Steroidal Side Effects: Conundrums Inside the Individual Chapter 11  
Taryn M. Darling Hill, Crocker Kuno PLLC, Seattle, Washington

While the individual Chapter 11 is still a small subset of Chapter 11 filings, its use is increasing as more individuals in financial distress possess income, equity, and debt exceeding the Chapter 13 limitations. Although BAPCPA sought to impose features of a Chapter 13 case into an individual Chapter 11 case, creating a "Chapter 13 on Steroids," there are some considerable differences arising from the creation of the bankruptcy estate as an entity separate from the individual debtors. This article examines some interesting developments that require the careful practitioner to advise her client of the potential side-effects of the individual Chapter 11 so that he or she may best weigh the costs and benefits of a filing.

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Carving Back Coverage In Chapter 11: Don't Forget The Debtor In Possession  
Monika S. Wiener, Hennigan Bennett & Dorman LLP, Los Angeles

The "insured vs. insured" exclusions typically included in corporate directors and officers liability insurance policies – which are designed to prevent collusive lawsuits filed by an insured corporation against its directors and officers in the hopes of recovering operational losses from the D&O insurer – have received significant attention from bankruptcy courts and commentators. There is an important corollary to this exclusion – the so-called "bankruptcy carve-back" endorsement. This article explains the intended function of these endorsements, analyzes the applicable case law, and provides guidance for companies shopping for D&O insurance policies.

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Settlements in Chapter 11: Fait Accompli or A New Opportunity to Retrade?  
Robert P. Charboneau, Ehrenstein Charboneau Calderin, Miami, Florida

Most courts eagerly enforce settlement agreements reached between parties. A recent opinion from the U.S. Bankruptcy Court of the Southern District of Florida, however, provides caution for parties entering into settlement agreements with entities who are or may be in a bankruptcy proceeding. Even when the terms of a settlement have been approved by an order of a court, if the settlement agreement is not carefully drafted and fully executed in writing, a bankruptcy court may later allow the debtor to later avoid performing its obligations by rejecting the court-approved agreement. This article analyzes the decision and provides guidance to practitioners who document settlement agreements involving parties who are or may become debtors.

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**Legislative Update**

Judith Greenstone Miller, Jaffe Raitt Heuer & Weiss PC, Southfield, Michigan, and Aisha L. Williams, Gilbert LLP, Washington, D.C.

This update reviews and summarizes recently enacted and pending rules and bills that affect bankruptcy practitioners.

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**The Kathryn R. Heidt Memorial Award**

Please consider nominating a worthy candidate for this prestigious award in honor of a past Chair of the Business Bankruptcy Committee, Kate Heidt. Nominations are due August 31, 2010.

- [Heidt Award Nomination Form](#)

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**Watch the Business Bankruptcy Committee Webinar "An Incredible Result: Limits On Credit Bidding In Bankruptcy Cases"**

On April 15, 2010, the Business Bankruptcy Committee presented a webinar presentation on several recent decisions that appear to limit the rights of secured creditors to credit bid in Chapter 11 cases. The moderator was Kyung S. Lee of Diamond McCarthy LLP in Houston, and the panelists were Robin Phelan of Haynes and Boone in Dallas and Martin Beeler of Covington & Burling LLP in New York. Below is a link to the full webinar and to the slide show presentation.

- [Business Bankruptcy Committee Webinar on Limits on Credit Bidding](#)

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**Materials from the Business Bankruptcy Section 2010 Spring Meeting**

At the Spring Meeting of the ABA Section of Business Law Business Bankruptcy Committee in Denver, members of the Committee presented a number of informative and interesting programs. Below is a link to all of the materials provided at these programs. (Access to some of the articles requires your ABA password.)

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The Business Bankruptcy Committee invites you to submit articles for possible publication in future issues. The articles do not need to be long or in-depth, and it is a great way to get involved in the Business Bankruptcy Committee. Articles can survey the law nationally or locally, discuss particular business bankruptcy issues, or examine a specific case. If you are interested in submitting an article, please contact Newsletter Editor-in-Chief Kay Kress at KRESSK@pepperlaw.com or Editor Chris Alston at ALSTC@foster.com.

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Steroidal Side Effects: Conundrums Inside the Individual Chapter 11

Taryn M. Darling Hill

Individual Chapter 11 bankruptcy filings are on the increase. While the individual Chapter 11 is still a small subset of Chapter 11 filings, its use is increasing as more individuals in financial distress possess income, equity, and debt exceeding the Chapter 13 limitations. Although the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) has sought to impose features of a Chapter 13 case into an individual Chapter 11 case, creating a “Chapter 13 on Steroids,” there are some considerable differences arising from the creation of the bankruptcy estate as an entity separate from the individual debtors, effectively creating a “no man’s land” where practitioners versed in both Chapter 13s and Chapter 11s fear to tread. Although there is limited case law interpreting the provisions as applied to individual Chapter 11 debtors, there are some interesting developments that require the careful practitioner to advise her client of the potential side-effects of the individual Chapter 11 so that he or she may best weigh the costs and benefits of a filing. Tax consequences and the effect of an individual filing on the attorney-client relationship are two areas in which a practitioner will want to take extra care to inform her clients.

Disclaimer: The Use of Steroids May Result In Increased Tax Liability.

Individuals filing a Chapter 11 must be advised of the consequences of a bankruptcy on taxation. Separate, albeit joint, estates are created for married individuals under both the Chapter 7 and the Chapter 11 context. In an individual Chapter 11, the bankruptcy estate is a separate taxpayer that is taxed at the rates established for married persons filing separately. 26 U.S.C. § 1398. A debtor in possession (“DIP”) is required to file a return individually (Form 1040), in addition to a return for the estate (Form 1041). If the debtor-in-possession (“DIP”) is also married, the DIP must file two separate forms for the estate (requiring taxes to be paid as “married filing separately”). Conversely in a Chapter 13, there is no separate taxable estate created – and the tax attributes remain with the individual debtor. Within the individual Chapter 11 case, however, the tax attributes of an individual debtor enter the bankruptcy estate and, as adjusted, pass back to the debtor when the estate is terminated. As a result, a married couple in a Chapter 11 case will most likely pay more taxes per year than a married couple outside of bankruptcy or in a Chapter 13 case, in addition to incurring the costs of hiring an accountant to determine the withholding and to file the returns. For example, if all other things are equal and a married couple has taxable income of $250,000, the married couple will pay about $12,500 more in federal income tax in a Chapter 11 case than a married couple filing a Chapter 13 case.3

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1 Taryn M. Darling Hill is an associate at the bankruptcy boutique, Crocker Kuno PLLC in Seattle, Washington.
Chapter 11 practitioner should inform the potential individual filers of the tax consequences in the individual Chapter 11 case so that they may better weigh the costs and benefits of an individual Chapter 11 filing.

Disclaimer: The Use of Steroids May Require Disclosure, and at Best, Discussion and Consideration of Potential Conflicts of the Representation.

