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# The Dodd-Frank's Orderly Liquidation Authority: bridge financial company

La Autoridad de Liquidación Ordenada de la Ley Dodd-Frank: una compañía de financiamiento puente

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## Abstract: Abstract

The main purposes of this article are to present background on the United States government in connection with the financial regulatory agencies, to analyze the financial situation from 2007 to 2009, and, consequently, to assess how said financial situation was managed. In addition, this article evaluates section 210(h) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (also known as Dodd-Frank) and the financial company in use prior to the process of the Orderly Liquidation Authority.

**Keywords:** financial regulatory agencies, Dodd-Frank Wall Street Reform and Consumer Protection Act.

## Resumen: Resumen

Los objetivos principales de este artículo son presentar la relación y como se manejó la situación financiera entre el gobierno federal de Estados Unidos, las agencias reguladoras financieras durante la situación financiera para el 2007-2009. Además, este artículo evalúa la sección 210(h) del la Ley Dodd-Frank de Reforma de Wall Street y de Protección al Consumidor (también conocida como Dodd-Frank) y la compañía financiera en uso previo al proceso de Autoridad de Liquidación Ordenada.

**Palabras clave:** agencias reguladoras financieras, Ley Dodd-Frank de Reforma de Wall Street y de Protección al Consumidor.

## Introduction

Throughout time, one of the most important concerns in financial markets has been the relationship between federal regulatory agencies, financial institutions, and consumers. Financial institutions have been considered the spinal column for every society around the world. For a long time, the United States of America has been the architect in financial matters, regulating financial institutions and promoting an appropriate and efficient financial system. As part of these efforts, the United States creates different agencies in order to supervise and regulate financial institutions, but perhaps its most significant role is to maintain an optimal economy. The first federal financial agency that we want to discuss is the United States Department of Treasury.

The U.S. Department of the Treasury (U.S. Treasury) was established on September 2, 1789 and since then, it has been responsible for promoting economic prosperity and ensuring the financial security of the United States. The U.S. Treasury is responsible for a wide range of activities, including advising the President of the United States on economic and financial issues, encouraging sustainable economic growth,

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and fostering improved governance over financial institutions. The U.S. Treasury establishes and maintains a close relationship with other federal agencies to implement an appropriate financial system. In addition, the U.S. Treasury creates a convenience relationship with overseas countries around the world. Furthermore, the U.S. Treasury attends to public policy matters regarding international financial institutions. The U.S. Treasury is a complex organization that is responsible for providing and fostering economic growth. The U.S. Treasury, in connection with the Federal Reserve Bank and the Federal Deposit Insurance Corporation (FDIC), has an active role in financial institutions and how these institutions are affected in the market and, consequently, how consumers are affected. The Federal Reserve Bank and the Federal Deposit Insurance Corporation are two federal financial agencies that are essential in the discussion of the Orderly Liquidation Authority (OLA). As part of this discussion, we want to first examine the Federal Reserve Bank.

The Federal Reserve Bank (FRB) is the central banking system of the United States. In 1913, the FRB was established by the United States Congress to provide and ensure that the United States obtain and preserve a flexible and reliable financial system. The Federal Reserve Act of 1913 sets out the purposes, structure, and functions of the system, as well as outlines aspects of its operation and accountability. The McFadden Act of 1927 established the FRB as a permanent central bank (FDIC, 2014b). The last federal financial agency that we will discuss is the Federal Deposit Insurance Corporation.

During the Great Depression in the United States, many banks failed, since they granted loans to stock market speculators, which were never paid. The United States government established several agencies as the means for discharging new and emergency functions; one of these agencies was the FDIC (2014c). On June 6, 1933, President Franklin D. Roosevelt signed the Banking Act of 1933. The main reason for this Act was to increase the confidence of the American consumers in the banking system by alleviating the disruptions caused by banks failures and bank runs. Initially, the Act established the FDIC as a temporary government corporation, gave the FDIC the authority to provide deposit insurance to banks, gave the FDIC the authority to regulate and supervise state nonmembers banks, extended federal oversight to all commercial banks for the first time, separated commercial and investment banking (Glass-Steagall Act) and more (FDIC, 2014b).

The FDIC is an independent federal agency that provides insurance to financial institutions like commercial banks. When the Great Depression occurred, the United States government had the responsibility to see to and participate in solutions to stop bank runs and crashes. This economic situation affected the stock market, unemployment rate, and banking system. Throughout time, the United States Treasury, the FRB, and the FDIC have been working together to benefit the United States economy. In fact, they have been integrating and designing different policies in order to establish an improved financial system. From time to time, the President of United States and the United States Congress have

combined their efforts to amend laws related to financial institutions: creating or modifying financial agencies and taking adequate actions to preserve economic stability.

Afterwards, prior to and in the nineteen eighties, many commercial banks failed for different reasons, such as lack of capital, negligence or mismanagement, issues with assets, and liquidity problems with losses. In many cases, these commercial banks needed assistance and/or attention from the FDIC. During that time, the FDIC used different transactions, resources, and financial strategies to deal with financial institutions under distressed circumstances.

