

FMU Recovery and Resolution: “Orderly Liquidation” in the Shadow of the Bankruptcy Code

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NOTE: The statements and opinions expressed herein are solely those of the author and not necessarily those of the Federal Reserve Bank of Chicago or the Board of Governors of the Federal Reserve System.

FMU Recovery and Resolution: “Orderly Liquidation” in the Shadow of the Bankruptcy Code

- **“Orderly Liquidation” and the Financial Crisis . . .**
- **Types of Resolution Regimes (U.S. Law)**
 - Bankruptcy Code of 1978
 - Special Resolution Regimes
 - Bank resolution
 - Resolution of “securities brokers,” “commodity brokers” and related entities
 - Insurance company resolution
 - Dodd-Frank “Orderly Liquidation Authority” (OLA)

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- **“Orderly Liquidation” and the Financial Crisis . . .**
 - Bailouts, bankruptcy and the need to “bullet-proof” financial utilities

“When the crisis hit, regulatory options for responding to distress in *large, non-bank financial companies* left policymakers with a *no-win dilemma*: either prop up failing institutions with *expensive bailouts* or allow *destabilizing liquidations through the normal bankruptcy process*.”

Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (February 17, 2011)

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“[T]he choice between bankruptcy and a rescue loan is *not an either/or choice*. If regulators conclude that the systemic risk concerns are so great that intervention is necessary, they could use an *intermediate strategy* of allowing the firm to file for bankruptcy, while selectively guaranteeing certain “*dangerous*” *liabilities* as an alternative to a rescue loan.”

Kenneth Ayotte & David A. Skeel, *Bankruptcy or Bailouts?*, Journal of Corporation Law, Vol. 35 (2010)

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“[T]he fact that [Central Counterparty clearing arrangements (CCPs)] will be central to the system dramatically increases their importance. In essence, ***global CCPs will be systemically important.***”

William C. Dudley, Remarks at the Harvard Law School's Symposium on Building the Financial System of the 21st Century, *Reforming the OTC Derivatives Market* (March 22, 2012)

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“Thus, for the system to be safer it is not sufficient to ensure that trades are standardized and that they are mandated to be cleared through CCPs, but also ***it is necessary that CCPs be “bullet proof.”*** They have to have the ability to perform and meet their obligations regardless of the degree of stress in the financial system and even if one or more of their participants were to fail in a disorderly manner.”

William C. Dudley, Remarks at the Harvard Law School's Symposium on Building the Financial System of the 21st Century, *Reforming the OTC Derivatives Market* (March 22, 2012)

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- U.S. bankruptcy law in historical perspective . . .

1787 – U.S. Constitution grants federal government authority to establish “uniform Laws on the subject of Bankruptcies throughout the United States” (Article I, Section 8)

1797 – “Panic of 1797” results in imprisonment of prominent debtors (e.g., Robert Morris, the “Financier of the Revolution”) – n.b., imprisonment for debt is abolished under federal (but not state) law in 1832

1800 – Bankruptcy Act of 1800 (repealed 1803)

1819/1827 – State insolvency statutes held constitutional in *Sturges v. Crowninshield* (1819) and *Ogden v. Saunders* (1827)

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1841 – Bankruptcy Act of 1841 (repealed 1843)

1867 – Bankruptcy Act of 1867 (amended 1874, repealed 1878)

1898 – “Panic of 1898” prompts enactment of the **Bankruptcy Act of 1898** (in effect, as amended, until 1978)

1929 to 1933 – Stock market crash and the “Great Contraction,” the Banking Act of 1933 and Glass Steagall establish the Federal Deposit Insurance Corporation (FDIC)

1950 – Federal Deposit Insurance Act of 1950 (FDIA)

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1970 – Securities Investor Protection Act of 1970 (SIPA)

1978 – Bankruptcy Reform Act of 1978 repeals the **Bankruptcy Act of 1898**, which is replaced by the **Bankruptcy Code**

1989 – Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA)

1990 – Amendments to Federal Deposit Insurance Act (FDIA) and the Bankruptcy Code to enhance the enforceability of “qualified financial contracts” (QFCs)

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1991 – Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) includes provisions for “least cost” resolution of depository institutions and to enhance the enforceability of “close-out” netting, etc.

