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FDIC Board Approves Interim Final Rule on New Orderly Liquidation Authority
Action Clarifies Treatment of Certain Creditor Claims

The Board of Directors of the Federal Deposit Insurance Corporation (FDIC) voted on Tuesday to approve an interim final rule clarifying how the agency will treat certain creditor claims under the new orderly liquidation authority established under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Title II of the Dodd-Frank Act provides a mechanism for appointing the FDIC as receiver for a financial company if the failure of the company and its liquidation under the Bankruptcy Code or other insolvency procedures would pose a significant risk to the financial stability of the United States.

FDIC Chairman Sheila C. Bair said: "The orderly liquidation process established under Title II of the Dodd-Frank Act imposes the losses on shareholders and creditors, while also protecting the economy and taxpayer interests. The interim final rule provides needed guidance to the market and underlines the clear statutory intent that creditors bear the losses of any failure. Shareholders and unsecured creditors should understand that they, not taxpayers, are at risk. This rule represents a significant narrowing of the discretion provided under Dodd-Frank for differentiation among creditors, consistent with the law's overarching public-policy objectives to maximize market discipline and make clear that all equity and unsecured debt holders are at risk of bearing loss."

The final rule follows a notice of proposed rulemaking and 30-day comment period during which the FDIC received 27 comment letters and held two meetings with various industry representatives and trade associations. The comments generally expressed support for the FDIC's efforts to promulgate rules for implementing the orderly liquidation authority of Title II. A majority of comments related to matters beyond the scope of the NPR, indicating the need for additional rulemaking in the future.

The interim final rule approved today differs from the NPR by clarifying the standard for valuation for collateral on secured claims and by clarifying the treatment of contingent claims. One aspect of the NPR elicited a number of comment letters: The availability of additional payments to creditors under the authority of the Dodd-Frank Act.

The interim final rule does not change this proposal from the NPR. Many commentators noted the importance of limiting any "additional payments" as a means of reducing moral hazard and instilling market discipline. Others were concerned with the prohibition of any additional payments to holders of long-term debt, which is defined as debt with an original term of more than 360 days, based on the misapprehension that shorter-term creditors are likely to receive such payments. Under the standards of the Dodd-Frank Act and the interim final rule, that concern is unwarranted. Short-term debt holders are highly unlikely to meet the criteria set forth in the statute for permitting payment of additional amounts. In virtually all cases, holders of shorter-term debt will receive the same pro rata share of their claim that is being provided to the long-term debt holders. Accordingly, a potential credit provider to a company subject to the Dodd-Frank resolution process should have no expectation of treatment that differs depending upon whether it lends for a period of over 360 days or for a shorter term.

The provisions allowing rare "additional payments" parallel the FDIC's longstanding authority under the Federal Deposit Insurance Act and must be narrowly construed consistent with the Congressional intent. Consistent with the FDIC's practice in bank resolutions, such additional payments are rare and payments to shareholders, subordinated debt holders, and long-term debt holders would not meet the statutory tests contained in the Dodd-Frank Act. Under the interim final rule, no creditor can receive any additional payment unless the FDIC Board of Directors has determined, by recorded vote, that the payments meet the statutory standards. In addition, such payments are subject to recoupment if ultimate recoveries are insufficient to repay any temporary government liquidity support provided as part of the orderly wind-down. This recoupment must occur before imposition of a general industry assessment to cover any shortfalls. In no event may taxpayer money be used to cover losses associated with the failure of a large financial firm.

The interim final rule also addresses discrete issues within the following broad areas:

(1) The authority to continue operations by paying for services provided by employees and others (by clarifying the payment for services rendered under personal services contracts);

(2) The treatment of creditors (by clarifying the measure of damages for contingent claims); and

(3) The application of proceeds from the liquidation of subsidiaries (by reiterating the current treatment under corporate and insolvency law that remaining shareholder value is paid to the shareholders of any subsidiary).