James (1991) describes the two kinds of operations that the FDIC intends to fix regarding financial institutions under distressed circumstances. The author explains how:

The FDIC uses two types of transactions when dealing with financially institutions. First, the FDIC may engage in either open bank assistance or arrange for the purchase or merger of the troubled institution with another bank; these were called 'live bank' transactions. Second, the institution may be declared insolvent so that the bank fails. (p. 1224)

During 2010, the United States government enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in order to reform and look after different aspects of financial regulation for the protection of consumers and investors. The Dodd-Frank includes dispositions to supervise financial distressed institutions. For that reason, the Dodd-Frank addresses and explains the OLA. This article has the purpose of discussing the OLA, corporate governance, the bridge financial company, and fiduciary duties.

The Dodd-Frank Act has the purpose of dealing with financial crisis and avoiding future issues in financial matters. Title II of Dodd-Frank sets up new procedures in relation with future and potential liquidations. The Dodd-Frank created the OLA as a new federal receivership process for financial institutions in financial distress. As part of our analysis, we want to evaluate the bridge financial institution concept and its areas like board of directors, corporate governance, and fiduciary duties.

In fact, this article reviews different aspects of the Dodd-Frank and areas related to financial crises. Consequently, some of the discussed fields include methods to resolve bank failures by the FDIC, the 2007 financial crisis, a general overview of bankruptcy, the Lehman Brothers, the Dodd-Frank act, the OLA, and the bridge financial company. In addition, we discuss the election process of the board of directors, corporate governance requirements, and fiduciary duties in the bridge financial company. The Act does not attend to these provisions because it assumes that all corporations have a duty to comply with each of them. Notwithstanding, it does not include a regulation nor regulatory letters about these points. As we mentioned, federal financial agencies have been involved in several occasions when commercial banks have failed.

## Methods to Resolve Bank Failures by the FDIC Between 1982 and 1988

Between 1982 and the year-end of 1988, 791 commercial banks failed, more than twice the number of failures that occurred in the previous 40 years. Losses are measured using data from the FDIC as the difference between the book value of a bank's assets at the time of its closure and the value of the assets in an FDIC receivership or value of the assets to an acquirer (James, 1991).

The FDIC uses several methods to resolve bank failures. The most common is a *clean bank* purchase (FDIC, n.d.) and assumption transaction (P&A) in which the FDIC auctions a package of the failed bank's assets and the obligation to assume the failed bank's liabilities. The auctioned package contains the bank's non-classified assets, including cash, securities, and certain performing loans, as well as the right to operate the bank. The second method is an insured deposit payoff. In this transaction, the FDIC pays off all insured depositors and establishes a receivership to manage all of the failed bank's assets. In a payoff, the FDIC receivership either sells the loans and other assets or holds them until they mature or are called. The third method is a deposit transfer in which the FDIC pays a bank to assume the failed bank's deposits, but in a payoff, the FDIC retains all of the failed bank's assets. Finally, in 1987, the FDIC began using *whole* bank transactions in which the bank acquired all of the failed bank's assets and liabilities; because the acquired assets are generally worth less than the failed bank's liabilities, the FDIC pays the purchaser a fee to assume the assets and liabilities (James, 1991). All methods available for the FDIC have considered the situation of bank failures since the beginning of the creation of the FDIC. In this way, the FDIC was consistent with the implementation of different regulations to provide and encourage an adequate financial system, not only for the United States and its territories. The FDIC is part of the financial guardians of the Financial Crisis of 2007 (including U.S. Treasury, Federal Reserve Bank, and the Office of the Comptroller of the Currency[1]) that could positively or negatively affect international markets. The financial guardians, to which we have referred, are deeply entangled in the promotion of a suitable financial picture.

The loss on assets is measured as the difference between the book value of a failed bank's assets and the market value of the assets at the time of the failure (net of the direct expenses of resolving the failure). The calculation of this loss varies with the method used by the FDIC to resolve the failure. In a clean bank P&A transaction, the loss on assets is calculated as the book value of the assets retained by the FDIC minus the estimated value of the assets to the FDIC receivership and any premium that the purchaser pays to the FDIC (the net of FDIC cash payments; James, 1991).

## Financial Crisis 2007-2009

Prior to the financial crisis, the federal government's policymaking and regulatory structure focused on the commercial banking system and the stock market. This focus left the government poorly equipped to deal with a crisis centered on the shadow banking system of investment banks, money market mutual funds, insurance companies, and hedge funds (Hubbard & O'Brien, 2014). At that moment, the United States government halted to take action in order to handle and fix the economic situation. It is probable that the United States government had a different situation in comparison to the Great Depression of 1930. At that moment of the financial crisis of 2007 the situation was more complicated, if we take into consideration that in 2007, the U.S. financial system was more complex, and the world was more globalized than in 1930.

In the late 1990s, a bubble developed in the stock market, especially in tech stocks. Prices reached a peak in March 2000, and then began a two-and-a-half-year slump, falling by nearly half over the period. The second bubble was the residential real estate bubble that followed. Real estate prices climbed rapidly until mid-2006 and then began to drop steadily. The cumulative drop over the next few years was about one third. The size of both markets was comparable at their respective peaks, about \$20 trillion for the stock market and \$25 trillion for the residential real estate market. These figures indicate that the dollar loss was a bit higher for the stock market decline (Simpson, 2014).