2001 – Bankruptcy Reform Act of 2001, amends the **Federal Deposit Insurance Act (FDIA)**

2005 – Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCA) amends the **Bankruptcy Code** and **Securities Investor Protection Act** to enhance the enforceability of certain financial contracts, exempt repo (RP) transactions collateralized by mortgage backed securities (MBS) from resolution under the Code, etc.

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2010 – Dodd-Frank Wall Street Accountability and Consumer Protection Act (Dodd-Frank Act) authorizes the Federal Deposit Insurance Corporation (FDIC) to resolve systemically important “financial companies”

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- **“Orderly Liquidation” and the Financial Crisis . . .**
 - U.S. bankruptcy law in historical perspective . . .
 - Constitutional Issues – federalism, state “impairment” of debt contracts (debt moratoria), judicial power, etc.
 - Continuity of Federal Legislation – federal bankruptcy law exists for only 96 of 191 years (1787 to 1978)
 - Creditor–Debtor Conflict and Social Change – continuous, rapid change in social norms regarding debt (i.e., the “commercialization” of society) and changes in political institutions and power

David A. Skeel, *Debt’s Dominion, A History of Bankruptcy Law in America* (2001)

Bruce H. Mann, *Republic of Debtors, Bankruptcy in the Age of American Independence* (2002)

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- **“Orderly Liquidation” and the Financial Crisis . . .**
 - U.S. bankruptcy law in historical perspective . . .
 - Development of Special Resolution Regimes and “Systemic Risk” Provisions
 - Reorganization of large corporate enterprises (e.g., railroads)
 - Depository institutions and insurance companies (state law)
 - Insured depository institutions and SIPC member broker-dealers (federal law)
 - Netting agreements and financial contracts (swaps and repo/RP)
 - Financial market infrastructure (FMI)/financial market utilities (FMUs)

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- **“Orderly Liquidation” and the Financial Crisis . . .**
 - U.S. bankruptcy law in historical perspective . . .
 - Special Resolution Regimes and “Systemic Risk” Provisions
 - Financial market infrastructure (FMI)/financial market utilities (FMUs)
 - Payment systems
 - Central Securities Depositories (CSDs) and other Securities Settlement Systems (SSSs)
 - Central Counterparties (CCPs)
 - Trade Repositories (TRs), n.b., TRs are excluded from Dodd-Frank’s definition of “financial market utility”

Committee on Payment and Settlement Systems (CPSS) and Technical Committee of the International Organization of Securities Commissions (IOSCO), *Principles for financial market infrastructures* (April 2012)

FMU Recovery and Resolution: “Orderly Liquidation” in the Shadow of the Bankruptcy Code

• Types of Resolution Regimes (U.S. Law)

○ Bankruptcy Code of 1978

▪ Types of debtors (all “*persons . . .*”)

– Individuals (“fresh start” policy)

– Corporations, partnerships, other legal persons (preserve “going concern” value or liquidate assets and liabilities)

– Exceptions – railroads, pension plans, other “non-code” debtors

– Municipalities

▪ U.S. domicile or place of business or property located in the U.S.

FMU Recovery and Resolution: “Orderly Liquidation” in the Shadow of the Bankruptcy Code

- **Types of Resolution Regimes (U.S. Law)**

- Bankruptcy Code of 1978

- Types of proceedings

- Chapter 7: liquidation (“discharge” for individual debtors)

- Chapter 11: reorganization

- Chapters 9 (municipalities), 12 (family farmers), 13 (individuals with “regular income”)

- Chapter 14 (not yet . . .)

