

ClientAlert

Financial Markets Developments

Financial Restructuring and Insolvency

April 2012

Dodd-Frank Wall Street Reform and Consumer Protection Act: FDIC Proposes Rules Regarding Receiver's Right to Enforce Subsidiary and Affiliate Contracts of Covered Financial Company

In its continued effort to implement certain provisions of its authority to resolve "covered financial companies" under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), on March 20, 2012, the Board of Directors of the Federal Depositary Insurance Corporation (the "FDIC") approved proposed rules relating to Enforcement of Subsidiary and Affiliate Contracts by the FDIC as Receiver of a Covered Financial Company (the "Proposed Rules"). For a detailed discussion of Title II, see the White & Case Client Alert titled Orderly Liquidation Authority, dated July 2010.

The Proposed Rules are intended to implement section 210(c) of the Dodd-Frank Act, codified at 12 U.S.C. §5390(c)(16), which permits the FDIC as receiver of 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 covered financial company. The FDIC's enforcement authority is not without conditions, however. In order to enforce these contracts, the FDIC must first either (i) transfer supporting obligations of the covered financial company that back the obligations of the subsidiary or affiliate under the contract (along with all assets and liabilities that relate to those supporting obligations) 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. *From a creditor perspective, it is important to note that this authority is in stark contrast to the Bankruptcy Code, which does not permit a bankruptcy trustee to enforce contracts between non-debtors.* According to the FDIC, its ability to enforce subsidiary and affiliate contracts will provide it substantial flexibility by allowing it to only place certain entities of a corporate family into receivership where the FDIC believes it would maximize the value of the receivership.

The Proposed Rules consist of the regulation itself along with the FDIC's commentary thereto. The FDIC is soliciting written comments, due no later than May 26, 2012, to specific questions posed by the FDIC and all aspects of the Proposed Rules. Below is a summary of the key provisions of the Proposed Rules.

I. Enforcement of affiliate and subsidiary contracts.

Under the Proposed Rules and consistent with the Dodd-Frank Act itself, contracts of subsidiaries or affiliates of a covered financial company that are **linked to or supported by the covered financial company** are in full force and effect notwithstanding any **specified financial condition** clause that permits a counterparty to terminate, accelerate, liquidate



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or exercise any other remedy arising solely by reason of such specified financial clause¹ *provided* that one of the two following events occur:

- **Assets and liabilities must be transferred to a qualified transferee.** Any support together with all related assets and liabilities are transferred by the FDIC to and assumed by a qualified transferee (*includes any bridge financial company or certain other third parties*) not later than 5:00 p.m. (Eastern Time) on the business day following the date of appointment of the FDIC as receiver for the covered financial company.²
- **Adequate protection provided.** If the FDIC does not transfer the assets and liabilities to a qualified transferee, the FDIC must provide adequate protection to the counterparties to such contracts with respect to the covered financial company's support of the obligations or liabilities of the subsidiary or affiliate and provide notice of the adequate protection no later than 5:00 p.m. (Eastern Time) on the business day following the date of the appointment of the FDIC as receiver.³

II. "Specified financial condition" clause defined.

The term "specified financial condition clause" is intended to broadly capture any provisions that give a 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. Specifically, a "specified financial condition clause" includes any provision of any contract (whether expressly stated in the contract or incorporated by reference to any other contract, agreement or document) that permits a contract counterparty to terminate, accelerate, liquidate or exercise any other remedy under any contract to which the subsidiary or affiliate is a party or to obtain possession or exercise control over any property of the subsidiary or affiliate or affect any contractual rights of the subsidiary or affiliate directly or indirectly based upon or by reason of:

- A change in the financial condition or the insolvency of a specified company that is a covered financial company.
- The appointment of the FDIC as receiver for the specified company or any actions incidental thereto including, without limitation, the filing of a petition seeking judicial action with respect to the appointment of the FDIC as receiver for the specified company and the issuance of recommendations or determinations of systemic risk.

- The exercise of rights or powers by the FDIC as receiver for the specified company, including, without limitation, the appointment of the Securities Investor Protection Corporation ("SIPC") as trustee in the case of a specified company that is a covered broker-dealer and the exercise by SIPC of all of its rights and powers as trustee.
- The transfer of assets or liabilities to a bridge financial company or other qualified transferee.
- Any actions taken by the FDIC as receiver for the specified company to effectuate the liquidation of the specified company.
- Any actions taken by or on behalf of the bridge financial company to operate and terminate the bridge financial company, including the dissolution, conversion, merger or termination of a bridge financial company or actions incidental or related thereto.⁴

In addition to the above, "walk-away clauses" are included as a "specified financial condition clause."⁵

III. "Related assets and liabilities" that will be transferred to the qualified transferee.

The FDIC's intention in transferring the related assets and liabilities is to ensure that the counterparty is in the same position as prior to the transfer to the qualified transferee. Thus, the FDIC will transfer any assets of the covered financial company that directly serve as collateral for the covered financial company's support, rights of offset or setoff or netting arrangements that directly arise out of or directly relate to the covered financial company's support of the obligations or liabilities of its subsidiary or affiliate; and liabilities of the covered financial company that directly arise out of or directly relate to its support of the obligations or liabilities of the subsidiary or affiliate.⁶ In the event that the "support" is in the form of a non-recourse guarantee or an unsecured limited recourse guaranty, only the guarantee would be transferred to the qualified transferee as compared to all of the assets of the covered financial company.