Individual Chapter 11 cases create competing fiduciary obligations for debtors and counsel, which are not present in the Chapter 7 or 13 cases. In a Chapter 11 case, the debtor has a fiduciary duty to creditors and debtor’s counsel is counsel for the bankruptcy estate and therefore owes fiduciary obligations to the estate. These obligations present potential conflicts when the debtor, as an individual, has interests that are contrary to those of the estate. See, e.g., In re McClelland, 418 B.R. 61, 67 (Bankr. S.D.N.Y. 2009) (noting the difficulty inherent in the concept that the attorney represents the debtor-in-possession and the debtor’s estate, but not the debtor as an individual).⁴

Because counsel represents the estate and not the debtor individually, counsel has an independent responsibility to determine whether an action is likely to benefit the estate or will produce an advantage solely for the individual debtor. Although the individual may direct counsel to take certain actions, such action may cause counsel to doubt the value of such action to the estate, resulting in a potential conflict in her representation. Recent Chapter 11 case law further highlights this tension, as courts determine whether to permit employment of counsel and whether to allow fees of such counsel in Chapter 11 cases. The analysis turns upon how much value the representation is likely to net for the estate as compared to the individual debtor. In re Miell, 2009 U.S. Dist. LEXIS 73757 (N.D. Iowa, Aug. 19, 2009), is an example of a Chapter 11 case wherein, the district court affirmed the bankruptcy court in denying a motion to employ attorneys to represent the individual debtor in his pending criminal suits. In so holding, the court reasoned that in addition to failing to provide a statutory basis, the debtor could not establish that the attorneys he intended to compensate rendered services “in connection” with the bankruptcy or that such services would provide a benefit to the estate. Id. Similarly, in a decision in which the court did grant an individual Chapter 11 debtor’s motion to employ two law firms to represent her as special counsel in post-divorce motions and an appeal of a divorce decree, the court based its decision to approve the employment on the basis that the efforts of outside counsel would be directed at maximizing the value of the estate. In re Graves, 2008 Bankr. LEXIS 3244 (Bankr. S.D. Tex. Step. 4, 2008). Transmitting to counsel the import of its role for the estate, however, the Court warned counsel that approval of a subsequent fee application

⁴ Quoting also the ABA’s own: GHOSTS OF INDIVIDUAL CHAPTER 11 DEBTORS: ETHICAL ISSUES IN REPRESENTING DEBTORS IN INDIVIDUAL CHAPTER 11S UNDER BAPCPA: Part I, C.R. "Chip" Bowles Jr., American Bankruptcy Institute Journal, December 2006-January 2007: “[R]epresenting a debtor's bankruptcy estate in an individual chapter 11 is almost an out-of-body experience. . . . It stretches the bounds of legal fiction to comprehend the difference between the bankruptcy estate of an individual (your client) and the individual himself (not your client).”
would depend upon whether the services provided were reasonably likely to benefit the estate and to be deemed as necessary for the administration of the case. *Id.*

The current economic environment has presented practitioners with ample opportunities to provide clients with solutions to their economic distress. The body of law with which to apply such solutions and the effects of its application are largely untested, particularly with regard to roles, expectations, and consequences to individual Chapter 11 debtors and counsel. It is a brave new world which may allow us to provide feasible and creative solutions, but one that requires the balancing of various competing interests and considerations. May you chart your course with as few side effects as possible.

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Carving Back Coverage In Chapter 11:  
Don’t Forget The Debtor-In-Possession

Monika S. Wiener

Over the past two decades, so-called “insured vs. insured” ("IVI") exclusions typically included in corporate directors and officers liability ("D&O") insurance policies – which are designed to prevent collusive lawsuits filed by an insured corporation against its directors and officers in the hopes of recovering operational losses from the D&O insurer – have received significant attention from bankruptcy courts and commentators. With one reported exception, however, courts have not yet been called upon to analyze an important corollary to the IVI exclusion – the so-called “bankruptcy carve-back” endorsement.

Carve-back endorsements generally function as an exception to the IVI exclusion for claims brought by bankruptcy trustees, receivers, or other entities that stand in the shoes of the debtor for purposes of bringing claims on behalf of the bankruptcy estate, yet are not the same entity as the prepetition debtor. These endorsements emerged in the wake of conflicting decisions by various courts evaluating applicability of IVI exclusions to claims asserted by a bankruptcy trustee against former officers and directors of the debtor, and have since become a fixture in corporate D&O policies. While they provide much-needed clarity for insureds as to the extent of their D&O coverage in the event of a bankruptcy filing by the insured entity, they often do not go far enough. The endorsements do not necessarily apply to claims asserted by Chapter 11 debtors-in-possession and creditors trusts to which such claims are frequently assigned by the debtor-in-possession under a confirmed plan.

Kelley v. Federal Insurance Co. (In re HA 2003, Inc.) is the only reported case to date analyzing a bankruptcy carve-back endorsement. In Kelley, the endorsement in question rendered the IVI exclusion contained in the debtor’s D&O policy inapplicable to claims “brought by or on behalf of a bankruptcy trustee, magistrate or any other person

1 Monika S. Wiener is of counsel to Hennigan Bennett & Dorman LLP in Los Angeles. She practices in the firm’s Business Reorganization and Bankruptcy group. Views expressed herein are the author’s and are not attributable to Hennigan Bennett & Dorman LLP.
5 See Kokinda, supra n.3 (noting that despite widespread use of bankruptcy carve-backs, suits brought in the name of the insured organization by a creditor committee or debtor-in-possession “may or may not be covered”).
appointed by a bankruptcy court or judge, or authorized under applicable law to act on behalf of a debtor or brought by or on behalf of any creditor of the Insured Organization.” The insurer argued that the carve-back did not extend to claims brought by a Chapter 11 debtor-in-possession because (among other things) the endorsement did not specifically identify debtors-in-possession as falling within its terms, despite the fact that elsewhere in the policy, debtors-in-possession were expressly named. Although the court rejected this argument based on a finding that the debtor-in-possession was clearly a “person. . . authorized under applicable law to act on behalf of a debtor” and therefore covered by the endorsement, many carve-back endorsements will not contain such a clause, leaving considerable room for uncertainty as to whether suits by a debtor-in-possession are covered.

This uncertainty is exacerbated by the decision of the Ninth Circuit Court of Appeals in Biltmore Associates LLC v. Twin City Fire Insurance Co. – which, as it nears its one-year anniversary, remains the last word on the application of an IVI exclusion to claims brought by a Chapter 11 debtor-in-possession against the debtor’s former officers and directors. In Biltmore, the Ninth Circuit barred D&O coverage for a lawsuit that was initially brought by debtor Visitalk.com, Inc. (“Visitalk”) in its capacity as Chapter 11 debtor-in-possession against former directors and officers of the company, and subsequently assigned to a creditors’ trust pursuant to a confirmed plan. The court examined whether Visitalk, as debtor-in-possession (and by extension, the plan trustee), should be viewed as the same entity as the pre-filing debtor company under the relevant policy provisions and under the Bankruptcy Code, and concluded that it should, noting that “[t]he differences in the fiduciary responsibilities of Visitalk's management on account of bankruptcy. . . do not make Visitalk a different entity for purposes of the insured versus insured exclusion.”

The Ninth Circuit also looked to the underlying rationale for the IVI exclusion – to bar coverage for collusive claims filed by one insured against another. The court was troubled in this regard by the settlement reached by the plan trustee and the individual defendants, in which the defendants agreed to a confession of judgment in the amount of $175 million in favor of the plan trustee, coupled with a covenant not to execute against them personally and an assignment to the trust of the individual defendants’ rights as insureds under the company’s D&O policy.

The Ninth Circuit viewed this arrangement as indicative of precisely the type of moral hazard that gave rise to IVI exclusions in the first place, stating that permitting the plan trustee to proceed against the insurer “would create a perverse incentive for the

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7 Id. at 717.
8 Id. at 718-19.
9 Id.
10 572 F.3d 663 (9th Cir. 2009).
11 Id. at 673.
12 See id. at 668. The court in Kelley also noted that both parties had raised arguments concerning the likelihood of collusion between the debtor-in-possession and the defendants, but dismissed these arguments as irrelevant, stating that “[t]he court must interpret the contract based on its terms, not based on theoretical or real concerns about collusion.” 310 B.R. at 719.
principals of a failing business to bet the dwindling treasury on a lawsuit against themselves and a coverage action against their insurers, bailing the company out with the money from the D&O policy if they win, and giving themselves covenants not to execute if they lose.”

