September 25, 2012

TO: Board of Directors

FROM: James R. Wigand
Director
Office of Complex Financial Institutions

Richard J. Osterman, Jr.
Acting General Counsel

SUBJECT: Enforcement of subsidiary and affiliate contracts by the FDIC as receiver of a covered financial company

RECOMMENDATION

The attached Final Rule ("Final Rule") implements the provisions of section 210(c)(16) (12 U.S.C. § 5390(c)(16)) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act").[1] This section permits the Federal Deposit Insurance Corporation ("FDIC" or the "Corporation"), as receiver for a covered financial company, to enforce contracts of subsidiaries or affiliates of the covered financial company despite contract clauses that purport to terminate, accelerate or provide for other remedies based on the insolvency, financial condition or receivership of the parent covered financial company. This section provides the FDIC as receiver with statutory authority that is critical to strategies designed to maximize the value of the financial group of companies owned by the covered financial company and to mitigate systemic risks.

Under the Act, this right to enforce subsidiary or affiliate contracts may be exercised with respect to all contracts "linked" to the covered financial company. As a

[1] 12 U.S.C. § 5301 *et. seq.*

result, contracting parties may not terminate, accelerate or exercise other remedies under the contract and the FDIC, as receiver, is not required to take any affirmative action. If, however, the covered financial company provided a guaranty or other support for that contract, that support and any related assets and liabilities must be transferred to or assumed by a bridge financial company or other qualified third party, or the receiver must otherwise provide adequate protection with respect to the obligations of the subsidiary or affiliate under the contract. The Final Rule would clarify the intent and scope of this important section, provide for notice to counterparties, and define certain key terms.

EXECUTIVE SUMMARY

Title II of the Dodd-Frank Act authorizes the appointment of the FDIC as receiver for a financial company whose failure would pose a significant risk to the financial stability of the United States (a "covered financial company"). Under section 210(c)(16) of the Act, the FDIC as receiver is empowered to enforce contracts of subsidiaries or affiliates of the covered financial company that link a counterparty's rights and remedies under the contract to the financial condition of the covered financial company. The regulation would make clear that the effect of this enforcement authority is that no party may terminate, liquidate, accelerate or exercise any remedy under a contract simply as a result of the appointment of the receiver and the exercise of its orderly liquidation authorities as long as the receiver complies with the statutory requirements. In order to exercise this authority, the Corporation as receiver must either: (i) transfer any supporting obligations of the covered financial company (along with all related assets and liabilities) to a bridge financial company or qualified third-party transferee by the statutory one-business-day deadline; or (ii) provide adequate protection to such contract counterparties.

This authority is critical to the preservation of going-concern value of a covered financial company that is part of a large, interconnected corporate structure. The preservation of these contracts in full force and effect will allow the receiver to continue operations of subsidiaries without triggering a cascading series of defaults following the appointment of the receiver and without causing otherwise viable subsidiaries and affiliates also to be placed into receivership.

The Final Rule would clarify the conditions and requirements applicable to the receiver, address requirements for notice to affected counterparties and define certain key terms. The Final Rule would provide definition and context to the type of default provision – called a "specified financial condition clause" in the Final Rule – that may be avoided by the receiver's enforcement authority. It would make clear that counterparties to contracts with subsidiaries or affiliates of the covered financial company may not terminate or exercise remedies under these contracts based solely upon the appointment of the receiver, as long as the support obligations have been transferred to a bridge financial company or other qualified transferee or the counterparties have otherwise been provided adequate protection. The Final Rule would clarify that a "specified financial condition clause" includes any clause that links termination rights or other remedies not only to the insolvency of the covered financial company or the appointment of the receiver, but also to any exercise of the orderly liquidation authority provided under Title II.

If approved by the Board, the Final Rule would be promulgated under section 209 of the Dodd-Frank Act, codified at 12 U.S.C. § 5389, which authorizes the FDIC, in consultation with the Financial Stability Oversight Council ("FSOC"), to prescribe such rules and regulations as the FDIC considers necessary or appropriate to implement provisions of Title II. In accordance with the consultation requirement of section 209, a term sheet outlining the issues arising under the Proposed Rule (as defined below) was provided to key staff, including members of the Resolutions Subcommittee of the FSOC on August 10, 2012, and significant issues raised by commenters were discussed with interested staff on a conference call on August 16, 2012. An updated term sheet with a draft of the regulatory text was also circulated to FSOC Deputies as well as to FSOC Resolution Subcommittee members on September 10, 2012.