IV. Contracts that are linked to or supported by the covered financial company.

As noted above, the FDIC can only enforce those contracts that are either **linked to or supported by the covered financial company** notwithstanding the occurrence of a specified financial condition.

1 Proposed Rule 380.12(a)(1).

2 Proposed Rule 380.12(a)(2)(i).

3 Proposed Rule 380.12(a)(2)(ii).

4 Proposed Rule 380.12(b)(2)(A).

5 Proposed Rule 380.12(b)(2)(B).

6 Proposed Rule 380.12(b)(4).

■ **Contracts that are linked to the covered financial company.**

A contract is “linked” to a covered financial company if it contains a specified financial condition clause that specifies the covered financial company.⁷

■ **Contracts that are supported by the covered financial company.** The term “support” as it relates to a covered financial company includes undertaking any of the following for the purpose of supporting the contractual obligations of a subsidiary or affiliate of a covered financial company for the benefit of a counterparty to a linked contract:

- 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
- To be contractually obligated to provide any other financial assistance to the subsidiary or affiliate⁸

It is important to note that the term “support” is limited to obligations of a financial nature and does not include specific performance obligations or other nonfinancial obligations.

V. Adequate protection.

As noted above, if the FDIC does not transfer the assets and liabilities to a qualified transferee but yet still wants to enforce an affiliate or subsidiary contract that contains a “specified financial condition clause,” the FDIC is required to provide adequate protection to the counterparties to such contracts. Under the Proposed Rules, the FDIC can provide adequate protection with respect to a covered financial company’s support of the obligations and liabilities of a subsidiary or an affiliate by any of the following means:⁹

- **Cash payments.** Making a cash payment or periodic cash payments to the counterparties of the contract to the extent that the failure to cause the assignment and assumption of the covered financial company’s support and related assets and liabilities causes a loss to the counterparties.¹⁰
- **FDIC guaranty.** Providing to the counterparties a guaranty, issued by the FDIC as receiver, of the obligations of the subsidiary or affiliate of the covered financial company under the contract.¹¹

7 Proposed Rule 380.12(b)(1).
8 Proposed Rule 380.12(b)(3).
9 Proposed Rule 380.12(c).
10 Proposed Rule 380.12(c)(1).
11 Proposed Rule 380.12(c)(2).

- **Providing the “indubitable equivalent.”** Providing relief that will result in the realization by the counterparty of the indubitable equivalent of the covered financial company’s support of such obligations or liabilities.¹²

VI. Request for comments.

The FDIC is seeking comments related to the following issues regarding the Proposed Rules:

- Identification of terms defined by the Proposed Rules that require clarification, including scope of clarification and whether other terms should be defined.
- Whether the scope of the definitions of “support” and “related assets and liabilities” are sufficiently broad so as to cover substantially all of the forms of financial assistance and related assets and liabilities that a company may provide in support of the obligations of the subsidiary or affiliate.
- Whether the definition of “control” used for purposes of determining whether an entity is a subsidiary or affiliate of the covered financial company is sufficient and clear.
- Whether the definition of “adequate protection” is appropriately consistent with the definition elsewhere found in the Dodd-Frank Act.
- Whether the term “Business Day” should be defined consistent with section 210(c)(10)(D) of the Dodd-Frank Act.
- Whether the specific mention of guarantees of the receiver as a form of adequate protection is necessary to clearly signal that this is one of the options available to the FDIC and whether 12 C.F.R. 380.52 should be amended to specifically reference guarantees of the FDIC as a form of adequate protection to assure that these provisions will be interpreted in harmony.
- Whether the notice provisions are reasonably calculated to provide notice and whether the scope of circumstances in which notice is provided is appropriate.
- Whether it is clear that no action is required of the FDIC to preserve the enforceability of a contract as long as the conditions with respect to the transfer of support or provision of adequate protection are met.
- Whether the definition of “specified financial condition” is clear and broad enough to cover all orderly liquidation events from the

12 Proposed Rule 380.12(c)(3).

point at which the covered financial company is insolvent or in danger of default to the final liquidation and transfer of assets of the covered financial company.

- Whether the definition of “specified financial condition” is sufficiently limited to make clear that the ability to enforce contracts is limited to events arising out of the specified financial condition clause and is not intended to affect rights or remedies arising out of defaults unrelated to the financial condition of the covered financial company or the related exercise of orderly liquidation authority.

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