Beginning in August of 2007, defaults in the mortgage market for subprime borrowers (borrowers with weak credit records) sent a shudder through the financial markets, leading to the worst U.S. financial crisis since the Great Depression; hence, a recession began in December 2007. By fall of 2008, the economy was in a tailspin, with the recession, which ended in June of 2009, being the most severe since World War II (Hubbard & O'Brien, 2014).

In 2008, in the wake of the collapse of the subprime mortgage market, investment banks Bear Stearns and Lehman Brothers went out of business, Bear Stearns was sold to JP Morgan Chase, and Lehman Brothers declared bankruptcy. Merrill Lynch, the third largest investment bank in the United States, merged with Bank of America, and two of the remaining major U.S. investment banks, Goldman Sachs and Morgan Stanley, legally converted their operations to those of bank holding companies (Apostolik & Donohue, 2015).

Consumers and businesses alike suffered because of the 2007-2009 financial crisis. The impact of the crisis was most evident in five key areas: the U.S. residential housing market, financial institutions' balance sheets, the shadow banking system, global financial markets, and the headline-grabbing failures of major firms in the financial industry (Mishkin & Eakins, 2015). In the United States, millions lost their homes and their life savings. Others became unable to borrow to buy a home or go to college. In addition, the weakness added to financial fragility elsewhere,



especially in Europe, where the viability of the euro, the world's leading currency after the U.S. dollar, was threatened (Cecchetti & Schoenholtz, 2015). One of the consequences of the financial crisis was the option of bankruptcy and reorganization in judicial process. In fact, Chapter 11 (reorganization) or Chapter 7 (liquidation) of the bankruptcy process are used as a legal resource for financial institutions.

## **Bankruptcy and Reorganization**

The insolvency of most firms is handled through the judicial process of bankruptcy. Depending on the type of bankruptcy petition filed—Chapter 11 (reorganization) or Chapter 7 (liquidation)—the bankruptcy process can involve negotiations between creditor committees and the management of the firm (Fitzpatrick & Thomson, 2011). On November 6, 1978, Congress enacted the Bankruptcy Reform Act of 1978 (the Reform Act), the most massive overhaul of the bankruptcy laws of the United States in 40 years. The Reform Act provided for a modernization of bankruptcy law and the repeal, as of October 1, 1979, of all existing bankruptcy laws with the respect to all bankruptcy proceedings commenced after that date (Lawniczak, 2018). Subsequently, there were different reforms until what was likely the most important one in 2005.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 primarily focused on consumer bankruptcy law. It also contained significant amendments affecting corporate bankruptcy cases, including amendments to expand the scope of exclusive bankruptcy jurisdiction, provide expanded opportunities for investment banks to represent a trustee or debtor possession, plus add exceptions to the automatic stay and alter the rules to the post-petition provision of utility services, among others (Lawniczak, 2018). The Reform Act has different options for bankruptcy procedures, but only two will be discussed: Chapter 7 (Liquidation) and Chapter 11 (Reorganization).

### *Chapter 7*

Chapter 7 proceedings are usually referred to as “straight” bankruptcy or “liquidation” bankruptcy cases. In theory, debtors in Chapter 7 liquidation proceedings give up all their (nonexempt) property in exchange for relief, in the form of a discharge, from their debts. Theoretically, liquidation makes sense when creditors will receive more from an immediate sale of the debtor's assets than they would from the receipt of installment payments made by the debtor over a period time (Ferriell & Janger, 2007). Moreover, Chapter 7 does not necessarily result in an immediate “fire sale” of all of the debtor's assets. When appropriate, the Chapter 7 trustee may opt for an extended, orderly liquidation and may even continue to run the debtor's business for a time, anticipating selling the enterprise as an ongoing concern (Ferriell & Janger, 2007).

Most entities, individuals, corporations, partnerships, and unincorporated associations are all eligible for relief under Chapter 7 if they reside in the United States or own property in the United States. Among these debtors, only railroads, insurance companies, and financial institutions are prohibited from seeking relief through Chapter 7 (Ferriell & Janger, 2007).

### *Chapter 11*

A unique innovation of Chapter 11 in the U.S. is that the debtor's business remains under the corporation and control of incumbent management, as the "debtor in possession" of the estate. In other words, the same individuals who operated the business before bankruptcy remain in control throughout the bankruptcy case (Ferriell & Janger, 2007). The financial crisis of 2007-2009 was a turbulent episode in the U.S. economy and one of the financial institutions that used the Chapter 11 bankruptcy proceeding was Lehman Brothers.

In Chapter 11 reorganization cases, the debtor generally may assume or reject an executory contract or an unexpired lease of residential real estate property at any time prior to the confirmation of a plan of reorganization or such assumption or rejection provided in a plan. When a trustee or debtor fails to assume or reject a contract on or before the confirmation of a plan, the debtor's obligations under the contract survive the discharge in bankruptcy (Lawniczak, 2018).

### **The Dodd-Frank's Wall Street Reform and Consumer Protection Act of 2010**

The financial crisis of 2007-2009 was an eminent and transcendental reason to make substantial changes in the financial industry. For this reason, in 2010, the Dodd-Frank's Wall Street Reform and Consumer Protection Act was enacted in order to attend to different regulatory aspects, including to provide financial stability and restore consumer and market confidence. In fact, consumer confidence is one of the principal aspects affecting financial markets and the economy. The consumers want to have important information about their investments, financial transactions, and every relevant aspect of financial markets. If consumers have doubts or do not have accurate and appropriate information about their financial institutions and financial markets, this can provoke financial instability and, clearly, affect consumer confidence. The Dodd-Frank is:

An act to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end too big to fail, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for the other purposes (Ramakrishna, 2015, p. 43).