On March 27, 2012, the FDIC published a Notice of Proposed Rulemaking (the "NPR") in the *Federal Register*[2] setting forth proposed rules (the "Proposed Rule") relating to the enforcement of subsidiary and affiliate contracts by the Corporation as receiver of a covered financial company under section 210(c)(16) of the Dodd-Frank Act. The comment period for the NPR ended on May 29, 2012. Upon consideration of these comments, staff recommends that the Final Rule be substantially consistent with the Proposed Rule, with two clarifying changes and some clarifying statements added to the preamble. The most significant comments are discussed below.

DISCUSSION

I. Background

Title II of the Dodd-Frank Act establishes the authority of the FDIC for the orderly liquidation of a covered financial company following the FDIC's appointment as receiver and provides for additional implementation of the orderly liquidation authority

[2] 77 FR 18127 (March 27, 2012)

by rulemaking. The Final Rule would be issued to interpret and implement the authorities granted to the Corporation under section 210(c)(16) of the Act to enforce subsidiary and affiliate contracts in certain circumstances. The provisions of the Final Rule are harmonized with otherwise applicable insolvency law, including the Bankruptcy Code, where possible, consistent with section 209 of the Act. In particular, the definition of the term "adequate protection," as interpreted under section 361 of the Bankruptcy Code,[3] is used in the Final Rule, and such definition has been conformed to the Bankruptcy Code definition in many respects.

Fundamental to the orderly liquidation of a covered financial company is the ability to continue key operations, transactions and services that will maximize the value of the firm's assets and operations and avoid a disorderly collapse in the marketplace. To facilitate this continuity of operations, the Dodd-Frank Act provides several tools to preserve the value of the covered financial company's assets and business lines, including the powers granted in section 210(c)(16). Specifically, section 210(c)(16) provides that:

> 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 –
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> (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). . . [by 5:00 p.m.

[3] 11 U.S.C. § 361.

(eastern time) on the business day following the date of appointment]; or

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

The conditions contained in (i) and (ii) of the quoted statute assure counterparties that any contractual right to guarantees or other support, including claims on collateral or other related assets, would be protected. Thus, section 210(c)(16) requires, as a condition to the authority to enforce subsidiary or affiliate contracts that are "linked to" the financial condition of the covered financial corporation through a default provision, that the Corporation as receiver transfer any guaranty or other support provided by the specified covered financial company for the contractual obligations together with all related collateral to a bridge financial company or other qualified transferee within one business day after its appointment as receiver. In the alternative, if the receiver does not transfer the support and the related assets and liabilities, the receiver must provide "adequate protection" with respect to any support or collateral not transferred in order to preserve its right to enforce the contract of the subsidiary or affiliate.

To facilitate the orderly liquidation authority of Title II, the Dodd-Frank Act provides a range of specific statutory authorities with respect to subsidiaries and affiliates of the covered financial company. For instance, section 210(a)(1)(E) of the Dodd-Frank Act provides an expedited procedure to allow the Corporation to appoint itself as the receiver of certain subsidiaries of a covered financial company if the Corporation and the Secretary of the Treasury jointly determine that such subsidiary is in default or in danger of default and that such action would mitigate serious adverse effects on the financial stability of the United States and would facilitate the orderly liquidation of the covered financial company. Section 210(a)(1)(E) of the Dodd-Frank Act, further provides that upon appointment of the FDIC as receiver, the subsidiary would be treated as a covered financial company, and the Corporation would be able to exercise the full range of special powers available to the receiver.

In certain cases, however, the receiver for the covered financial company may find that the best course of action to maximize the value of the covered financial company and to mitigate systemic risk would be to avoid actions that place subsidiaries in danger of default or that necessitate complex interlocking receiverships. The affiliated legal entities that collectively comprise a complex financial institution typically share and provide intra-group funding, guarantees, administrative support, human resources and other operational and business functions. Some of these operations and activities may be critical to the day-to-day functions and overall operations of the group. In addition, certain significant subsidiaries of a covered financial company may be essential to core business lines or may conduct critical operations that, if discontinued, may threaten the stability of the financial markets. In these circumstances, orderly liquidation of a covered financial company may best be accomplished by establishing a single receivership of the parent holding company and transferring valuable operations and assets to a solvent bridge financial company, including the stock or other equity interests of the company's various subsidiaries. Accordingly, the Dodd-Frank Act provides the FDIC with the tools and flexibility to act effectively as receiver for the covered financial company at the holding company or parent level without placing solvent subsidiaries into receivership. This approach may be the best means of preserving value, minimizing the shock to the financial system, providing additional flexibility to mitigate cross-border resolution issues for global systemically-important financial companies and allowing for a more expeditious resolution of a covered financial company.