The court therefore concluded that “[t]he liability insurance that the corporation and its principals bought to protect against shareholders’ derivative suits cannot be turned into an available pot for the corporation's creditors by enforcing the insurers' obligations while disregarding the parties' agreement to limit those obligations to exclude insured versus insured claims.”

The Ninth Circuit’s sweeping denouncement of the practice of converting the proceeds of the debtor’s D&O insurance policy into an “available pot” for creditors merits a second look in light of the widespread emergence of bankruptcy carve-back endorsements, because the effect of such endorsements, broadly speaking, may be to do precisely that. In this sense, the moral hazard identified by the court in Biltmore is alive and well for companies with policies that include a bankruptcy carve-back. Nonetheless, the current prevalence of carve-backs in D&O policies would seem to indicate that insurers are willing (for a price, undoubtedly) to put up with the risk that the availability of coverage for lawsuits brought in the name of the bankrupt entity against its prepetition officers and directors will create a prepetition moral hazard for those individuals, and a post-petition windfall for creditors.

But there is also a more important lesson to be gleaned from the emergence of bankruptcy carve-backs: companies that purchase policies containing such provisions intend to protect against more than just shareholders’ derivative suits. They intend to protect against all kinds of personal liability for the insureds that might arise under a variety of circumstances, including insolvency. From the perspective of the insureds, it makes no difference whether they are sued by a bankruptcy trustee, a creditors committee, a plan trustee, or a Chapter 11 debtor-in-possession – they want to know that the coverage will be there if needed. Period.

For this reason, the Biltmore court’s concern with collusive post-petition lawsuits being filed by debtors in possession against the debtor’s prepetition management should be given little weight in coverage disputes involving bankruptcy carve-back endorsements. Subject to the language of the carve-back in question, courts should err on the side of finding that debtors-in-possession have been carved back in, even where they are not identified by name. And prospectively, companies shopping for D&O policies in these uncertain times should look for policies that include bankruptcy carve-backs that make explicit reference to debtors-in-possession.

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13 572 F.3d at 674.
14 Id.
15 This is true regardless of whether the carve-back is limited to court-appointed trustees, creditors committees, and other entities that are wholly separate from the debtor. Under the Biltmore court’s reasoning, the same moral hazard would exist. The Visitalk officers and directors could just as easily have reached the same settlement with a bankruptcy trustee or committee, resulting in a recovery for the estate if the coverage action was successful, with no potential downside for the individual defendants if it was not.
Settlements in Chapter 11: Fait Accompli or A New Opportunity to Retrace?

Robert P. Charbonneau

The Law loves a settlement. Settlements add a degree of certainty for business parties in the unpredictable world of litigation, and place those parties, to some extent, in control of their destinies. More than one judge has been overheard saying “a bad settlement is still better than a good lawsuit.” Settlements, especially when reached fairly early on in a proceeding, can often save the litigants enormous sums of money. This is why most courts are loathed to disturb a settlement reached between parties, and so enthusiastic about enforcing them when a party begins to get buyer’s remorse or cold feet.

Nowhere in the law is this more true than in bankruptcy. Assets are declining in value. Creditors and parties in interest seek to minimize losses and maximize value. So when the debtor, creditors and other major parties in interest present a settlement to the court that effectively resolves the case, you would be very hard pressed to find another court, let alone the very court that approved the settlement, to allow one of the parties to try and undo that which had already been negotiated and agreed, right? Yet that is exactly what happened in the rather curious case of In re W.B. Care Center. In W.B., the Debtor, a nursing home operator, had previously filed for bankruptcy on February 23, 2009. In an effort to resolve that case, the Debtor, Millennium Management, (the Debtor’s back office support provider), and Institutional Leasing 1, LLC, (the Debtor’s landlord and primary secured creditor), negotiated a settlement that involved, among other things, dismissal of the Debtor’s bankruptcy case, but without prejudice. While the parties articulated the terms of the settlement on the record, the parties ultimately added additional terms into the settlement agreement, and did not sign a settlement stipulation. Rather, they presented the agreement by inserting the terms into an agreed order. Judge John K. Olson, the judge presiding over the case, was unavailable to sign the settlement order, and so the duty judge signed the order in his absence.

Among other things, the settlement provided for the Debtor’s release of claims for preferences and fraudulent transfers against Institutional and others, and constituted a stipulation by the Debtor to the perfected security interest of Institutional in certain property of the Debtor.

In the intervening five months, the settlement between Institutional, Millennium, and the Debtor broke down. Institutional filed an eviction action against the Debtor, and the Debtor filed another Chapter 11 case. That case eventually found its way back to Judge Olson. Shortly after the filing of the second case, the Debtor filed a motion to reject the settlement in the prior case as an executory contract.

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1 Robert P. Charbonneau is a Partner with Ehrenstein Charbonneau Calderin in Miami, Florida, where he represents corporate debtors, secured lenders, creditors' committees, panel bankruptcy trustees, and individual creditors. The author wishes to thank Dan Gold, an associate with Ehrenstein Charbonneau Calderin, who provided invaluable assistance with the writing of this article.
2 Old English proverb.
In the motion to reject the settlement, the Debtor alleged that Institutional had induced the settlement by fraud. Judge Olson, however, found that he did not have to deal with such a fact intensive inquiry in resolving the Debtor’s motion as it simply sought rejection versus rescission of the prior agreement. In its motion, the Debtor argued that: (i) the prior settlement agreement, although memorialized as an order of the Court, was simply a contract, and not a judgment on the merits; and (ii) the settlement was executory, under both the classic “Countryman” definition, as well as under the Eleventh Circuit’s “Functional Approach.” Not surprisingly, Institutional argued that the settlement was an order of the Court, and could not simply be rejected under §365. Institutional further argued that even if the settlement order could be construed as a contract, it did not meet the “Functional Approach” test of the Eleventh Circuit for “executoriness,” and, even if it did, the Debtor could not get out of a prior stipulation to the perfection of a security interest in certain assets, nor out of certain releases of preferential and fraudulent transfers.

As a threshold issue, the Bankruptcy Court first found that, notwithstanding its approval by the Court, the prior settlement agreement was a contract between the parties. In reaching this conclusion, the Bankruptcy Court analyzed *Enterprise Energy Corp. v. United States (In re Columbia Gas System, Inc.),* 50 F.3d 233 (3d Cir. 1995). There, the Third Circuit Court of Appeals held that a similar court-approved settlement agreement, purporting to release claims against the debtor, was a “contract” and not a “judgment.” In *Columbia Gas,* a class of producers of natural gas, who were parties to gas purchase contracts with the debtor’s subsidiary, Columbia Gas Transmission Company (TCO), sued the subsidiary for breaches of the gas purchase contracts, alleging that TCO breached the contracts by paying less than the maximum price after it invoked a cost recovery clause in the contracts. *Id.* at 236. The class of aggrieved purchasers was certified, and the parties reached a settlement as trial approached. *Id.* Pursuant to the settlement, the class released TCO from all claims asserted by the plaintiff in exchange for TCO depositing $30 million into an escrow account. TCO was to pay the settlement funds into the escrow account in two installments of $15 million each. TCO made the first $15 million installment but then filed for bankruptcy. *Id.*

During the bankruptcy case, the former class members filed a motion to compel TCO to assume or reject the settlement agreement. TCO agreed to assume the settlement, and the parties filed a proposed order. *Id.* at 236-7. The IRS filed an objection, arguing that the settlement could not be assumed because it was not executory. The bankruptcy court sustained the objection and denied the motion to compel assumption. *Id.* In denying the motion to compel assumption, the bankruptcy court held that the settlement agreement was not a contract. *Id.* at 237, n.5. On appeal, the district court held that the settlement agreement was a contract, but affirmed the bankruptcy court on the grounds that the contract was not executory for purposes of §365. On further appeal, the Third Circuit affirmed the district court, holding that the settlement agreement was, indeed, a contract, but that it was not executory for purposes of rejection under §365.