The Dodd-Frank grants the FDIC the power and authority necessary to affect an orderly liquidation of systemically important financial institutions (SIFIs). These authorities are analogous to those the FDIC uses to resolve failed insured depository institutions under the Federal Deposit Insurance Act of 2010. The key to an orderly resolution of a systemically important financial company that preserves financial stability is the ability to plan for resolution and liquidation, provide liquidity to maintain key assets and operations, and conduct an open bidding process to sell the company and its assets and operations to the private sector as quickly as possible (Evanoff & Moeller, 2014).

Although Dodd-Frank is a very important and innovative act, like other acts, it had issues. One of the inconveniences in enacting any law in a fast-track mode is the impossibility of debating and discussing medullar aspects in public hearings, including sectors like financial institutions and consumers. The aforementioned aspect could represent a misunderstanding in the application of law and regulations, independently of it being good legislation.

## **The OLA and its relationship to the FDIC**

When a large nonbank financial firm becomes troubled and in danger of default, government policymakers traditionally have two options: they can (1) allow the firm to enter bankruptcy, or (2) provide aid (i.e. bailout) to forestall failure, in the event that policymakers believe bankruptcy is likely to produce widespread (system-wide or systemic) financial difficulties. In 2010, a third option was made available by the OLA provisions, contained in the the Dodd-Frank Act. This legislation authorizes the FDIC to pursue an agency-administered wind-down for certain troubled financial firms. The OLA provisions are modeled, in part, after the process long followed by the FDIC for handling troubled banks (Pellerin & Walter, 2012). A number of reports have suggested that Title II replaces bankruptcy as the default method for resolving the insolvency of large nonbank financial firms, especially those identified as systemically important (Fitzpatrick & Thomson, 2011).

The OLA is designed to swiftly appoint the FDIC as a receiver for a covered financial company. Once the Secretary of Treasury (the Secretary) determines that a financial company poses a systemic risk, the Secretary must notify the financial company and the FDIC. If the financial company's board of directors consents or acquiesces to the appointment of the FDIC as receiver, the FDIC becomes the receiver. Board members cannot be liable to shareholders or creditors for acquiescing or consenting in good faith to the FDIC's appointment as receiver (Boston University School of Law, 2010). Like other provisions in the Dodd-Frank Act, Title II was intended as a response to perceived inadequacies in U.S. legal regulatory regimes during the financial crisis (Lee, 2016).

Title II of the Dodd-Frank section 204(a) establishes the OLA "to provide the necessary authority to liquidate failing financial companies

that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard” (2010, 124 stat. 1455).

The Dodd-Frank Act is clear on its detailed goal for the OLA applied to financial institutions, stating:

It is the purpose of this title to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard. The authority provided in this title shall be exercised in the manner that best fulfills such purpose, so that – (1) creditors and shareholders will bear the losses of the financial company; (2) management responsible for the condition of the financial company will not be retained; and (3) the Corporation (FDIC) and other appropriate agencies will take all steps necessary and appropriate to assure that all parties, including management, directors, and third parties, having responsibility for the conclusion of the financial company bear losses consistent with their responsibility, including actions for damages, restitution, and recoupment of compensation and other gains not compatible with such responsibility. (Acharya, Cooley, Richardson, & Walters, 2011, pp. 223-224)

As specified in the aforementioned provisions, OLA must provide a confident process to cope with distressed institutions in the United States, and Dodd-Frank is the new vehicle to do this with the FDIC.

The process initiated under OLA may be meticulous and is conveyed as follows. To start with, the FDIC and the Federal Reserve Bank (FRB) must recommend, either on their own initiative or at the request of the Secretary of the Treasury, the appointment of the FDIC as a receiver of a financial company. The appointment of the receiver must be approved by at least 2/3 of the then-serving members of the FRB and two-thirds of the then-serving members of the FDIC board of directors. The recommendation must address the following:

I. Whether the financial company is in default or in danger of default; II. The effect the default would have on the financial stability of the United States; III. The effect the default would have on the financial stability and economic conditions for low-income, minority, or underserved communities; IV. Recommendations for actions to be taken under the OLA; V. The likelihood of private-sector alternatives to prevent the default; VI. Why bankruptcy filing is not appropriate; VII. The effects of the receivership on the company's creditors, counterparties, shareholders, and other market participants; and VIII. Whether the company satisfies the definition of a financial company. (Gabai, Nachelsky, Barrage, & Freimuth, 2010, para. 7)

If both the FDIC and FRB determine the plan is not credible or cannot facilitate an orderly resolution, these regulators may impose more stringent regulatory requirements or other restrictions on the company's operations and ultimately may order the company to divest operations. The resolution plan requirement has proven to be one of the most demanding Dodd-Frank Act requirements. Large financial firms have

been required to make significant structural and operational changes in an attempt to facilitate their orderly resolution under the provisions of the current Bankruptcy Code (Lee, 2016).

