muster with respect to the limitation on the review of the District Court, the expediency of the review and the secrecy of the hearing remains to be seen.

Impact on Creditors and Counter Parties

How creditors and counterparties will fare in the event of an orderly liquidation remains in many respects an open question, because Dodd-Frank deviates from traditional bankruptcy law in several important ways. Under traditional bankruptcy law, a debtor-in-possession (DIP), a DIP lender, and a creditors' committee each have distinct rights and clearly defined roles, and a bankruptcy court is empowered to direct the reorganization process according to established legal precedents.

In contrast, Dodd-Frank concentrates power in the FDIC, including the power to reorganize the failing institution by transferring selected assets and claims to a ''bridge financial company'' that is owned, controlled, and potentially capitalized by the FDIC. The FDIC may operate a bridge financial company for up to five years, and may merge it with another institution or sell a majority of its equity to private investors. Dodd-Frank also gives the FDIC broad authority to deviate from traditional principles of bankruptcy law in order to promote the amorphous concept of ''market stability.'' This authority includes the ability to favor some creditors over others with equal priority, provided the favored treatment maximizes value, minimizes losses, or is otherwise essential to the receivership.

In remarks made on May 10, 2012 to the Bank Structure Conference at the Federal Reserve Bank of Chicago, Martin J. Gruenbert, Acting Chairman of the FDIC, indicated that, from the FDIC's point of view, ''the most promising resolution strategy'' will be to ''place the parent company into receivership and to pass its assets, principally investments in its subsidiaries, to a newly created bridge holding company.'' This procedure, newly authorized by Title II, will allow solvent subsidiaries to remain open and avoid the disruption that would likely accompany their closings. ''Because these subsidiaries will remain open and operating as going-concern counterparties, we expect that qualified financial contracts will continue to function normally as the termination, netting and liquidation will be minimal. In short, we believe that this resolution strategy will preserve the franchise value of the firm and mitigate systemic consequences,'' Mr. Gruenberg opined.

Regardless of whether a contracting party is placed in a receivership, Dodd-Frank establishes ''safe harbors'' to ensure that a counterparty's rights under a qualified financial contract are unaffected. These safe harbor provisions apply to repurchase agreements, commodity and forward contracts, security contracts, and swaps. However, for contractual obligations that do not meet the definition of a qualified financial contract, the FDIC is given authority to repudiate any contract to which the failed institution is a party; and, unlike a debtor or trustee under the Bankruptcy Code, the FDIC may reject contracts regardless of whether they are executory. Additionally, the FDIC may unwind certain types of transactions, including those that would be preferences or fraudulent transfers under the Bankruptcy Code, as well as certain types of setoffs.

These untested new federal receivership procedures give the FDIC great flexibility to do what it deems appropriate on an expedited basis with limited avenues for judicial review. As a result, parties dealing with institutions that may be covered by Dodd-Frank would be well advised to consider carefully whether their agreements fall within the definition of a ''qualified financial contract.'' For parties to contracts that do not benefit for safe harbor treatment, Dodd-Frank creates significant risk, due to the loss of the relative certainty of proceedings under the Bankruptcy Code.

Bureau of Consumer Financial Protection—Title X

Title X of Dodd-Frank establishes the Bureau of Consumer Financial Protection (''Bureau''). Under the structure created by Title X, the Bureau has exclusive rulemaking authority over a wide range of Federal consumer protection laws. This authority could, in limited circumstances, be overruled by the Oversight Council created by Dodd-Frank. One writer on the subject opines:

''The establishment of the Bureau, and the nature and extent of its responsibilities and activities, were some of the most controversial aspects of Dodd-Frank.

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Concerns were raised that the creation of a regulatory entity that would be solely focused on consumer protection might not give sufficient attention to the impact of its actions on the safety and soundness of financial institutions that provide products and services to consumers. Concerns were also raised that actions by the Bureau intended to protect consumers could have the impact of restricting the availability and terms of credit and other products and services offered to consumers.''

Although Title X does not directly modify existing bankruptcy law, concern has been expressed that it could affect consumer bankruptcy proceedings when consumer debtors seek to attack creditors based on perceived violations of provisions of Dodd-Frank that cover unfair, deceptive or abusive acts or practices.

The Bureau's authority includes certain powers that were previously exercised by existing governmental agencies and an array of broad new powers created by Dodd-Frank.

Under Dodd-Frank, departments will be created to protect members of the military and older Americans, foster research and financial education, and insure fair lending.

The Bureau's rulemaking authority extends to a broad range of providers of financial products and services. However, the Bureau's authority for examination, supervision and enforcement is shared with several other regulatory entities. The Bureau has primary supervisory and enforcement authority over certain nondepository institutions, principally those in the mortgage business and large providers of consumer financial services, and depository institutions with more than $10 billion in assets and their affiliates.

Other Provisions of Dodd-Frank

This article touches on only two areas of federal regulations embodied in Dodd-Frank. Other provisions of Dodd-Frank include Financial Stability Oversight, Supervision of Depository Institutions, Private Fund Advisers, Insurance, Bank and Thrift Regulatory Improvements, OTC Derivatives, Clearing and Settlement, Investor Protection and Securities Regulation, Strengthening the Federal Reserve, Access to Mainstream Finance, Pay It Back Act, and Mortgage Reform and Anti-Predatory Lending.

Some critics have speculated that Dodd-Frank is going to be a gold mine for financial and bankruptcy lawyers. The provisions of Dodd-Frank are confusing, contradictory and contrary to long established legal principals. Regulations are continuing to be formulated and many believe that those will add more controversy and legal actions.