- Chapter 15: ancillary proceedings (foreign debtors)

FMU Recovery and Resolution: “Orderly Liquidation” in the Shadow of the Bankruptcy Code

- **Types of Resolution Regimes (U.S. Law)**

- Bankruptcy Code of 1978 – Key features (collective creditor remedies)

“Bankruptcy provides a ***collective forum*** for sorting out the rights of “owners” (creditors and others with rights against a debtors’ assets) and can be justified because it provides protection against the destructive effects of an ***individual remedies system*** where there are not enough assets to go around.”

Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (1986)

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“The basic problem that bankruptcy law is designed to handle . . . is that the ***system of individual creditor remedies*** may be bad for the creditors *as a group* when there are not enough assets to go around. Because creditors have conflicting rights, there is a tendency in their ***debt-collection efforts to make a bad situation worse.***”

Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (1986)

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“A . . . feature [of current law] that deals with the *“panic run” problem* is bankruptcy’s automatic stay. The banking literature suggests that *suspending convertibility* (prohibiting depositor withdrawals, so that the bank need not liquidate long-term assets) is perhaps the most effective response to a panic run. The *automatic stay* serves the same function in bankruptcy: it effectively places a shield around the firm’s assets, and ceases creditor collection efforts.”

Kenneth Ayotte & David A. Skeel, *Bankruptcy or Bailouts?*, Journal of Corporation Law, Vol. 35 (2010)

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“This can provide the firm with the ***breathing space it needs to conduct its business in an orderly fashion***, preventing a desperate scramble to satisfy the claims of withdrawing creditors. This breathing space can be valuable not only if the firm plans to remain as a going concern, but also if it plans to liquidate its assets but needs time to do so.”

Kenneth Ayotte & David A. Skeel, *Bankruptcy or Bailouts?*, Journal of Corporation Law, Vol. 35 (2010)

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- **Types of Resolution Regimes (U.S. Law)**

- Bankruptcy Code of 1978 – Key features (collective creditor remedies)

- **“Automatic Stay”** – creditors are prohibited from taking remedial (enforcement) actions, such as collecting pre-petition debts, obtaining or realizing on collateral and filing lawsuits against the debtor; secured creditors entitled to “adequate protection”

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- **“Ipso Facto” Based Remedies** – contract terms which allow creditors to terminate or modify contracts solely on the basis of the debtor’s insolvency or bankruptcy are not enforceable

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- **“Setoff” Rights** – creditors’ setoff (non-contractual netting) and assignment rights are limited and, under certain conditions, may be avoided by the trustee

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- **Contract Performance (“Cherry-Picking”)** – the debtor may elect to repudiate an executory contract under which the debtor and its counterparty have continuing performance obligations and may “cherry-pick” among separate contract obligations

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- **Avoidance** – debtor can sue third parties to recover for the estate certain pre-petition payments or transfers, as either voidable “preferences,” fraudulent transfers or unperfected security interests, except for certain “settlement payments” or “margin payments”

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- “Automatic Stay”

- “Ipso Facto” Based Remedies

- “Setoff” Rights

- Contract Performance (“Cherry-Picking”)

- Avoidance

FMU Recovery and Resolution: “Orderly Liquidation” in the Shadow of the Bankruptcy Code

- **Types of Resolution Regimes (U.S. Law)**

- Bankruptcy Code of 1978 – Key features (“safe harbors” for financial contracts)

*“Financial institutions and other financial market participants in their daily operations use a number of mechanisms designed to reduce their risk exposure. Amongst other things, first, they provide to each other **security or collateral**. In addition, they may agree that **close-out netting** shall apply to the contracts into which they enter with each other.”*

UNIDROIT, Committee of governmental experts on the enforceability of close-out netting provisions, *Draft Principles regarding the enforceability of close-out netting provisions* (May 2012)

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“Both mechanisms . . . serve the same purpose, that is, to ensure that one party’s ***exposure to the other parties’ solvency and to considerable changes in the value of the relevant assets*** is kept at manageable levels.”