Section 11 U.S.C. § 101, et. seq. discusses the key provisions of Title II and highlights the differences between the resolution of a systemically important financial institution under Title II of the Dodd-Frank Act, and a proceeding under the Bankruptcy Code. What follows is a brief summary of the appointment process and five of the most important elements of the authority available to the FDIC as receiver of a covered financial company. These five elements are:

(i) the ability to conduct advanced resolution planning for systemically important financial institutions through a variety of mechanisms similar to those used for problem banks (these mechanisms will be enhanced by the supervisory authority and the resolution plans, or living wills, required under section 165 (d) of Title I of the Dodd-Frank Act);

(ii) an immediate source of liquidity for an orderly liquidation, which allows for the continuation of essential functions and maintains asset values;

(iii) the ability to make advance dividends and prompt distributions to creditors based on expected recoveries;

(iv) the ability to continue key, systemically important operations, including through the formation of one or more bridge financial companies; and

(v) the ability to transfer all qualified financial contracts with a given counterparty to another entity (such as a bridge financial company) and avoid their immediate termination and liquidation to preserve value and promote stability. (Evanoff & Moeller, 2014. p. 133)

The FDIC's 2013 Annual Report states that:

During 2013, there were 24 institution failures, compared to 51 failures in 2012. For the institutions that failed, the FDIC successfully contacted all known qualified and interested bidders to market these institutions. The FDIC also made insured funds available to all depositors within one business day of the failure if it occurred on a Friday and within two business days if the failure occurred on any other day of the week. There were no losses on insured deposits, and no appropriated funds were required to pay insured deposits (FDIC, 2014a, para. 9).

Based on Table 1, during the three years of 2011-2013, the commercial banks were reducing their financial problems. The years discussed in this chart include 2011, one year after Dodd-Frank was passed. In 2011, we can find 92 financial institutions that failed, versus in 2013, in which this number lowered to 24 financial institutions. This indicates a reduction of 68 institutions in 2013 in comparison to 2011.

In relation to the total assets, failed institutions are very similar regarding the reduction between 2011 and 2013. Table 1 shows that in 2011, the total assets of failed institutions are 31.1 billion dollars by contrast to 5.1 billion dollars in 2013. Although there is no evidence that the aforementioned failures were a result of the Dodd-Frank, we can with confidence that they are strongly related.

**Table 1**  
*Failure Activity 2011-2013, Dollars in Billions*

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*Failure Activity 2011-2013, Dollars in Billions*

	2013	2012	2011
Total Institutions	24	51	92
Total Assets of Failed Institutions <sup>1</sup>	\$6.0	\$11.6	\$34.9
Total Deposits of Failed Institutions <sup>2</sup>	\$5.1	\$11.0	\$31.1
Estimated Loss to the DIF <sup>2</sup>	\$1.2	\$2.8	\$7.6

<sup>1</sup> Total assets and total deposits data are based on the last Call Report filed by the institution prior to failure.

<sup>2</sup> Estimated DIF losses from 2011 and 2012 failures are updated as of December 31, 2013. (FDIC, 2014a)  
Source: FDIC (2014a).

FDIC (2014a).

1 Total assets and total deposits data are based on the last Call Report filed by the institution prior to failure.

2 Estimated DIF losses from 2011 and 2012 failures are updated as of December 31, 2013. (FDIC, 2014a)

The FDIC, as a receiver, manages failed banks and their subsidiaries with the goal of the expeditious winding-up of their affairs. The oversight and prompt termination of receiverships help to preserve the value for the uninsured depositors and other creditors by reducing overhead and other holding costs. Once the assets of a failed institution are sold and the final distribution of any proceeds is made, the FDIC terminates the receivership. In 2013, the number of receiverships under management increased by three percent because of new failures. Table 2 shows overall receivership activity for the FDIC in 2013 (FDIC, 2014a).

**Table 2**  
*Receivership Management Activities*

Table 2

*Receivership Management Activities*

Active Receiverships as of 12/31/12 <sup>1</sup>	466
New Receiverships	24
Receiverships Terminated	10
Active Receiverships as of 12/31/13 <sup>1</sup>	480

<sup>1</sup> Includes one FSLIC Resolution Fund receivership at year-end 2013.  
Source: FDIC (2014a).

FDIC (2014a).

1 Includes one FSLIC Resolution Fund receivership at year-end 2013.

As presented above, the FDIC received 480 banks, including its subsidiaries. During the first three years of Dodd-Frank, the FDIC

worked as a receiver and had the responsibility of dealing with the commercial banks that failed.

The Dodd-Frank Act provides that the FDIC may borrow funds from the Department of the Treasury, among other things, to make loans to, or guarantee obligations of, a covered financial company to provide liquidity for the operations of the receivership and the bridge company. Section 204 (d) of the Dodd-Frank Act provides that the FDIC may make funds available to the receivership for the orderly liquidation of the covered financial company (FDIC, 2011).

The information previously presented shows the situation after Dodd-Frank was enacted. Although there is specific information about the OLA and its procedures, it is highly relevant and important to discuss some aspects of the OLA related to the Board of Directors, corporate governance, and fiduciary duties.