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5 Judge Olson noted that a separate motion to vacate the prior order as having been procured by fraud pursuant to Rule 60 was pending at the time of the W.B. decision, but that motion was never prosecuted by the Debtor.

6 An executory contract is one “under which the obligation of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.” See Professor Vern Countryman, Executory Contracts in Bankruptcy, 57 Minn. L.Rev. 439, 446 (1973).
Like the district court in *Colombia Gas*, the Bankruptcy Court in *W.B.* accepted the debtor’s argument that the prior settlement agreement was a contract. The Bankruptcy Court found that the parties to the prior settlement agreement negotiated its terms and outlined those terms to the Bankruptcy Court at a hearing. In fact, during that hearing the Bankruptcy Court noted that it gave the parties ‘wide latitude’ to include additional terms into the settlement agreement not announced on the record at the hearing. The parties drafted the settlement agreement in the form of an order approving it, and it was approved without further hearing.

Institutional, which was opposing the Debtor’s attempts at rejection, attempted to distinguish *Colombia Gas*, which involved a settlement of class claims, to the treatment of classes of claims under Chapter 11 plans. Institutional argued that to treat settlement orders as mere contracts could undermine parties’ reliance upon confirmed Chapter 11 plans if such plans were to be interpreted as mere contracts and subject to rejection. The *W.B.* Court, however, rejected this argument, adopting the reasoning of the *Colombia Gas* court, noting that mere application of the Bankruptcy Code does not generally change the attributes of a legal relationship. Therefore, if a relationship was contractual outside of bankruptcy, it would remain so in bankruptcy.

The *W.B.* Court also took guidance from the Eleventh Circuit’s often cited opinion in *Wallis v. Justice Oaks II, Ltd. (In re Justice Oaks II, Ltd.)*, 898 F.2d 1544, 1549 (11th Cir. 1990) (‘*Justice Oaks II*”). In *Justice Oaks II*, the Eleventh Circuit noted that approval of a settlement is not necessarily an adjudication of an action on its merits, and therefore cannot be given preclusive effect in a subsequent action or proceeding. The *W.B.* Court noted that while the prior settlement was judicially approved, that approval did not touch upon or involve an adjudication of the merits of the various issues presented to the *W.B.* Court in the settlement agreement.

In granting the Debtor’s motion to reject the prior settlement agreement under Section 365, the *W.B.* Court noted that, while the Eleventh Circuit has approved the use of the Functional Test to analyze whether an agreement is executory for purposes of assumption or rejection, the Eleventh Circuit had not adopted the Functional Test outright, and therefore analyzed “executoriness” of the prior settlement agreement under both the Functional Test and the more traditional Countryman definition. The *W.B.* Court found the settlement agreement was a contract under which performance remained due by both parties, thus satisfying the Countryman definition. The *W.B.* Court further found that, even if one side or the other had fully performed under the prior settlement agreement, the Eleventh Circuit’s “amenable” approach to the Functional Test of interpreting agreements favored finding “executoriness” in the contract if such a classification benefits the bankruptcy estate. *Thompkins v. Lil’ Joe Records, Inc.*, 476 F.3d 1294, 1306 n.13 (11th Cir. 2007).

This analysis was critical to the *W.B.* Court’s holding because the Debtor was, through the rejection process, attempting to reject a settlement where the Debtor (i) stipulated to the perfection of Institutional’s security interest, (ii) approved broad release provisions in favor of Institutional and a number of related individuals, and (iii) confirmed the validity and force of a number of other agreements between the Debtor, Institutional, and a number of affiliates. So while the *W.B.* Court authorized rejection under Section 365, the Court reminded the Debtor that rejection constitutes a pre-petition breach of the agreement, and not a rescission, repudiation or cancellation of the agreement. Because of this, Institutional argued, a rejection victory for the
Debtor would be merely pyrrhic in nature, and would not grant the Debtor any effective relief from its prior settlement agreement with Institutional.

In an opinion with something for everyone, the *W.B.* Court agreed with Institutional to the extent provisions of the settlement agreement required no prospective performance. The Court noted, however, that the release and enforceability provisions of the settlement agreement did require prospective performance. While the Court found that rejection does not equal rescission, its approach to the Debtor’s stipulation to Institutional’s perfected status was neither rejection nor rescission. Rather, the *W.B.* Court found that these particular provisions did not require any prospective performance by either party, but were, *ipso facto*, invalid and unenforceable because perfection of security interests is a question of law, to be determined by the Court, and a private agreement between parties cannot change applicable law on the question of perfection.

The Court next focused on the language of the settlement agreement dealing with mutual releases of liability for causes of action accruing between the parties prior to February 27, 2009. The Court began its analysis by noting that it would at first appear that no performance remained due from either party under the release. The Court, however, observed that the Ninth Circuit, in *Everex Systems, Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673 (9th Cir. 1996), held that waivers of the right to sue are covenants not to sue, and therefore do involve prospective performance. Judge Olson noted that this view has been adopted by bankruptcy courts in Delaware and in the Eleventh Circuit as well. See *Jacob Maxwell, Inc. v. Veeck*, 110 F.3d 749, 753 (11th Cir. 1997); and *In re Access Beyond Techs., Inc.*, 237 B.R. 32, 44 (Bankr. D. Del. 1999). Judge Olson distinguished, however, a covenant not to sue from a release. With the former, settling parties enter into a covenant not to sue only where the grant of a release would affect the release of non-settling parties (such as joint tortfeasors) as a matter of law. Judge Olson noted that, while a breach of a covenant not to sue gives rise to a counterclaim for damages, a covenant not to sue constitutes a promise not to sue a party on a claim, but does not modify or extinguish the claim itself.

By contrast, a release terminates the enforceability of a claim. A release gives rise to an affirmative defense under Fed. R. Bankr. P. 7008, applying Fed. R. Civ. P. 8(c)(1), and that defense is generally complete absent fraud, failure of consideration, and the like. The *W.B.* Court found that the Debtor and Institutional had indeed released each other, that any claims were extinguished and therefore that aspect of the settlement agreement was not executory.

Given the reasoning of the *W.B.* Court and the analysis of the *Columbia Gas and CFLC, Inc.* decisions, settling parties in bankruptcy cases should be leery of covenants not to sue. Settling parties may also want to consider additional recitals under any settlement stipulation that satisfactorily addresses the potential ‘executoriness’ of the settlement, under both the Countrymen and Functional approaches to interpretation of agreements under Section 365. If the parties to a settlement intend to keep the settlement agreement intact, which may include a covenant not to sue or a release, despite a potential bankruptcy of either party, then they should include recitals that account for and preclude possible rejection under 365 of the Bankruptcy Code.
“Red Flag” Rules:

The Red Flag Rules were promulgated under the Fair and Accurate Credit Transactions ("FACT") and require financial institutions and other creditors with covered accounts to have in place identity theft prevention programs to identify, detect and respond to patterns, practices or specific activities that could indicate identity theft. Although originally intended to take effect on November 1, 2009, the FTC has delayed implementation of the Red Flag Rules five times, most recently on May 28, 2010, when implementation and enforcement was postponed until December 31, 2010.

The ABA has challenged the Red Flag Rules, arguing in American Bar Association v. Federal Trade Commission, Case No. 09-1636 (RBW), that the FTC should be prohibited from applying the rules to practicing attorneys, which, under the present language, could be included in the broadly-defined category of creditors. One reason for the FTC’s repeated decisions to delay implementation of the rules is to allow Congress to address concerns related to the FTC’s broad interpretation of the rules, including those raised by the ABA.

