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Nuts and Bolts of Resolution Planning Under the Dodd-Frank Wall Street Reform and Consumer Protection Act

DUANE D. WALL, ERNEST (ERNIE) T. PATRIKIS, GERARD UZZI, AND
LINDA M. LEALI

The authors discuss the key provisions of the resolution plan requirements under the Dodd-Frank Act for companies that may be subject to the regulators' jurisdiction.

Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") in part to address widespread concerns that the bankruptcy process provided for under Title 11 of the U.S. Code (the "Bankruptcy Code") was not adequately equipped to rapidly and effectively resolve the unexpected failure of certain perceived "too big to fail" financial companies, such as Lehman Brothers Holdings, Inc. Congress concluded that the bankruptcy process was insufficient because it did not allow for extensive pre-planning that

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Duane D. Wall, a partner in White & Case LLP's New York office, advises U.S. and non-U.S. banks and other financial institutions on the nature and structure of their operations and activities in the U.S. and abroad. Ernest (Ernie) T. Patrikis is a partner in the New York office in the firmwide Bank and Insurance Regulatory Practice. Gerard Uzzi is a partner in the New York office in the Global Financial Restructuring and Insolvency Practice Group. Linda M. Leali is a senior associate in the Global Financial Restructuring and Insolvency Practice Group and resident in the firm's office in Miami. The authors can be reached at dwall@whitecase.com, epatrikis@whitecase.com, guzzi@whitecase.com, and lleali@whitecase.com, respectively.

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included the input of financial regulators.[1] In Congress' view such a collaborative process would have facilitated the continuity of critical operations and prompt acquisition of, among others, Lehman Brothers, resulting in the minimization of economic disruption.[2]

In an effort to prevent the recurrence of such a catastrophic failure, Section 165 of the Dodd-Frank Act authorizes the Board of Governors of the Federal Reserve System (the "Board of Governors") to impose additional regulations and reporting requirements, referred to as prudential standards.[3] Key among the prudential standards is the requirement that nonbank financial companies ("NFCs") supervised by the Board of Governors[4] and bank holding companies ("BHCs") with total consolidated assets equal to or greater than $50 billion periodically prepare and submit a resolution plan, commonly known as a "living will."[5] The resolution plan requirement essentially requires regular reporting to the Financial Stability Oversight Council (the "Council"), the Board of Governors and the Federal Deposit Insurance Corporation (the "FDIC") of the plan of an affected company for rapid and orderly resolution in the event of material financial distress or failure.[6] In this regard, the Dodd-Frank Act shifts the burden of gathering and deciphering information necessary to determining the company's plan of liquidation to the affected companies and seeks to ensure that the information would be ready and available in the event of a material financial distress or failure. Such pre-planning is intended to aid the orderly resolution authority under Title II of the Dodd-Frank Act by providing the necessary information to quickly, effectively, and efficiently liquidate a subject company if necessary. To stress the importance of such contingency planning, Congress empowered the Board of Governors and the FDIC, in consultation with the Council, to require the divestiture of certain assets or operations of a covered company in the event that the company persistently fails to provide a credible resolution plan that would facilitate an orderly resolution under the Bankruptcy Code.[7]

The Dodd-Frank Act's resolution plan requirement has been harshly criticized by industry experts on a variety of bases. The most significant criticism appears to be that the large cost and use of company resources required to prepare the resolution plan vastly outweigh any benefits that can hope to be garnered from having a resolution plan on the shelf. This criticism primarily derives from the fact that the resolution plan is based upon the company's conjecture as to the causes that would result in the company's need to liquidate as well as what would happen under those circumstances, rather than the circumstances that actually caused the financial distress which could result in a resolution plan which has drastically different components. Additionally, in the event that the orderly liquidation authority is actually required to be utilized, it would seem questionable to rely on a resolution plan created by the very same management team that was responsible for the company's level of financial distress.