The OLA, as such, raises significant issues. The OLA will replace a predictable, transparent judicial bankruptcy process with an unpredictable, untested agency process. The OLA also alters shareholder and creditor rights, particularly bankruptcy proceedings (Boston University School of Law, 2010).

With the availability of the liquidation authority, regulators may be able to improve the “time-consistency” of regulators’ responses to troubled and failing financial firms. In the past, the only way to prevent the instability that might result from a large firm being resolved through bankruptcy was to keep it afloat or smooth its resolution with an infusion of funding. This new resolution authority created a viable option for providing funds to failing firms and should send markets a clear signal of how such firms will be resolved. The provision of such authority by Congress does not, in itself, end too-big-to-fail. Consistent and appropriate use of the authority, however, is an important step toward addressing the too-big-to-fail problem (Fitzpatrick & Thomson, 2011).

The basic model for the OLA process is existing law that provides for administrative receiverships of FDIC-insured banks. Dodd-Frank takes this bank receivership law and adds a number of provisions borrowed from the Bankruptcy Code to it, which is essentially a judicially supervised resolution process. As a result, the OLA is an administrative, rather than a judicial, resolution process—but one that hews more closely to the substantive law of bankruptcy than the law governing bank receiverships (Merrill & Merrill, 2014).

Recently, the United States Congress has been working with H.R. 1667-Financial Institution Bankruptcy Act of 2017 (FIBA). In sum, this bill amends federal bankruptcy law to allow certain large financial institutions to elect a new “Subchapter V” bankruptcy process specific to such institutions. Under the new process, a debtor institution may request the bankruptcy court to order the transfer of the debtor’s assets to a newly formed bridge company (FIBA, 2017). Notwithstanding, it is necessary to include the mechanism known as Bridge Financial Company during the OLA process.



## Bridge Financial Company

The bridge financial company is a newly established, federally chartered entity owned by the FDIC. It includes those assets, liabilities, and operations of the covered financial company necessary to achieve the maximum value of the firm (FDIC, 2011).

Title II of the Dodd-Frank “Orderly Liquidation Authority” in Section 210(3) establishes the definition of a bridge financial company (BFC) as a new financial company organized by the corporation in accordance with section 210(h) for resolving a covered financial company. In fact, section 210(h)(a) indicates that “The Corporation, as receiver for one or more covered financial companies or in anticipation of being appointed receiver for one or more covered financial companies, may organize one or more bridge financial companies” (2010, 124 stat. 1496).

The Dodd-Frank Act provides an efficient mechanism—the bridge financial company—to preserve the ongoing concern value of the firm’s assets and business lines. There are no specific parallel provisions in the Bankruptcy Code, and therefore it is more difficult for a debtor company operating under Chapter 11 of the Bankruptcy Code to achieve the same result as expeditiously, particularly where circumstances compel the debtor company to seek bankruptcy protection before a wind-down plan be negotiated and implemented (FDIC, 2011). A bridge financial company also provides the receiver with flexibility in preserving the value of the assets of the covered financial company and in effecting an orderly liquidation. The receiver can retain certain assets and liabilities of the covered financial company in the receivership and transfer other assets and liabilities, as well as the viable operations of the covered financial company, to the bridge financial company. The bridge financial company can operate until the receiver is able to stabilize the systemic functions of the covered financial company, conduct marketing for its assets, and find one or more appropriate buyers (FDIC, 2011).

Based on section 210(h) of Dodd-Frank, the FDIC can organize a new financial company for a covered financial company. In this section and other reviewed literature, we did not find direct information about the Bridge Financial Company and the authority of the FDIC to select a board of directors or its authority in corporate governance matters and fiduciary duties.

In addition, the consumers do not have specific information about the process and the matters of this new financial company. We understand that the process must be clear and completely transparent to every person that has interest in the situation generated as consequence of orderly liquidation resolution. A complete disclosure shall be evoking for consumers to avoid misunderstanding, uncertainty, and lack of confidence. If a financial institution is taken by the FDIC and starts an orderly liquidation process, we can expect a full disclosure of any kind of process during the transition or liquidation. Even though the U.S. federal government and federal agencies have been working to



maintain laws, regulations, and information through different ways of communication, the truth is that consumers do not necessarily understand this information. Many consumers' concerns could be satisfied merely under the premise that their money is safe and guaranteed by a federal agency called the FDIC.

In section 210 (h)(B), <sup>[2]</sup> the bridge company may assume such liabilities, purchase such assets, and perform any other temporary function which the corporation may prescribe. In spite of this section 210(h), in practice it will depend on the duties and powers of the bridge financial company, the board of directors, and the directions of both.

## **Board of Directors**

The bridge financial company will have a board of directors appointed by the corporation. <sup>[3]</sup> If the financial company's board of directors consents or acquiesces to the appointment of the FDIC as receiver, the FDIC becomes the receiver. Board members cannot be liable to shareholders or creditors for acquiescing in or consenting in good faith to the FDIC's appointment as receiver.

Dodd-Frank requires the removal of financial firm officers and directors if they are found to have been "responsible" or "accountable" for the company's financial failure. It also permits the FDIC to claw back any compensation those individuals received during the two-year period prior to the start of the receivership (Merrill & Merrill, 2014).

The corporation shall evaluate and designate the members of the board of directors, but the Act does not specify how the corporation must address this procedure. If we evaluate different aspects or characteristics of the selection process of board members, we need to include the work experience, education, independence, and financial resources of each candidate, along with how long they will take the position of director of the board.