UNIDROIT, Committee of governmental experts on the enforceability of close-out netting provisions, *Draft Principles regarding the enforceability of close-out netting provisions* (May 2012)

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- Bankruptcy Code of 1978 – Key features (“safe harbors” for financial contracts)

“Both mechanisms are capable of independently ***mitigating counterparty risk as well as market risk***. However, in practice, their functions are intimately linked: where collateral and netting mechanisms are used cumulatively, netting reduces the exposure in the sense that much less collateral has to be put up. Taken together, security/collateral and close-out netting are one of the ***primary tools of risk management in the financial market***.”

UNIDROIT, Committee of governmental experts on the enforceability of close-out netting provisions, *Draft Principles regarding the enforceability of close-out netting provisions* (May 2012)

FMU Recovery and Resolution: “Orderly Liquidation” in the Shadow of the Bankruptcy Code

• Types of Resolution Regimes (U.S. Law)

- Bankruptcy Code of 1978 – Key features (“safe harbors” for financial contracts)
 - Protected contracts (a/k/a “qualified financial contracts” or “QFCs”)
 - “Securities contracts”
 - “Forward contracts”
 - “Commodity contracts”
 - “Repurchase agreements”
 - “Swap agreements”
 - “Master netting agreements”

FMU Recovery and Resolution: “Orderly Liquidation” in the Shadow of the Bankruptcy Code

• Types of Resolution Regimes (U.S. Law)

- Bankruptcy Code of 1978 – Key features (“safe harbors” for financial contracts)
 - Protected counterparties
 - “Stockbrokers” and “securities clearing agencies”
 - “Forward contract merchants”
 - “Commodity brokers” (including “derivatives clearing organizations”)
 - “Repo participants” and “swap participants”
 - “Financial institutions” and “Financial participants”

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- **Types of Resolution Regimes (U.S. Law)**

- Bankruptcy Code of 1978 – Key features (“safe harbors” for financial contracts)

- Some policy issues

- Do the Code’s “safe harbors” make it impossible to resolve a non-bank financial company (e.g., a broker-dealer, futures commission merchant or CCP) in bankruptcy? Are “bailouts” the only alternative?

- Do the Code’s “safe harbors” effectively give qualifying financial contracts between protected counterparties a “super-priority” in bankruptcy? If so, is that a problem?

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“Taken together, this special treatment of derivative counterparties puts them in a much stronger position than regular creditors. While they do not have priority in the strict legal sense, their ***special rights relative to other creditors make derivative counterparties effectively senior***, at least to the extent that they are collateralized. In practice, this collateralization is usually ensured via regular marking to market and collateral calls.”

Patrick Bolton & Martin Oehmke, *Should Derivatives Be Privileged in Bankruptcy?* (March 5, 2012)

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- Bankruptcy Code of 1978 – Key features (“safe harbors” for financial contracts)

“Our analysis suggests . . . that the strengthening of derivatives’ treatment in bankruptcy may have been inefficient. While seen in isolation the super-protection lowers the cost of hedging, this is more than offset by a **greater cost of debt** and a **greater incentive to over-hedge**. Based on our analysis, it appears that, at a minimum, further research is required into the consequences for firms’ cost of borrowing before one can conclude that the **super-priority status** of derivatives is warranted.”