On October 8, 2009, Representative John Adler (D-NJ) introduced HR 3763, which would exempt certain businesses from the Red Flag Rules. Under Adler’s bill, health care, accounting and legal practices with 20 or fewer employees would not be included as creditors, and the FTC would be required to issue rules allowing other businesses to apply for an exemption from the
rules. The House passed the Bill on October 20, 2009, and the Senate subsequently referred the Bill to the Committee on Banking, Housing and Urban Affairs, where no significant action has been taken.

Senator John Thune (R-SD) introduced S 3416 on May 25, 2010. Like its House counterpart, SB 3416 would exclude health care, accounting and legal practices with 20 or fewer employees from the reporting requirements of the Red Flag Rules. Other businesses could apply for exemptions as well, subject to a determination by the FTC that the business either (1) knows all of its customers or clients individually, (2) only performs services in or around the residences of its customers, or (3) has not experienced incidents of identity theft and identity theft is rare for businesses of that type. Upon introduction, S 3416 was referred to the Committee on Banking, Housing, and Urban Affairs and no further action has been reported.

Protecting Employees and Retirees in Business Bankruptcies Act of 2010

Representative John Conyers (D-MI) introduced HR 4677 on February 24, 2010. The Bill would revise numerous provisions of the Bankruptcy Code relating to claims held by employees and retirees. A non-exhaustive summary of some of the major provisions of the Bill follows.

The Bill would increase the amount of a claim for unpaid wages, salaries or commissions in the fourth order of priority in Section 507 to $20,000 from $11,725, and would include within the scope of a claim certain equity securities held in some defined contribution plans, but only where the bankrupt employer has committed fraud or breached some duty to the participant which caused the loss of value. Severance pay owed to certain employees and damages incurred due to certain violations of law by the debtor would also be allowed as administrative expense claims.

In order to confirm a plan of reorganization, a debtor must provide for (1) recovery of damages payable for the rejection of a collective bargaining agreement, (2) continued payment of retiree benefits established pre-petition, and (3) recovery of claims arising from the modification of retiree benefits.

In approving a sale of business assets, the Bill would require a court to consider certain facts, beyond simply what constitutes the highest and best offer, including: the extent to which a bidder has offered to maintain existing jobs, preserved the terms and conditions of employment, and assumed or matched pension and retiree health benefit obligations.

If either (1) the debtor has moved to reject a collective bargaining agreement and a labor organization has proposed an alternative plan which is reasonably likely to be confirmed in a reasonable time, or (2) another party has proposed to file an alternative plan which would incorporate some settlement with the labor organization and said plan is reasonably likely to be confirmed within a reasonable time, the Bill would enable the court to reduce the debtor’s time frame for filing a plan.

The Bill sets strict limits on any payments or distributions to insiders, senior executive officers and other highly compensated employees in confirming a proposed plan of reorganization.
Labor organizations would be treated as creditors for the purpose of filing a proof of claim.

On March 19, 2010, the Bill was referred to the Subcommittee on Commercial and Administrative Law, where hearings were held on May 25, 2010.

A companion Senate bill was also introduced by Senator Richard Durbin (D-IL) on February 24, 2010. S 3033 was referred to the Judiciary Committee and no further action has been reported.

**Private Student Loan Bankruptcy Fairness Act of 2010 (HR 5043) / Fairness for Struggling Students Act of 2010 (S 3219)**

Representative Steve Cohen (D-TN) introduced HR 5043 on April 15, 2010, which would amend the Bankruptcy Code to remove qualified educational loans as an exception to discharge from bankruptcy. The Bill would make debt resulting from student loans issued by private, for-profit institutions dischargeable in bankruptcy. Student loans funded by nonprofit institutions would remain non-dischargeable. The Bill is currently before the Subcommittee on Commercial and Administrative Law, where hearings were held on April 22, 2010.

A companion to HR 5043 was also introduced in the Senate on April 15, 2010 by Senator Richard Durbin (D-IL), where it was referred to the Judiciary Committee. No further action on S 3219 has been reported.

**HR 4729 – To clarify the situations in which a corporation may be treated as a person under Federal law**

Representative Linda Sanchez introduced HR 4729 on March 2, 2010, which provides that a corporation shall be considered a person under Federal law only for purposes of, *inter alia*, the ability to declare bankruptcy. The Bill was referred to the Committee on House Administration and the Judiciary Committee and no further action has been reported.

**United States Covered Bond Act of 2010**

Representative Scott Garrett (R-NJ) introduced HR 4884 on March 18, 2010. The Bill would direct the Secretary of the Treasury (or its designee) to establish a regulatory oversight program for specified senior recourse debt obligations and an eligible issuer.

The covered bond regulator would be required to: (1) consult with the primary federal regulator of an eligible issuer before approving any covered bond program, and (2) maintain a registry on a website available to the public containing the name of each approved covered bond program and information on all outstanding covered bonds issued thereunder.

The Bill prescribes procedures governing the default and insolvency of a covered bond both prior and subsequent to any conservatorship, receivership, liquidation or bankruptcy of the issuer, including requiring the covered bond regulator to act as trustee of the estate, which would be comprised of the applicable cover pool.
The Bill has been referred to the Committee on Financial Services and the Ways and Means Committee and no further action has been reported.

Helping Families Save Their Homes Act of 2009 (S 895)

This Bill would authorize, in specified circumstances, the reduction of a claim secured by the debtor's principal residence in a chapter 13 case. The requirements to modify a home loan are as follows:

The chapter 13 plan cannot modify a home loan unless the debtor certifies that (a) not less than 30 days before the commencement of the case, the debtor contacted the lender regarding a loan modification; the debtor provided the lender with a written statement of the debtor's current income, expenses, and debt; and considered any qualified loan modification offered to the debtor by the lender, or (b) a foreclosure sale is scheduled to occur on a date in the 30-day period beginning on the petition date.

Home loans may be modified as follows under the Bill:

(1) Payment of the secured claim may be determined under section 506(a)(1) of the Bankruptcy Code. In determining a holder's allowed secured claim under section 506(a)(1), the value of the debtor's principal residence shall be the fair market value of such residence on the date such value is determined and, if the issue of value is contested, the court shall determine such value in accordance with the appraisal rules used by the Federal Housing Administration.

(2) Any applicable adjustable rate of interest under the loan may be frozen as of the petition date. The interest rate may be set at a fixed annual rate equal to the average prime offer rate as of the petition date.

(3) The loan may be modified by extending the repayment period up to 40 years.

A claim may be reduced only on the condition that if the debtor sells the principal residence securing such claim before completing all payments under the plan or receiving a discharge, and the debtor receives net proceeds from the sale, then the debtor must agree to pay to the holder of the claim not later than 15 days after receiving proceeds (1) if such residence is sold in the first year after the plan's effective date, 90% of the amount of the difference between the sales price and the amount of such claim as modified, but not to exceed the unpaid amount of the allowed secured claim; (2) if such residence is sold in the second through fifth year after the plan's effective date, 70%, 50%, 30%, and 10% of the difference between the sales price and the amount of such claim as modified, respectively.

The computation of debts under section 109(e) of the Bankruptcy Code shall not include (1) debts secured by the debtor's principal residence or debts secured or formerly secured by what was the debtor's principal residence that was sold in foreclosure or surrendered to the creditor as

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1 A "qualified loan modification" means a loan modification agreement made in accordance with the guidelines of the Obama Administration's Homeowner Affordability Plan (which reduces the debtor's payments to a percentage of the debtor's income) and permits payments to the lender notwithstanding the debtor's filing of a bankruptcy case.
of the petition date so long as such debt is less than the applicable maximum amount of noncontingent, liquidated, secured debts specified in section 109(e).