Boards of directors require a variety of skills and experience in order to execute an adequate performance. These skills will vary by industry, although core skills such as knowledge in finance, accounting, and legal matters are required by all boards. The members' evaluation should include an assessment of whether the needed skills are available among the board members. The required qualifications and core competencies that an investor should look for in the board, both as a group and in individual members or candidates for the board, include:

1. Independence;
2. Relevant expertise in the industry;
3. Indications of ethical soundness, including public statements or writings of the director; problems in companies with which the director has been associated in the past, such as legal issues;
4. Experience in strategic planning and risk management;

5. Other board experience with companies regarded as having sound governance practices and that are effective stewards of investors' capital as compared to serving management's interests;

6. Dedication and commitment to serving the board and investors' interests;

7. Commitment to the needs of investors. (Clayman, Fridson, & Trouhton, 2012, pp. 15-16)

On the other hand, Dodd-Frank does not establish financial management resources for bridge financial companies, including the tools to work without capital. The reason for this is that, despite the fact that the act <sup>[4]</sup> establishes that a capital requirement is not necessary, it also does not establish removal procedures against directors for any breach of law, confidence, etc.

In short, the main purpose of the board shall be supervising operations and implementing management strategies and different mechanisms to reach appropriate guidelines in the best interests of the corporation. In this case, the board does not necessarily represent all of the shareholders nor the consumers with respect to the shareholders; this board has to manage a financial distressed institution in accordance with Dodd-Frank and the FDIC. If any shareholder has a right to claim, he or she must be prepared to file a civil action against the board of directors and/or management.

If the board of directors is composed of the same members of the board of directors of the failed institution, it can provide an inadequate appearance or direct intervention in the worst way with some aspect of the failed institution. We need to remember that all members or some members of the board of directors could gain influence in some aspects of the failed institution to avoid or minimize a potential administrative, civil, or criminal claim against them. This scenario is possible if the Dodd-Frank and/or regulation do not successfully prevent this possibility.

Another situation that is not presented to the board of directors is the lack of a code of ethics. All financial institutions must have an adequate and appropriate code of ethics. We can suggest the code of ethics of the *Director's Book* of the Office of the Comptroller of the Currency (OCC, 2016) as a starting point. The OCC establishes, for the board of directors, the following: (a) Conflict of interest, (b) Insider activities, (c) Self-dealing and corporate opportunity, (d) Confidentiality, (e) Fair dealing, (f) Protection and use of bank assets, (g) Compliance, (h) Whistle-blower policy, and (i) Consequences of their actions (OCC, 2016). These guidelines could serve to prepare a draft in order to create a code of ethics for the board of directors.

## Corporate Governance

Corporate governance is the system of principles, policies, procedures, that clearly define the responsibilities and accountabilities used by stakeholders to overcome the conflicts of interest inherent in the

corporate form (Clayman et al., 2012). The relation among stakeholders, management and board of directors should be transparent, informed and based in the best interests of the business. The last one mentioned is not necessary to produce the best result for each one. On the one hand, a business decision should be an adequate decision for whole company, but it does not necessarily represent an immediate benefit for stakeholders—although it could represent a good decision in the long term. In addition, the board of directors could draft and present an effective strategy for management, but management does not have the ability to implement it effectively. This kind of situation could represent a conflict of interest or misunderstanding among these parts.

Corporate governance is defined as the collection of control mechanisms that an organization adopts to prevent or dissuade potentially self-interested managers from engaging in activities detrimental to the welfare of shareholders and stakeholders (Larcker & Tayan, 2016). At a minimum, the monitoring system should consist of a board of directors to oversee the management and an external auditor to express an opinion on the reliability of financial statements (Larcker & Tayan, 2016). Likewise, corporate governance is defined as “the set of processes and procedures established to manage the organization in the best interests of its owners” (Booth, Cleary, & Drake, 2013, p. 48). Consequently, Section 210 (F) of Dodd-Frank explains:

The bridge financial company may elect to follow the corporate governance practices and procedures that are applicable to a corporation incorporated under the general corporation law of the State of Delaware, or the State of incorporation or organization of the covered financial company with respect to which the bridge financial company was established, as such law may be amended from time to time. (2010, 124 stat. 1497)

Although Dodd-Frank allows using corporate governance practices and procedures of the incorporation under corporate law, the Act does not provide a guide or recommendations about what characteristics or elements an effective corporate governance must have for a BFC.

What are the duties of the board? Typical duties of the board include the establishment of broad policies and objectives for the company, selecting and reviewing the performance of the chief executive and management compensation, ensuring adequate financial resources, and approving annual budgets and accounting to the stakeholders for the company's performance (Wilson, 2015). In addition, to ensure sufficient knowledge, good corporate governance also dictates that there should be sufficient independent directors on the board to challenge management (Wilson, 2015).