Furthermore, as discussed below, under the Dodd-Frank Act the Board of Governors and the FDIC are both required to approve the resolution plan. Because of the historical rivalry between the two agencies, concern has been expressed that the agencies will have a difficult time agreeing on what constitutes a credible resolution plan for any particular company, the result of which will most likely be significant increased costs to the plan proponent with little commensurate benefit. In that regard, industry officials are encouraging the FDIC and the Board of Governors to closely coordinate efforts so that they can present a unified front to those subject to the resolution planning requirement so that companies are not left spending significant efforts trying to appease both agencies on various fronts.

Concern also exists regarding the level of confidentiality that will be maintained as it relates to the information contained within the resolution plan. However, under the proposed regulations for IDI's discussed below, proprietary information and information which, if disclosed, could endanger the institution's safety and soundness, is required to be identified and segregated by the company to the extent possible, and be accompanied by a request for confidential treatment and such confidential information will not be disclosed except as required by law. It would seem likely that the proposed rules for resolution planning will contain similar confidentiality requirements and indeed the FDIC has indicated that it intends to keep the resolution plan confidential as part of the supervisory relationship which includes private supervisory confidential communications. Further, because many of the companies subject to the resolution planning requirement have cross-border operations, concern exists that non-U.S. international regulators may have different rules and timelines for resolution planning than those of the Board of Governors and FDIC resulting in overlapping regulatory burden and conflicting requirements for expectations pre- and post failure. In that regard it should be noted that this area of "cross-border resolution" has been a particular focus of the regulators. Specifically, the federal government has been working to encourage the international community to enact resolution regimes that are similar to the Title II orderly resolution authority and to recognize the Title II orderly resolution authority.

Another issue to consider is whether a forced divestiture process is a simple and expeditious one. The Board of Governors and the FDIC might be able to learn from AIG's experience. That was not a smooth or expeditious process. Would the bank supervisors require divestiture at any price? If market participants are aware of a sale under regulatory stress, the seller's bargaining power is greatly diminished.

Finally, industry officials have expressed significant concern that the resolution planning process itself will cause legal enterprises to weaken if they are required to trap capital in various legal entities in order to support those entities' operations as counterparties will no longer be able to rely on the credit of the enterprise as a whole. On the flip side, notwithstanding this long list of criticisms, industry experts and some industry officials are generally in agreement that companies going through the resolution planning process required under the Dodd-Frank Act will come out on the other side as much more cost-efficient streamlined enterprises as they eliminate or fix identified inefficiencies and redundancies in their corporate structure and operations. The exercise could also result in a core group of staff members who will know the corporate group well, and that could be beneficial in times of financial stress.

Below is a discussion of the key provisions of the resolution plan requirements under the Dodd-Frank Act for companies that may be subject to the regulators' jurisdiction.

ENTITIES SUBJECT TO THE RESOLUTION PLANNING REQUIREMENT

As part of an overall effort by Congress to prevent or mitigate risks to the United States that could arise from the material financial distress or failure, or ongoing activities, of large interconnected financial institutions, the Dodd-Frank Act requires NFCs supervised by the Board of Governors and BHCs with total consolidated assets equal to or greater than $50 billion[8] to report periodically to the Council, the Board of Governors and the FDIC, the plan of each such company for rapid and orderly resolution in the event of material financial distress or failure.[9]

Generally, a BHC is defined to include any company which, directly or indirectly, has control over any bank or over any company that is or becomes a bank holding company by virtue of the BHC Act of 1956.[10] To qualify as an NFC, a company must be "predominately engaged in financial activities."[11] Although the Board of Governors is required to adopt regulations for determining under what facts and circumstances a company is "predominately engaged in financial activities," the Dodd-Frank Act establishes a floor which requires that either (i) the annual gross revenues derived by the company and its subsidiaries from financial activities (as defined in Section 4(k) of the BHC Act of 1956),[12] including the ownership or control of insured depository institutions, represent at least 85 percent of the consolidated annual gross revenues of the company; or (ii) the consolidated assets of the company and its subsidiaries related to financial activities, including the ownership or control of insured depository institutions, represent at least 85 percent of the consolidated assets of the company.[13]