The requirement that the debtor received credit counseling within the 180-day period prior to the date of commencing the chapter 13 case is met if the debtor provides a certificate that the debtor has received notice that the holder of the secured claim may commence foreclosure on the debtor's principal residence and such certificate is considered satisfied if made within 30 days of the petition date.

The Congressional Research Service has summarized additional terms of the Bill as follows:

Requires the court to disallow a claim that is subject to any remedy for statutory rescission, notwithstanding a prior foreclosure judgment.

Excludes from the final discharge of debts any unpaid portion of a reduced claim.

Amends the federal judicial code to prescribe standing trustee fees regarding certain payments received under a Chapter 13 bankruptcy plan.

Expands federal procedures governing default on veterans' housing loans. Authorizes the Secretary of Veterans Affairs, in the event of a modification in bankruptcy, but only in specified circumstances, to pay the holder of the obligation the unpaid balance that is due as of the filing date of the bankruptcy petition.

Amends the National Housing Act to authorize the Secretary of Housing and Urban Development (HUD) to: (1) pay Federal Housing Administration (FHA) mortgage insurance benefits for a mortgage modified under federal bankruptcy law; and (2) implement a program to encourage loan modifications for eligible delinquent mortgages through the payment of insurance benefits, assignment of the mortgage to the Secretary, and mortgagee-approved loan modification.

Amends the Housing Act of 1949 to authorize the Secretary of Agriculture to pay: (1) the guaranteed portion of losses incurred by mortgage holders or servicers that result from a modification in a bankruptcy proceeding; and (2) for losses incurred in the event of a modification pursuant to a bankruptcy proceeding.

Declares certain investment contracts contrary to public policy and, therefore, unenforceable.

Shields loan servicers from liability for implementing mortgage loan modifications or loss mitigation plans as long as they are in compliance with certain fiduciary duties.

Amends the National Housing Act to modify the HOPE for Homeowners Program (HOPE).

Reduces the limit on the Secretary of the Treasury's authority to purchase troubled assets under the Troubled Asset Relief Program (TARP).

Amends the Federal Deposit Insurance Act ("FDIA") and the Federal Credit Union Act ("FCUA") to increase: (1) deposit insurance coverage permanently to $250,000; and (2) the borrowing authority of the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration (NCUA).
Amends the FDIA to: (1) extend the time period applicable to a Deposit Insurance Fund (DIF) restoration plan; and (2) revise requirements for special assessments to recover DIF losses arising from actions taken to contain systemic risk in connection with certain insured depository institutions.

Amends the FCUA to direct the NCUA Board to establish a National Credit Union Share Insurance Fund Restoration Plan whenever the Board projects that the equity ratio of the National Credit Union Share Insurance Fund will fall below a minimum designated equity ratio.

Expresses the sense of Congress that: (1) the Secretary of the Treasury should use specified funds to purchase mortgage revenue bonds for single-family housing issued through state housing finance agencies and local governmental entities; and (2) certain foreclosures on a principal dwelling should not be initiated until the foreclosure mitigation provisions of this Act and the President's "Homeowner Affordability and Stability Plan" have been implemented and determined to be operational.

Nationwide Mortgage Fraud Task Force Act of 2009 - Establishes in the Department of Justice the Nationwide Mortgage Fraud Task Force.


Bankruptcy Judgeships Act of 2010 (H.R. 4506):

On May 27, 2010, the Bill was placed on the Senate Legislative Calendar. See April 20, 2010 Legislative Update for further information on this Bill.


Senator Specter (D-PA) and Congressman Nadler (D-NY) each introduced these Bills in 2009 to overturn the Supreme Court's opinion in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007). In *Twombly* the Supreme Court displaced the liberal, "no-set-of-facts" pleading standard enunciated in *Conley v. Gibson*, 355 U.S. 41 (1957), for the more exacting "plausibility" standard to be applied under Fed. R. Civ. P. 8. While *Twombly* involved a motion to dismiss an antitrust complaint under the Sherman Act, the new plausibility standard implicates complaints filed in adversary cases.

Under *Twombly* courts should not assume the truth of mere legal conclusions in the context of a motion to dismiss. At a minimum, legal conclusions must be supported by well-plead factual allegations. "Threadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice." *Ashcroft v. Iqbal*, 129 S.Ct. 1937, 1949 (2009) (citing *Twombly*, 550 U.S. at 556). While courts must assume the veracity of factual allegations in the context of a motion to dismiss, courts are now directed to determine whether the factual allegations of a complaint "plausibly give rise to an entitlement to relief." The Supreme Court instructs that "a claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Id. Ashcroft* also made clear that the new plausibility standard applies in all cases.
The plausibility standard contrasts markedly with the no-set-of-facts pleading standard set forth in *Gibson*. The Bills seek to again impose *Gibson's* more liberal pleading standard. The Bills would prohibit a court from dismissing a complaint under subdivisions (b)(6), (c) or (e) of Fed. R. Civ. P. 12, "unless it appears beyond doubt that the plaintiff can prove no set of facts in support of the claim which would entitle the plaintiff to relief." Under the Bills, a court shall not dismiss a complaint "on the basis of a determination by the judge that the factual contents of the complaint do not show the plaintiff's claim to be plausible or are insufficient to warrant a reasonable inference that the defendant is liable for the misconduct alleged."


Last Major Action (S 1504): 7/22/2009 Referred to Senate committee. Status: Read twice and referred to the Committee on the Judiciary.

**Restoring American Financial Stability Act of 2010 (Too Big to Fail) (S 3217/ HR 4173)**

S 3217 was introduced by Senator Chris Dodd (D-CT) on April 15, 2010. The Bill would establish a Financial Stability Oversight Council to: (1) identify risks to the financial stability of the United States, (2) promote market discipline, and (3) respond to emerging threats to financial markets.

Senator Jeff Sessions (R-AL) proposed an amendment to the Bill on May 12, 2010, which would have provided an orderly and transparent bankruptcy process for non-bank financial institutions and would prohibit bailout authority. This amendment was rejected in the Senate by a 58-42 vote.

On May 20, 2010, the Senate incorporated the Bill into companion bill HR 4173, as an amendment to the House bill, and passed HR 4173 in lieu of S 3217.

HR 4173 is currently in conference between House and Senate negotiators.

There follows a summary, prepared by the Financial Institutions Group of Covington & Burling LLP, comparing the key provisions of the new systemic risk regulation and systemic resolution legislation that has been passed by the House and Senate and that is now in conference.
E-ALERT | Financial Institutions

June 2, 2010

FINANCIAL REGULATORY REFORM LEGISLATION

SYSTEMIC RISK REGULATION AND RESOLUTION OF SYSTEMICALLY IMPORTANT FIRMS

On May 20, 2010, the Senate passed the Restoring American Financial Stability Act of 2010 (S. 3217). The Senate bill must now be reconciled through the conference process with the House’s version of financial regulatory reform legislation, which was passed in December 2009.¹

Both the House- and Senate-passed legislation would subject systemically important financial firms to heightened prudential regulation by the Federal Reserve. Also, both bills would establish a regime for resolving systemically important financial firms outside of traditional bankruptcy processes.

Below is a side-by-side comparison that summarizes the key elements of the Senate and House bills regarding systemic risk regulation and the resolution of systemically important firms, including the principal respects in which the Senate-passed legislation differs from the House-passed legislation.

If you have any questions regarding the two bills, please feel free to contact the Covington attorneys listed at the end of this alert or any other members of Covington’s Financial Institutions Group.