Patrick Bolton & Martin Oehmke, *Should Derivatives Be Privileged in Bankruptcy?* (March 5, 2012)

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- **Types of Resolution Regimes (U.S. Law)**

- Special Resolution Regimes

- Bank resolution
 - Resolution of “stockbrokers,” “commodity brokers” and related entities
 - Insurance company resolution
 - Dodd-Frank Title II “Orderly Liquidation Authority” (OLA)

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- **Types of Resolution Regimes (U.S. Law)**

- Special Resolution Regimes

- Bank resolution

- **Insured Depository Institutions (IDIs)** – resolution by FDIC (either conservatorship or receivership)

- **Other Banking Institutions** – resolution under state banking law, or (potentially) Chapter 11 of the Bankruptcy Code

FMU Recovery and Resolution: “Orderly Liquidation” in the Shadow of the Bankruptcy Code

- **Types of Resolution Regimes (U.S. Law)**

- Special Resolution Regimes

- Resolution of “stockbrokers,” “commodity brokers,” and related entities

- **“Stockbrokers”** – liquidation (only) under Chapter 7 of the Bankruptcy Code and, for SIPC members, proceedings under the Securities Investor Protection Act of 1970 (SIPA)

- **“Securities Clearing Agencies”** – liquidation (only) under Chapter 7 of the Bankruptcy Code

- **“Commodity Brokers” (including “Clearing Organizations”)** – liquidation (only) under Chapter 7 of the Bankruptcy Code and CFTC Part 190 Rules, or (potentially) federal court equity receivership

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- **Types of Resolution Regimes (U.S. Law)**

- Special Resolution Regimes

- Insurance company resolution

- **Insurance Companies** – resolution under state insurance law, or (potentially) backup proceedings under Dodd-Frank Title II (for systemically important insurance companies)

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- **Types of Resolution Regimes (U.S. Law)**

- Special Resolution Regimes

- Dodd-Frank “Orderly Liquidation Authority” (OLA)

“Title II of the [Dodd-Frank] Act provides for the appointment of the FDIC as receiver of a ***nonviable financial company*** that poses ***significant risk to the financial stability of the United States*** (a “covered financial company”) following the prescribed recommendation, determination, and judicial review process set forth in the Act. Title II outlines the process 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 by rulemaking.”

FDIC, Certain Orderly Liquidation Authority Provisions, 76 Fed.Reg. 41,626 (July 15, 2011)

FMU Recovery and Resolution: “Orderly Liquidation” in the Shadow of the Bankruptcy Code

• Types of Resolution Regimes (U.S. Law)

○ Special Resolution Regimes

▪ Dodd-Frank “Orderly Liquidation Authority” (OLA)

– Any legal person incorporated or organized under federal or state law that is

– A **bank holding company**, or

– A **nonbank financial company supervised by the Federal Reserve** (upon designation by FSOC), or

– “**Predominantly engaged**” in activities that are “**financial in nature (or incidental thereto)**” (85% of annual gross revenues, but not assets, derived from Reg. Y activities)

– **Subsidiaries** (but not other affiliates?) of the foregoing entities, if “predominantly engaged” in activities that are “financial in nature (or incidental thereto)” and

– Determined to be “**systemically important**”

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- **Types of Resolution Regimes (U.S. Law)**

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- NOTE: Determination of “systemic importance”

- Treasury Secretary, in consultation with the President, after recommendation by the Federal Reserve and FDIC (or others)

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• Types of Resolution Regimes (U.S. Law)

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– NOTE: Title VIII designated financial market utilities (DFMUs) are not expressly covered or excluded by Title II

– Example: Chicago Mercantile Exchange, Inc. (CME Clearing House Division)

– Designated by FSOC under Title VIII (July 18, 2012)

– Clearing and settlement activities (“safeguarding of money”?)