A U.S. or non-U.S. NFC may become subject to supervision by the Board of Governors and, therefore, required, among other things to prepare and submit a resolution plan, upon a determination by the Council by vote, on a nondelegable basis of not fewer than 2/3 of the voting members then serving on the Council, including an affirmative vote by the Chairperson, that the material financial distress at the NFC or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the NFC could pose a threat to the financial stability of the United States.[14] In making that determination the Council is required to consider the following factors:

- the extent of the leverage of the company;
- the extent and nature of the off-balance-sheet exposures of the com-

pany, and with respect to non-U.S. NFCs the extent and nature of the U.S. related off-balance-sheet exposures;

- the extent and nature of the transactions and relationships of the company with other significant NFCs and significant BHCs;
- the importance of the company as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the U.S. financial system;
- the importance of the company as a source of credit for low-income, minority, or underserved communities in the United States, and the impact that the failure of such company would have on the availability of credit in such communities;
- the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse;
- the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;
- the degree to which the company is already regulated by one or more primary financial regulatory agencies and with respect to non-U.S. NFCs, the extent to which the company is subject to prudential standards on a consolidated basis in its home country that are administered and enforced by a comparable non-U.S. supervisory authority;
- the amount and nature of the financial assets (U.S. assets for non-U.S. NFCs) of the company;
- the amount and types of liabilities of the company (U.S. liabilities for non-U.S. NFCs), including the degree of reliance on short-term funding; and
- any other risk-related factors that the Council deems appropriate.[15]

Additionally, the Board of Governors, in consultation with the Council, is required under the Dodd-Frank Act to promulgate safe harbor regulations that exempt certain types of NFCs from supervision based upon these above-listed factors.[16]

Further, under the so-called "Hotel California" provision of the Dodd-Frank Act any bank holding company or successor entity (as defined by the Board of Governors in consultation with the Council) which had total consolidated assets equal to or greater than $50 billion as of January 1, 2010 and which received financial assistance under or participated in the Capital Purchase Program established under the Troubled Asset Relief Program ("TARP") will be treated as a nonbank financial company supervised by the Board of Governors, as if the Council had made the necessary determination discussed above under Section 113 of the Dodd-Frank Act.[17] An entity subject to the "Hotel California" provision can appeal its treatment to the Council.[18]

RESOLUTION PLAN CONTENTS

The Dodd-Frank Act sets the following minimum informational requirements for inclusion in a resolution plan:

- information regarding the manner and extent to which any insured depository institution affiliated with the company is adequately protected from risks arising from the activities of any nonbank subsidiaries of the company;
- full descriptions of the ownership structure, assets, liabilities, and contractual obligations of the company;
- identification of the cross-guarantees tied to different securities, identification of major counterparties, and a process for determining to whom the collateral of the company is pledged; and
- any other information that the Board of Governors and the FDIC jointly require by rule or order.[19]

The FDIC and Board of Governors are expected to jointly issues rules in 2011 which are intended to provide more information as to what should be included in a credible resolution plan.

TIMING OF RESOLUTION PLAN SUBMISSION

The Dodd-Frank Act itself does not establish any specific deadlines for NFC and BHC's required submission of the resolution plan. Rather, it only requires those companies subject to the resolution plan requirement "to report periodically." The final rules implementing the resolution plan requirement should provide more clarity with respect to timing of the initial resolution plan and updates thereto.