Where such an approach is adopted, the powers granted to the receiver under section 210(c)(16) are essential to preservation of going-concern value of the subsidiaries for the benefit of the parent in receivership. Absent this statutory provision, counterparties to contracts of subsidiaries and affiliates could exercise contractual rights to terminate their agreements based upon the insolvency of the specified covered financial company. As a result, otherwise viable affiliates of the covered financial company could become insolvent, thereby inciting the collapse of interrelated companies and potentially amplifying ripple effects throughout the economy.

As described in more detail below, the Final Rule would clarify the scope of the authority granted in section 210(c)(16) as well as conditions and requirements applicable to the receiver. The Final Rule would address requirements for notice to affected counterparties and define key terms. It would also clarify the term "adequate protection" in a manner consistent with the interpretation of that term under the Bankruptcy Code.

II. Summary of Comments on the Proposed Rule and Proposed Changes to the Final Rule

The FDIC received six comments in response to the Proposed Rule. Two letters were from individuals and fully supported the Proposed Rule. The other four letters, of which two were submitted by insurance industry trade groups, one by an insurance underwriter and one jointly on behalf of three financial industry associations, proposed that various changes be made to the Proposed Rule. Staff also held a follow-up teleconference at the request of one of the authors of the financial industry association letter. These letters raised a variety of issues, which are discussed in detail in the draft preamble to the Final Rule. Some of the more significant issues that staff particularly reviewed and discussed with FSOC members include the following:

One comment letter suggested that parties to contracts that are linked to a covered financial company through a specified financial condition clause but are not supported by the covered financial company should receive adequate protection in consideration of the continued enforceability of these contracts. This issue had previously been reviewed and discussed with FSOC members prior to the adoption of the NPR but, as it is central to the approach taken in the Proposed Rule, staff reviewed the issue again and discussed it further with FSOC members. Staff does not recommend any change to the Proposed Rule in this respect. The Proposed Rule provided that if no financial support (e.g., a guarantee or collateral) is in place, no adequate protection is needed to assure enforceability of a linked contract. This is consistent with the plain language of the statute, and with the intent to provide protection to counterparties consistent with the level of protection that they had prior to the appointment of the receiver. Providing new protection to counterparties who previously did not have the benefit of financial support from the parent company would potentially constitute a windfall to such counterparties. Accordingly, no change is recommended in the draft Final Rule in response to this comment.

A comment letter also raised the question whether margin calls should be included within the scope of remedies that are precluded based upon a change in financial condition of the covered financial company, and, in particular, whether margin calls prior to the conclusion of the orderly liquidation process that are based on the financial condition of the covered financial company or a bridge financial company or a successor to the bridge financial company should be permitted. This comment was among those that staff discussed further with the commenter on a follow-up conference call. Although such actions would be permitted prior to the appointment of the receiver, once the receiver has been appointed, it is important to maintain the operations of subsidiaries to avoid a cascading effect of contract terminations throughout the corporate family. Allowing unlimited margin calls would impede the orderly resolution of the covered financial company and may be functionally equivalent to the termination of the applicable subsidiary or affiliate contract if demands for collateral exceed the resources available. The Proposed Rule provided that no remedy could be exercised based upon a change in the financial condition of the parent during the orderly liquidation process, which includes a remedy that allows for margin calls, as long as the required protections were provided and assuming that the subsidiary or affiliate is performing its obligations under the contract. No change is recommended in the draft Final Rule with respect to any particular remedy, including the remedy of demanding additional collateral.

Comment letters from insurance industry associations raised the issue whether director and officer liability insurance policies entered into by a subsidiary or affiliate of a covered financial company should be excluded from the scope of the Final Rule. No such exemption is contained in the statute. Furthermore, in the event that the FDIC is appointed receiver of a holding company, the officers and directors of subsidiaries and affiliates in most instances will continue to fulfill their roles in the management and operation of these companies and will need to have the protection afforded by this insurance. The Proposed Rule applied to all contracts, with no exception for D&O insurance policies. No change is recommended in the draft Final Rule with respect to the treatment of D&O policies.