– But not more than 85% of CME’s total revenues

– Exchange-related activities (not “financial in nature”)

Comment letter of CME Group, Inc. to FDIC, Proposed Rules on Orderly Liquidation Authority (Nov. 18, 2010)

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- Example: Clearing House Payments Company LLC, as operator of the Clearing House Interbank Payments System (CHIPS)

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• Types of Resolution Regimes (U.S. Law)

○ Special Resolution Regimes

▪ Dodd-Frank “Orderly Liquidation Authority” (OLA): Titles I and II distinguished

– Certain companies must submit “resolution plans” (a/k/a “living wills”) and are subject to additional risk management and supervisory requirements under Title I

– **Bank holding companies** (with more than \$50B total consolidated assets); and

– Nonbank financial companies **designated by the Financial Stability Oversight Council (FSOC)** for supervision by the Federal Reserve

– If “**predominantly engaged**” in activities that are “**financial in nature**” (85% of annual gross revenues or 85% of consolidated assets derived from Reg. Y activities)

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– Certain companies must submit “resolution plans” (a/k/a “living wills”) and are subject to additional risk management and supervisory requirements under Title I

– However, SEC-registered “**clearing agencies**” and CFTC-registered “**derivatives clearing organizations**” (and certain others) are **excluded from the class of nonbank financial companies that may be designated by FSOC for supervision by the Federal Reserve**

n.b., CPSS-IOSCO *Principles for financial market infrastructures* and related standards provide a basis for requiring FMUs to prepare “resolution plans”

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• Types of Resolution Regimes (U.S. Law)

○ Special Resolution Regimes

▪ Key features

- Liquidation or reorganization under the Bankruptcy Code is the primary resolution procedure
- FDIC preference for “top of the house” (holding company level) resolution
- Transfer of assets and liabilities to “bridge company” to sustain operations
- “Business as usual” (from perspective of creditors, other stakeholders)
- No taxpayer support, except for Treasury lending facility (the “orderly liquidation fund”)
- Losses borne by equity holders and management replaced

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- Key features – collective creditor remedies

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- **Automatic Stay** – not automatic, but FDIC may request (and the court shall grant) a 90 day stay of creditors’ remedial actions

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- **Contract Performance (“Cherry-Picking”)** – the FDIC’s power to repudiate contracts is not limited to executory contracts; FDIC also has power to transfer contracts
- **Avoidance** – similar, but not identical, to the Bankruptcy Code

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• Types of Resolution Regimes (U.S. Law)

○ Special Resolution Regimes

▪ Key features – collective creditor remedies

- **Automatic Stay** – not automatic, but FDIC may request (and the court shall grant) a 90 day stay of creditors’ remedial actions
- **“Ipso Facto” Based Remedies** – unenforceable against FDIC for 90 days at a minimum
- **Setoff Rights** – based on the Bankruptcy Code
- **Contract Performance (“Cherry-Picking”)** – the FDIC’s power to repudiate contracts is not limited to executory contracts; FDIC also has power to transfer contracts
- **Avoidance** – similar, but not identical, to the Bankruptcy Code
- **Executive Compensation** – FDIC may clawback the compensation of senior executives and directors who failed to act with due care

FMU Recovery and Resolution: “Orderly Liquidation” in the Shadow of the Bankruptcy Code

• Types of Resolution Regimes (U.S. Law)

○ Special Resolution Regimes

▪ Key features – “safe harbors” for financial contracts

– Protected contracts (a/k/a “qualified financial contracts” or “QFCs”)

– Similar to Bankruptcy Code (i.e., “securities contracts,” “forward contracts,” “commodity contracts,” “repurchase agreements” and “swap agreements”)

– But does not include (express) protection for “master netting agreements” (why?)

FMU Recovery and Resolution: “Orderly Liquidation” in the Shadow of the Bankruptcy Code

- **Types of Resolution Regimes (U.S. Law)**

- Special Resolution Regimes

- Key features – “safe harbors” for financial contracts

- Protected counterparties

- Same as under the Bankruptcy Code with additional (express) protection for ***clearing organizations*** as counterparties [Dodd-Frank §210(c)(8)(G)]

FMU Recovery and Resolution: “Orderly Liquidation” in the Shadow of the Bankruptcy Code

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NOTE: The statements and opinions expressed herein are solely those of the author and not necessarily those of the Federal Reserve Bank of Chicago or the Board of Governors of the Federal Reserve System.