DEFICIENCIES IN THE RESOLUTION PLAN

If the Board of Governors and the FDIC jointly find that a resolution plan is deficient because it is not credible or would not facilitate an orderly resolution of the company under the Bankruptcy Code they will notify the company of such deficiency.[20] Upon receipt of such a notice of deficiency, the company is required to revise and resubmit its resolution plan within a timeframe to be determined by the Board of Governors and the FDIC. Any revisions must demonstrate that the plan is credible and would result in an orderly resolution under the Bankruptcy Code,[21] including any proposed changes in business operations and corporate structure to facilitate implementation of the plan.[22] In the event that a company fails to timely resubmit a revised resolution plan after being notified by the Board of Governors and the FDIC that its resolution plan is deficient, the Board of Governors and the FDIC "may jointly impose more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the company, or any subsidiary thereof," until the company resubmits a resolution plan that remedies the deficiencies.[23]

Importantly, if two years after the Board of Governors and the FDIC impose the more stringent requirements and standards the company still has not resubmitted a resolution plan that remedies the deficiencies, then the Board of Governors and the FDIC, in consultation with the Council, may jointly direct the company to divest certain assets or operations to facilitate an orderly resolution under the Bankruptcy Code in the event of material financial distress or failure.[24] Note though, to the extent that the imposition of any of the above restrictions or forced divestitures would have a significant impact on a functionally regulated subsidiary or depository institution subsidiary of an NFC supervised by the Board of Governors or a BHC with total consolidated assets equal to or greater than $50 billion, the Board of Governors is required to consult with the Council member that primarily supervises any such subsidiary with respect to the restriction or forced divestiture.[25] Unfortunately, the Dodd-Frank Act does not provide any guidance with respect to what would constitute a "significant impact."

MISCELLANEOUS PROVISIONS

The resolution plan is nonbinding on any bankruptcy court, receiver appointed under Title II of the Dodd-Frank Act, or any other authority that is authorized or required to resolve the company, or any subsidiary or affiliate of the company.[26] The resolution plan is intended to serve only as a contingency plan and may not give rise to any private right of action.[27] A question that remains unanswered is whether the contingency plan can be used as a basis for a shareholders derivative lawsuit on the basis that the officers and directors were grossly negligent in the plan's preparation.

RESOLUTION PLAN REQUIREMENTS IN ACTION

Because the Dodd-Frank Act was only recently signed into law, *i.e.,* July 21, 2010, there are no specific examples or detailed explanations of what would constitute a credible resolution plan under the Dodd-Frank Act or what would constitute for the FDIC and the Board of Governors a resolution plan that would facilitate an orderly resolution under the Bankruptcy Code. The Dodd-Frank Act requires the finalization of rules which will provide more guidance in this regard within 18 months after the enactment of the Dodd-Frank Act.[28]

Ahead of the issuance of the rules on resolution plan reporting, FDIC Chairman Sheila Bair, however, has shed some light on what the FDIC expects that resolution plans should include. "[I]t must provide a clear discussion with regard to corporate structure and key business operations."[29] According to Chairman Bair, the resolution plans should "describe which assets and liabilities belong to which legal entities, identify functions or services provided by third parties and who within the financial firm has the relevant information about these functions."[30] She also noted that other essential information to provide in the resolution plan includes: "infrastructural elements that support the businesses, such as information technology, services, risk management, and liquidity; the key legal, funding, and operational interconnections within and outside the group; identification of potentially systemic operations and interconnections; identification and assessment of participation and role in exchanges, clearing houses, and other financial market infrastructure elements; cross-border operations, assets, liabilities, and dependencies; and key staff and information resources."[31]

Further, some guidance as to what might be expected in the form of rulemaking may be garnered from the FDIC's proposed rules for resolution planning in the context of large insured depository institutions.[32] These proposed rules require the largest U.S. depository institutions (each an "IDI") that are subsidiaries of large and complex financial parent companies to develop contingent resolution plans that address and demonstrate the IDI's ability to be separated from its parent structure and be able to be wound down or resolved in an orderly fashion.[33] As set forth in the rules, included among the minimum components that an IDI resolution plan must include are the following items that seem likely to be included in a resolution planning rule under Section 165 of the Dodd-Frank Act:

- *Organizational Structure.* Information regarding the enterprise's legal and functional structures, and identity of key personnel.[34]
- *Business Activities, Relationships and Counterparty Exposures.* Identification and description of the business activities of the enterprise, along with an explanation of the material interrelationships in the organizational structure that provide key services and support.[35]
- *Capital Structure and Corporate Financing Arrangements.* Description of the enterprise's capital structure including financial information in the form of audited financial statements, presented along with line-item descriptions of the assets, liabilities, and equity comprising the balance sheets of each of the entities making up the enterprise. Description of

the various corporate financing arrangements utilized by the enterprise. Identification of funding, liquidity, refinancing and concentration risks associated with the various capital pools being utilized. Identification of the key exposures to systemic risk and the availability of a substitute that would mitigate the effect of a systemic event.[36]

- *Systemically Important Functions.* Description of systemically important functions that the enterprise provides, critical vulnerabilities, estimated exposure and potential losses, and why certain attributes of the businesses could pose a systemic risk to the broader economy.[37]
- *Cross-Border Elements.* Description of the enterprise's cross-border relationships and exposures, assets and components of the business located outside of the United States.[38]

Against this background, there are various key considerations that a company may want to keep in mind in taking its first steps to prepare a resolution plan. First, one of the hallmarks of being able to facilitate an orderly resolution under the Bankruptcy Code is that a company must have a high degree of understanding and clarity on its corporate enterprise and operations. To achieve such a high level of clarity, companies with complex legal structures may be required to spend significant time and resources working to identify and be able to explain the location of its assets and liabilities and operations on an entity by entity basis. A good first step is to map the business operations through the legal entities. With respect to large business enterprises it is likely that single business lines will cross various entities. Very frequently such an analysis will result in the company needing to take some remedial actions to fix any significant ambiguities and legal entanglements that may be discovered. In that regard, it would not be surprising in order to set forth a credible resolution plan that the company may find instances where it or its subsidiaries need to restructure contractual obligations in an effort to clarify with whom its counterparty is actually contracting. Along these lines, frequently in large complex enterprises a disconnect may exist in the way that account data is recorded throughout the operations as compared to which entity is actually incurring the liabilities. This may require some clarification and correction. As noted above, industry experts and some industry officials are in agreement that this process will likely serve some benefit to the overall enterprise by eliminating redundancies resulting in a more stream-lined operation.

Once a company gains a clear understanding of its operations and corporate structure and has remedied any necessary defects or entanglements, it can begin the steps to develop a clear action plan for implementing an orderly winddown of various operations and potential liquidation plans that can be activated in times of severe distress. In establishing such an action plan, the company may want to create a core team of individuals who at a minimum represent the company's key business functions, including the IT function, who can assist both in the creation of the plan and its implementation. Frequently the information that a company would need to gather in preparing or updating its resolution plan is not centrally located in the corporate organization and in fact could be quite spread out. In that regard, companies may consider establishing a centralized data suppository that will facilitate the gathering and synthesizing of information relevant to a company's resolution plan on a real time basis.

The goal of any resolution plan is to maximize the value of the company's assets for the benefit of its creditors. As such, a thoughtful resolution plan requires careful consideration of the best method to maximize the value of the assets of the company. In many cases, the value of many of the assets of a company may be maximized through a public auction process as compared to a private party sale. Likewise, a sale of various parts of the company may yield more value than a sale of the whole. It is a good idea for BHCs and NFCs to work closely with the FDIC and the Board of Governors to obtain a clear understanding as to their expectations as it relates to what would constitute a credible resolution plan. Further, a company should pay close attention to the guidance set forth in the FDIC's rules and regulations on living wills as they are issued. Finally, a plan is likely to be found more credible if it does not rely upon significant financial support from the U.S. government.