A comment letter also asked whether contractual rights of a counterparty to demand performance from an affiliate of a covered financial company at any time and for any reason, without inquiry as to the reason for such demand would be impacted by the Proposed Rule. The Proposed Rule only addresses remedies arising out of the change in financial condition of the covered financial company. Staff agrees with the commenters that an absolute call right would not be such a remedy, however staff believes that the language of the Proposed Rule supports this conclusion and does not recommend any change in the draft Final Rule. The draft preamble to the Final Rule does include additional discussion of this issue in order to make the intent of the rule as clear as possible.

One comment letter discussed whether references to a covered financial company in a financial condition clause (for example, a provision permitting a counterparty to call for margin based on the credit quality of a covered financial company) should have effect after the resolution of a covered financial company and, if so, to what entity should the clause then be deemed to refer. This also was further discussed on a conference call with the commenter, and with FSOC staff members. Staff does not recommend a change to the Proposed Rule in this regard. If changed circumstances arising out of the failure of the covered financial company leave any provisions of a contract incomplete, the parties to the contract are best capable of fashioning an appropriate amendment. This commenter also raised the question of whether margin levels should effectively be frozen during the orderly liquidation process. To the extent that margin levels are based upon the financial condition of the covered financial company rather than on the condition of the subsidiary or affiliate, the value of the collateral, or performance under the contract, the Proposed Rule would not provide for the exercise of a remedy permitting additional margin calls. This is consistent with the operation of the statute to create a period of stability following the appointment of a receiver to allow for the orderly resolution of the covered financial company. The draft Final Rule does not contain any recommended change in this regard.

One comment letter also objected to the provision in the Proposed Rule that permits notice of the transfer of support and related assets and liabilities or the provision of adequate protection to be made on a website. Although section 210(c)(16) does not require that any notice be given, counterparties have a legitimate need to know the status of their contracts. The option of posting on a website was included in the Proposed Rule in acknowledgement of the public's growing reliance on internet communication as well as the prevalence of online commerce. Imposing a duty on the receiver to send many thousands of individual notices would be unduly burdensome and staff believes that the notice provisions of the Proposed Rule are reasonably calculated to provide actual notice. No change to the Proposed Rule is recommended in the Final Rule with respect to this comment.

One additional change to the Proposed Rule is recommended by staff. The FDIC is currently considering, as a possible resolution strategy, causing a bridge financial company to terminate its status as a bridge financial company before the completion of the resolution process and having the successor to the bridge financial company transfer to creditors of the covered financial company assets or interests in the successor to the bridge financial company in satisfaction of such creditors' claims against the covered financial company. Accordingly (as indicated in the draft Final Rule), staff recommends adding an additional clause to the definition of "specified financial condition clause" and adding an additional related definition ("successor") in order to make clear that section 210(c)(16) and the Final Rule continue to protect covered contracts of subsidiaries and affiliates through the completion of the resolution process, even where the process is completed by a successor to a bridge financial company and results in a change of control of the successor. The extension of such protections to cover this step was clearly contemplated by the NPR, which stated that the term "specified financial condition clause" is intended to "broadly capture any provision that gives any counterparty a right to terminate, accelerate or exercise default rights or remedies as a result of any action or circumstance that results in or arises out of the exercise of the orderly liquidation authority." In addition, the NPR stated that the intent of the definition of "specified financial condition clause" is to "allow the subsidiary or affiliate contract to remain in effect despite the exercise of any or all of the authorities granted to the FDIC as receiver for a covered financial company throughout the orderly liquidation process, " and that each aspect of the definition of the term "specified financial condition clause" should be read expansively so that "counterparties are effectively stayed from exercising rights . . . during a Title II resolution process . . . ." While the definition of "specified financial condition clause" included in the Proposed Rule referred to actions to operate or terminate a bridge financial company, the definition did not refer to actions taken by a successor to a bridge company and, thus, it was not completely clear from the text of the

Proposed Rule that the protections of section 210(c)(16) would extend to such action. The new language is proposed to eliminate any doubt.

CONCLUSION

Except as noted above, the draft Final Rule is substantially the same as the Proposed Rule. A section-by-section analysis is provided in the draft preamble included in the proposed *Federal Register* submission.

The Final Rule would: establish the scope of the powers of the Corporation as receiver under section 210(c)(16) as well as the conditions and requirements applicable to the Corporation as receiver for a covered financial company under that section; address requirements for notice to certain affected counterparties; and define key terms as used in section 210(c)(16).

The Office of Complex Financial Institutions and the Legal Division recommend that the Board of Directors approve and adopt the Final Rule and authorize its publication in the *Federal Register*.

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