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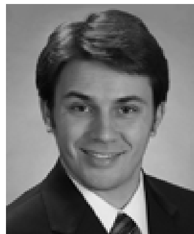
REGULATORY REFORM

FDIC Treatment of Creditor Claims Under Orderly Liquidation Process



BY ROBERT P. SIMONS AND LUKE A. SIZEMORE

When a traditional nonbanking company files a case under the Bankruptcy Code, a judge is appointed to be the neutral arbiter of disputes that arise between the debtor and its creditors. Under the new insolvency regime created by Title II of the Dodd-Frank Wall Street and Consumer Protection Act (the ''Act''), the Federal Deposit Insurance Corporation (the ''FDIC''), who, until now, was only the receiver for banks, also may be appointed as receiver of the non-bank financial company if the Secretary of Treasury, in consultation with the President, determines that the company is in default or in danger of default, and the failure of the company would have serious adverse effects on the nation's financial stability.

Although it is likely that such a nonbank financial company will have been previously designated by the Financial Stability Oversight Council as a ''systemically important financial institution'' under Title I of the Act, the express language of Title II permits the Secretary of Treasury to pull any financial company into the orderly liquidation process regardless of its Title I designation. Once the FDIC is appointed as receiver under Title II, it is required to liquidate the failing company, without assistance or oversight from a judge, in a manner that imposes all losses on the company's creditors and shareholders (rather than on taxpayers). If the proceeds from the disposition of the failing financial company are insufficient to cover the costs of receivership, the remaining obligations incurred by the FDIC may be the responsibility of the financial sector, through assessments.

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The orderly liquidation process established by Title II is an extraordinary remedy that should, and likely will, be used sparingly. Certain of these financial institutions may utilize their ''living wills,'' which are required by the Act, to convince regulators that they could reorganize or liquidate under the Bankruptcy Code without posing a systemic risk. Nevertheless, creditors of these financial institutions, who likely are familiar with proceedings under the Bankruptcy Code, should be prepared to adapt to a different claims procedure under Title II that places significant discretion in the hands of the FDIC. This article highlights those aspects of Title II's claims procedures where the FDIC, as receiver, has been provided with significantly more discretion than that given to a debtor or trustee under the Bankruptcy Code.

Upon its appointment as receiver, the FDIC will initiate an administrative process for the resolution of claims against the failing financial company. Unlike the Bankruptcy Code, where the court serves as arbiter of claims disputes, Title II empowers the FDIC, as receiver, to allow or disallow all or any portion of a claim in its sole discretion. If the FDIC fails to make a determination to allow or disallow a claim within 180 days after the claim is filed and no agreement is reached to extend this deadline, the claim is deemed disallowed. In effect, inaction by the FDIC equals disallowance of claims.

Under Title II, claimants of disallowed claims are not without recourse and have 60 days after notification of disallowance to seek a judicial determination of their claims in the district court for the district in which the financial company is located. The district court must conduct a *de novo* review of the merits of the claim, not a review of the FDIC's determination. This standard of review favors creditors because the court will make an independent determination without deference to the

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FDIC's decision. If the claimant fails to seek judicial review within the requisite 60-day period, the claimant will have no further rights or remedies with respect to its claim.

FDIC Powers Over Liquidation Priority Scheme

The priority scheme established by Title II is based upon the fundamental principle that an orderly liquidation should fairly treat similarly situated creditors. Nevertheless, the priority scheme may be altered by the FDIC. First, the FDIC, as receiver, has discretion to determine which expenses are necessary and appropriate to facilitate a smooth and orderly liquidation. Such expenses will be paid as a first priority administrative claim. Second, there are limited circumstances in which the FDIC is permitted to pay some creditors more than other similarly situated creditors. Additional payments are permitted when they are necessary (1) to maximize the value of the assets; (2) to initiate and continue operations essential to implementation of the receivership and any bridge financial company; (3) to maximize the present value return from the sale or other disposition of the assets; (4) to minimize the amount of any loss on sale or other disposition; and, the catch-all, (5) to minimize the losses from the orderly liquidation of the financial company. Accordingly, the FDIC has substantial leeway to make additional payments to certain creditors when they are deemed necessary.

Other than a lack of immediate judicial oversight, the FDIC's final rule regarding the treatment of secured claims under Title II is nearly identical to the Bankruptcy Code. This is by design, as Title II directed the FDIC to draft regulations relating to secured claims that would harmonize with relevant provisions of the Bankruptcy Code. The FDIC notes in the final rule, however, that complete harmonization of Title II with the Bankruptcy Code is impossible due to the differences in judicial review. In a bankruptcy case, the debtor's or trustee's actions are subject to prior court approval. In contrast, the FDIC's receivership under Title II is an administrative process, and court jurisdiction is limited.

When reviewing a secured claim under Title II, the FDIC has discretion to determine the amount of the claim, the relative priority of the security interest, whether the security interest is legally enforceable and perfected, and the fair market value of the collateral. To the extent that the claim exceeds the value of the collateral, the claim will be bifurcated into secured and unsecured components. To the extent that the value of the collateral exceeds the amount of the secured claim, the secured creditor will be allowed interest and any reasonable fees, costs, or charges provided for in the agreement or State statute under which the claim arose. Any excess value remains with the financial company.

The FDIC also has discretion in the disposition of collateral. The FDIC may: (1) surrender the collateral upon written request by the secured creditor; (2) sell, use, or lease the collateral and provide adequate protection to the creditor; and (3) redeem the property from a lien by paying the creditor the fair market value of the property up to the value of its lien. Although the first option is similar to seeking relief from the automatic stay under the Bankruptcy Code, it is the FDIC, rather than a judge, that determines whether the collateral will be surrendered.

The FDIC's discretion, however, is limited in at least one respect. Upon a secured creditor's written request for the surrender of collateral, which must state the amount of the claim, a description of the property, the value of the property, and the proposed disposition, the FDIC is required to surrender the collateral if it decides not to use, sell, or lease the property. If the FDIC does not act on such request for a period of 30 days, consent to surrender will be deemed to have been granted. In the event that the FDIC decides to sell, use, or lease the collateral, it must provide the secured creditor with adequate protection to the extent that the sale, use, or lease of the property results in a decrease in the value of the creditor's security interest. Adequate protection may consist of making a cash payment or periodic cash payments to the secured creditor or providing the secured creditor an additional or replacement lien to the extent of the lost value or providing any other relief that results in the realization of the ''indubitable equivalent'' of the creditor's security interest. When the value of the collateral is not depreciating or is sufficiently greater than the amount of the secured claim, adequate protection will be presumed. The concept of adequate protection was a late addition in the FDIC's rulemaking process. It was added to the Final Rule to ensure that secured creditors are able to realize the full value of their collateral in the liquidation process.

The lack of judicial oversight is perhaps the biggest difference between Title II and the Bankruptcy Code. Bankruptcy judges are responsible for balancing the competing interests between a debtor and its creditors. Conversely, the FDIC is responsible for ensuring that the creditors and shareholders bear the losses of the financial company so that no taxpayer funds are utilized. To accomplish this goal, the FDIC has been provided broad discretion with respect to the determination and treatment of creditors' claims.

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