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<tr>
<td><strong>SYSTEMIC RISK REGULATION</strong></td>
<td>Senate Bill Differences – Senate Bill’s overall approach to systemic risk regulation is similar to the House Bill’s approach, but is different in a number of significant respects including:</td>
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<tr>
<td>■ Potential Applicability – Any U.S. company, or any foreign company with “significant” U.S. operations, engaged, “in whole or in part, directly or indirectly,” in any “financial activities,” including depository institutions (a “financial company”) may be designated by the Financial Services Oversight Council (“FSOC”) for systemic risk regulation by the Fed.</td>
<td>■ <strong>Automatic Applicability</strong> - All bank holding companies (“BHCs”) with total consolidated assets of $50 billion or more are automatically subject to systemic risk regulation by the Fed unless the Fed establishes a higher asset cutoff for BHCs (“automatically covered BHCs”).</td>
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<td>■ FSOC Identification as Systemically Important Financial Companies – By FSOC designation, taking into account the threat to U.S. financial stability and U.S. economy posed by “material financial distress” at a financial company or “nature, scope, size, scale, concentration and interconnectedness, or</td>
<td>■ <strong>Potential Applicability</strong> - Any U.S. or foreign company (other than a BHC or subsidiary thereof) “predominantly engaged in financial activities” in the United States may be designated by the Financial Stability</td>
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</table>

**House Bill**

- **Automatic Exclusions From Identification** – None.

- **Consequences of Identification** – Include being subject to:
  - Stricter prudential standards established by Fed for identified company, including risk-based capital requirements (taking into account off-balance sheet exposures), leverage limits, liquidity requirements, concentration requirements, and overall risk-management requirements.
  - “Well-capitalized” and “well-managed” requirements (as defined by Fed).
  - Maximum leverage limit of 15-to-1 “debt to equity” (and possible short-term debt limits as established by Fed regulation).
  - Limit on maximum credit exposure to any unaffiliated company of 25 percent (unless Fed specifies lower amount by regulation).
  - “Rapid Resolution” plan requirement (as implemented by joint Fed and FDIC regulations).
  - Treatment as financial holding company for purposes of sections 4 (nonbanking activities), 5 (reports and examinations) and 8 (penalties) of BHC Act if not otherwise a BHC (subject to creation of separate intermediary holding company if engaged in activities not “financial in nature” within meaning of section 4(k) of the BHC Act).
  - Steps to mitigate risk (e.g., additional prudential standards, activity restrictions, required asset divestitures) based on FSOC determination that company’s size or activities pose a “grave threat” to U.S. financial stability or U.S. economy.
  - Fed authority to require by regulation maintenance of minimum amount of “long-term hybrid debt” convertible to equity if company fails to meet specified

**Senate Bill**

- Oversight Council (“FSOC”) for systemic risk regulation by the Fed.
  - A company is “predominantly engaged in financial activities” if either (i) the annual gross revenue derived by the company and all of its subsidiaries from activities that are “financial in nature” (as defined in section 4(k) of the Bank Holding Company Act) represents 85 percent or more of the consolidated annual gross revenues of the company or (ii) the consolidated assets of the company and all of its subsidiaries related to activities that are “financial in nature” represents 85 percent or more of the consolidated assets of the company.

- **Exclusions from Identification** - The Fed is required to promulgate regulations setting forth criteria for exempting certain types or classes of Financial companies from supervision by the Fed.

- **Anti-Evasion Authority** - FSOC can designate any company for systemic risk regulation by the Fed if it finds that material financial distress related to the company's financial activities would pose a threat to U.S. financial stability and that the company is organized or operates in such a manner as to evade FSOC designation.

- **Consequences of Identification** - FSOC to make recommendations to Fed concerning the establishment and refinement of prudential standards applicable to systemically important firms, including automatically covered BHCs.
  - Subject to specific minimum leverage capital and risk-based capital requirements to be established by the Fed.
  - No statutorily prescribed leverage limitation, but Fed is empowered to impose such a limitation.
  - May not merge or acquire a company if the total consolidated liabilities of the resulting company would exceed 10 percent of the aggregated consolidated liabilities.
prudential standards and Fed determines threat to U.S. financial system stability makes conversion necessary.

- Fed authority to prohibit proprietary trading (subject to Fed authorized exceptions).
- Annual stress tests by Fed; quarterly self-stress tests and reporting.
- Assessment (except generally firms with less than $50 billion in assets) for Systemic Dissolution Fund to cover cost of resolving systemically important firms.

**FSOC Identification of Systemically Important Activities and Practices** – Any “financial activity or practice” may be determined by FSOC to be systemically important based on the potential effect of the “conduct, size, scale, concentration, or interconnectedness” on U.S. financial stability or the U.S. economy.

- Fed to recommend stricter prudential standards for identified activities or practices to primary regulators.
- Primary regulators must notify FSOC and Fed whether they have imposed the stricter prudential standards recommended by Fed and provide “specific justification” to extent they have not done so.

**FSOC Recommendations to Any Federal Financial Regulator** – FSOC also authorized to issue to any federal financial regulator “formal recommendations” that it adopt stricter prudential standards for firms it regulates “to mitigate systemic risk.”

- Federal regulators receiving such formal recommendations must notify FSOC as to implementation action taken or reasons for not adopting recommendations.

**Preemption** – Stricter prudential standards established or recommended by the Fed or the FSOC do not preempt:

- Any consumer protection standards promulgated under a state or federal liabilities of all financial companies.

- Treatment as BHC for purposes of section 3 of the BHC Act (prior approval for certain acquisitions of interests in banks or BHCs) and the Depository Institutions Management Interlocks Act (prohibiting in certain circumstances service as a director or senior management of another systemically important firm or BHC with more than $50 billion in assets).

- Prior notice required before acquiring any company that conducts financial activities having total consolidated assets of $10 billion or more.

- Required reporting of the company’s credit exposure to other systemically important firms and systemically important firms’ exposure to the company.

- For systemically important firms (and also for BHCs with at least $10 billion in assets that are publicly traded), required establishment of a risk committee.

- Fed may require systemically important firms that conduct both financial and non-financial activities to establish an intermediate holding company to conduct the financial activities.

- Fed may impose escalating remediation requirements if the company experiences increasing financial distress.

- Potential assessment for Orderly Resolution Fund (with no asset threshold) to cover cost of resolving systemically important firms.

- Assessment to pay for costs and expenses of new Office of Financial Research within the Department of the Treasury (following two years after the Bill’s enactment).

**FSOC Identification of Systemically Important Activities and Practices** - Also authorizes FSOC to identify systemically important activities and practices for which Fed is to
### HOUSE BILL

- consumer protection law, including the Consumer Financial Protection Act and the Federal Trade Commission Act.
  - Any investor protection standard that protects consumers and that is imposed under state or federal securities laws.

**Other Exposure of Financial Companies (Even if Not Identified as Systemically Important)**

- Financial companies with total assets of more than $10 billion required to conduct semi-annual self-administered stress tests, and to report results to Fed.
- Financial companies (generally with $50 billion or more in total assets) that are engaged “predominantly” in activities permitted under section 4(k) of the BHC Act subject to FDIC assessment for Systemic Dissolution Fund to cover cost of resolving systematically important firms.
- All financial companies subject to FDIC assessment to cover “any shortfall in TARP” that would “add to the deficit or national debt.”

### SENATE BILL

- recommend stricter prudential standards to primary regulators.
  - FSOC Recommendations to Any Federal Financial Regulator - FSOC not authorized to recommend stricter prudential standards to any federal financial regulator.