On a final note, in light of the recent change of control in the House of Representatives in favor of the Republican party it is speculated that certain parts of the Dodd-Frank Act will be targeted for reform through congressional action. It remains to be seen what impact, if any, such a change will have on the resolution planning components of the Dodd-Frank Act.

NOTES

[1] FDIC Chairman Sheila C. Bair's Testimony as Prepared for Delivery at a Hearing of the FDIC, 2010 WL 3443111(F.D.C.H.), 6 (Sept. 2, 2010).
[2] *Id.*
[3] Dodd-Frank Act §165(a)(1).
[4] The Dodd-Frank Act sets forth various considerations for determining whether a nonbank financial company is likely to be supervised by the Board of Governors and such supervision requires a 2/3 vote by the Council, including an affirmative vote by the Chairperson. *See* Dodd-Frank Act §§ 113(a)(1), 113(a)(2), 113(b)(1), 113(b)(2).
[5] Dodd-Frank Act §165(b)(1).
[6] Dodd-Frank Act §165(d)(1).
[7] Dodd-Frank Act §165(d)(5)(B).
[8] This asset threshold may be increased above $50 billion by the Board of Governors pursuant to a recommendation by the Council. Dodd-Frank Act § 165 (a)(2)(B).
[9] Dodd-Frank Act §165(d)(1).
[10] 12 U.S.C. § 1841(a)(1). A company has control over a bank or a company if: "(A) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank or company; (B) the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or (C) the Board of Governors determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company." 12 U.S.C. § 1841(a)(2).
[11] Dodd-Frank Act § 102(a)(4).
[12] What constitutes a financial activity under Section 4(k) of the BHC Act is fairly broadly defined and includes, among other things, insurance underwriting; securities dealing and underwriting; providing financial, investment, or economic advisory services; "merchant banking"; issuing or selling securitized interests in bank-eligible assets; and engaging in the United States in any activity which a BHC can engage outside of the United States and which has been determined to be a usual and customary financial activity abroad under BHC Act Section 4(c)(13).
[13] Dodd-Frank Act §102(a)(6).

[14] Dodd-Frank Act §113(a)(1).
[15] Dodd-Frank Act § 113(a)(2).
[16] Dodd-Frank Act §170.
[17] Dodd-Frank Act § 117(a) and (b).
[18] Dodd-Frank Act § 117(c)(1).
[19] Dodd-Frank Act § 165 (d)(1).
[20] Dodd-Frank Act § 165 (d)(4).
[21] Because it is likely that certain of the BHCs and NFCs non-U.S. subsidiaries are not capable of being debtors under the Bankruptcy Code some ambiguity exists as to this requirement that the resolution plan facilitate an orderly resolution under the Bankruptcy Code.
[22] Dodd-Frank Act § 165 (d)(4).
[23] Dodd-Frank Act § 165 (d)(5)(A).
[24] Dodd-Frank Act § 165 (d)(5)(B).
[25] Dodd-Frank Act § 165 (b)(4).
[26] Dodd-Frank Act § 165 (d)(6).
[27] Dodd-Frank Act §165(d)(7).
[28] Dodd-Frank Act §165(d)(8).
[29] Financial Overhaul Implementation, FDIC Chairman Sheila C. Bair's Testimony at the Senate Committee on Banking, Housing and Urban Affairs, 2010 WL 3820990 (F.D.C.H.), 4 (Sept. 30, 2010).
[30] *Id.*
[31] FDIC Chairman Sheila C. Bair's Testimony as Prepared for Delivery at a Hearing of the FDIC, 2010 WL 3443111(F.D.C.H.), 13 (Sept. 2, 2010).
[32] *See* 75 Fed. Reg. 27464.
[33] *Id.*
[34] *See* 75 Fed. Reg. 27470.
[35] *Id*.
[36] *Id*.
[37] *Id*.
[38] *Id*.