**Other Exposure of Financial Companies (Even if Not Identified as Systemically Important)**

- No provision requiring financial companies with total assets of more than $10 billion to conduct semi-annual self-administered stress tests.
- Financial companies with $50 billion or more in total assets that are engaged “predominantly” in activities permitted under section 4(k) of the BHC Act subject to FDIC assessment, in limited circumstances, for Orderly Resolution Fund to cover cost of resolving systematically important firms.
- No provision subjecting financial companies to FDIC assessment to cover “any shortfall in TARP” that would “add to the deficit or national debt.”

### RESOLUTION OF SYSTEMATICALLY IMPORTANT FIRMS

#### Potential Applicability - Any financial company, defined as any BHC, financial company subject to stricter prudential standards, any insurance company, any company engaged predominantly in activities permissible under section 4(k) of the BHC Act, or any subsidiary of such a company (other than an insured depository institution or an SIPC member), may be designated by the Secretary of the Treasury for resolution by the FDIC.

#### “Covered Financial Company” - A financial company as to which Secretary of the Treasury, upon recommendation of Fed and FDIC (or SEC) (and the relevant state insurance authority if the company or an affiliate is an insurance company), has determined that: (i) the company is in default or danger of default; (ii) its failure and

### RESOLUTION OF SYSTEMATICALLY IMPORTANT FIRMS

#### Senate Bill Differences – Senate Bill’s systemic resolution authority provisions are generally comparable to those of House Bill, with following principal exceptions:

- **Purpose of Resolution Regime** - Provides authority to liquidate failing financial companies that pose a significant risk to U.S. financial stability in a manner that mitigates risk and minimizes moral hazard, with the presumption that (i) creditors and shareholders will bear all losses, (ii) management responsible for the company’s condition will not be retained, and (iii) the FDIC will take all steps necessary and appropriate to assure that all parties (including management and third parties) having responsibility for the company’s condition will bear losses consistent with
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| resolution under otherwise applicable law would have “serious adverse effects” on U.S. financial stability or U.S. economic conditions; and (iii) its resolution under this new authority would avoid or mitigate such adverse effects.  
- There is an express “strong presumption” that resolution under the bankruptcy laws will remain the “primary method” of resolving financial companies, and systemic dissolution authority is “only [to] be used in the most exigent circumstances.”  
- With the approval of the Secretary of the Treasury and after consulting with the FSOC, the FDIC may at any time convert a systemic dissolution receivership to a proceeding under chapter 7 or 11 of the federal Bankruptcy Code; and the FDIC may serve as trustee for the covered financial company in bankruptcy. | their responsibility.  
- **Potential Applicability** - Any financial company, defined as any BHC, financial company designated by the FSOC and subject to Fed regulation, any company predominantly engaged in activities “financial in nature” that are permissible under section 4(k) of the BHC Act, or any subsidiary of such a company (other than an insured depository institution or an insurance company), may be designated by the Secretary of the Treasury for resolution by the FDIC.  
- A company is not predominantly engaged in activities “financial in nature” that are permissible under section 4(k) if the consolidated revenues of such company from such activities constitute less than 85 percent of the total consolidated revenues of the company.  
- **“Covered Financial Company”** – A financial company for which the Secretary of the Treasury has made the required determination and the United States District Court for the District of Columbia has approved the Secretary’s appointment of the FDIC as receiver for the company.  
- Secretary must determine that: (i) the company is in default or in danger of default, (ii) the failure of the company or its resolution under otherwise applicable federal and state laws would have serious adverse effects on financial stability in the United States, (iii) no viable private sector alternative is available to prevent the company’s default, (iv) effects on the company’s creditors, counterparties, and shareholders as a result of actions taken by the FDIC are appropriate given the corresponding impact on U.S. financial stability, (v) any actions would avoid or mitigate adverse effects, taking into consideration the action’s effectiveness in mitigating potential adverse effects on the financial system, cost to the Treasury general fund, and the potential to |
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<td>Government, a U.S. agency, a GSE, the Fed or a Federal Reserve Bank, or secured by real property) as an unsecured credit.</td>
<td>increase excessive risk taking on the part of creditors, counterparties, and shareholders of the company, and (vi) a federal regulatory authority has ordered the company to convert all of its convertible debt instruments subject to regulator order.</td>
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<tr>
<td>Limits on FDIC Powers as Receiver</td>
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<td>FDIC is to impose risk-based assessments on financial companies with $50 billion or more in assets (except a financial company that manages a &quot;hedge fund,&quot; as defined by the FDIC, is subject to assessment if it has $10 billion or more in assets).</td>
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<tr>
<td>FDIC Receipt of Warrants – FDIC may obtain warrants as consideration for any payment, credit extension or guarantee provided for the benefit of a covered financial company.</td>
<td>FDIC is to administer the Systemic Dissolution Fund, and must do so separately from the FDIC Deposit Insurance Fund.</td>
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<td>FDIC is directed to build the Systemic Dissolution Fund to, and to maintain the Fund at, $150 billion.</td>
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<tr>
<td>FDIC is to administer the Systemic Dissolution Fund, and must do so separately from the FDIC Deposit Insurance Fund.</td>
<td>FDIC is authorized to borrow funds from Treasury if necessary to permit the orderly dissolution of one or more covered financial companies (due to lack of sufficient funds in the Systemic Dissolution Fund), but any borrowed amounts must be repaid, with interest, through assessments on financial companies (as described above).</td>
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<tr>
<td>FDIC is authorized to make additional payments, beyond the amount that would be allocated under the standard receivership process, to certain claimants (subject to clawback of such additional payments if necessary if available funds for orderly liquidation otherwise insufficient (see below)).</td>
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<td>FDIC As Receiver - FDIC authorized to provide funds for the “orderly liquidation” of the covered financial company.</td>
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</tr>
<tr>
<td>FDIC takes over company’s assets and operates company with all powers of the members, shareholders, directors, and officers.</td>
<td>Bankruptcy laws expressly deemed applicable to financial companies for which the Secretary has not made the required determination.</td>
</tr>
<tr>
<td>FDIC not authorized to treat up to 10 percent of certain security interests as unsecured credits.</td>
<td>FDIC Receipt of Warrants - FDIC not authorized to obtain warrants as consideration for any benefits provided to financial company.</td>
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<td>FDIC authorized to make additional payments, beyond the amount that would be allocated under the standard receivership process, to certain claimants (subject to clawback of such additional payments if necessary if available funds for orderly liquidation otherwise insufficient (see below)).</td>
<td>Funding of FDIC Receivership - FDIC directed to make available to the receivership funds for the orderly liquidation of the company from the Orderly Liquidation Fund.</td>
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| Orderly Liquidation Fund - Proceeds only available if FDIC develops and submits an orderly liquidation plan that is | }
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<td>acceptable to Treasury.</td>
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<td>✓ FDIC Assessment Authority</td>
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<td>o FDIC first to impose assessments on claimants that receive additional payments, except for payments to initiate and continue operations essential to implementation of the receivership and other payments.</td>
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<td>o FDIC next to impose risk-based assessments on “eligible companies” (bank holding companies with assets equal to or greater than $50 billion and on financial companies designated by the FSOC and regulated by the Fed) and financial companies with assets equal to or greater than $50 billion (that are not eligible companies).</td>
<td></td>
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Attorneys in Covington’s Financial Institutions Group advise a range of clients on recent financial services and banking developments. The Financial Institutions Group’s expertise derives from advising clients on the impact of such developments over the course of the past three decades. Please do not hesitate to contact any member of our Financial Institutions Group, including the undersigned, should you have any questions.

Stuart Stock 202.662.5384 sstock@cov.com
Keith Noreika 202.662.5497 knoreika@cov.com
Mark Plotkin 202.662.5656 mplotkin@cov.com
D. Jean Veta 202.662.5294 jveta@cov.com
Michael Nonaka 202.662.5727 mnonaka@cov.com

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