In the case of a bridge financial company, we need to look at other duties or requirements related to corporate governance and other issues, since the other option is simply ignoring in part or, in whole, the good corporate governance used daily. For example, we do not know how long the bridge financial company will exist in some OLA cases, nor if the board or management will have compensation. What kind of

compensation? Who will pay this compensation? In addition, it is not clear if this bridge financial company will work with or without money as established in Section 210 (G)(i) of Dodd-Frank (2010). If capital is not necessary, how and when will the FDIC determine these requirements? These requirements are determined and assigned by the FDIC and other complementary laws, but what is the scope of the board regarding this matter? We can understand that the FDIC will work together with the bridge financial company, but we do not know the scope and real duties of the bridge financial company.

As we know, the board of directors is an essential part to execute an appropriate corporate governance system. They have the primary responsibility to:

1. Establish corporate values and governance structures for the company, in order to ensure that the business is conducted in an ethical manner, fairly and professionally;
2. Ensure that all legal and regulatory requirements are met and complied with in full and in a timely fashion;
3. Institute long-term strategic objectives for the company with a goal of ensuring that the best interests of shareholders come first and that the company's obligations to others are met in a timely and complete manner;
4. Create clear lines of responsibility and a strong system of accountability and performance measurement in all phases of a company's operations;
5. Certify that management has supplied the board with sufficient information for it to be fully informed and prepared to make the decisions that are its responsibility, and to be able to adequately monitor and oversee the company's management;
6. Acquire adequate training so that members are able to adequately perform duties and so on. (Clayman et al., 2012, p. 11)

Likewise, as a practical matter, the board will be effective in every assignment, but it will depend on the scope, the lack thereof, or limitations in all aspects related to duties and responsibilities, while also including, but not limited to, corporate governance, financial management, the authority to hire people in different areas, and the design and implementation of all policies required by the FDIC and any federal and applicable state law in those cases.

In summary, neither Dodd-Frank nor any regulation regarding this matter establishes a corporate governance guideline in order to attend to or explain the principles in the OLA procedures. Since the FDIC is in charge of this process, it should explain how they will work this matter. In other words, they should disclose if they have guidelines or use corporate governance principles to implement an adequate corporate governance during OLA process.

## **Fiduciary Duties**

The board, elected primarily by shareholders, is the highest body of authority in the company and oversees the company's activities. The

members of the board have a fiduciary responsibility to the shareholders as a matter of enlightened self-interest for benefit of shareholders. Boards also consider the interests of other stakeholder groups such as employees, the community, and the environment (Wilson, 2015). We can define fiduciary duty as the legal duty to watch out for the better interests of the company. Furthermore, we can mention two types of fiduciary duties in a board of directors: duty of loyalty and duty of care.

### *The Duty of Loyalty*

The most important fiduciary duty is the duty of loyalty. The concept is simple: the decision makers within the company should act in the interests of the company, and not in their own interests. The easiest way to comply with this duty is not to engage in transactions that involve a conflict of interest (Black, 2001).

The duty of loyalty is of central importance, since it underpins the effective implementation of other principles, such as the equitable treatment of shareholders, monitoring of related-party transactions, and the establishment of remuneration policy for key executives and board members. It is also a key principle for board members who are working within the structure of a group of companies: even though a company can be controlled by another enterprise, the duty of loyalty for a board member relates to the company and all its shareholders and not to the controlling company of the group. Where board decisions may affect shareholder groups differently, the board should treat all shareholders fairly (Vallabhaneni, 2008).

### *The Duty of Care*

The second core duty of directors, in situations where they do not have a conflict of interest, is the duty of care—the duty to pay attention and to try to make good decisions (Black, 2001). The duty of care requires board members to act on a fully informed basis, in good faith, with due diligence and care. In some jurisdictions, there is a standard of reference, which is the behavior that a reasonably prudent person would exercise in similar circumstances. Good practice takes this to mean that they should be satisfied that key corporate information and compliance systems are fundamentally sound and underpin the key monitoring role of the board (Vallabhaneni, 2008).

U.S. courts simply do not hold directors liable for business decisions made without a conflict of interest, unless those decisions are completely irrational. This is the doctrine of noninterference, also known as the business judgment rule. It has several justifications. First, courts are bad at second-guessing in hindsight decisions that turned out poorly. Second, an investment in a business can turn out badly for a whole host of reasons (Black, 2001).

The duty of care requires a director to act in good faith and strive to exercise ordinary prudential care in making business decisions for the corporation. Directors are not guarantors of their decisions but are, absent a conflict of interest, protected by the business judgment rule, which provides a presumption in favor of a director's decision making even if, after the fact, the decision turned out to be wrong. The business judgment rule requires a director to exercise due diligence in their decision-making process and not rush into a decision without becoming fully informed of the implications of the decision they are making. Process, not result, is what is paramount for enjoying the protection of the business judgment rule (Droms & Wright, 2015). This duty is highly important, since it exhorts and pushes each member to act in good faith and to follow an ordinary prudential care in business decisions. At this point, the member forgets any personal interest, including any appearance of interest in any matters, because his or her goal is to obtain the best interests and decisions for the company.

In nearly all jurisdictions, the duty of care does not extend to errors of business judgment so long as board members are not grossly negligent, and a decision is made with due diligence. Good practice takes this to mean that they should be satisfied that key corporate information and compliance systems are fundamentally sound and underpin the key monitoring role of the board. In many jurisdictions, this meaning is considered an element of the duty of care, while in others, securities regulation or accounting standards require it (Vallabhaneni, 2008).

## Conclusion

The United States government and the financial regulatory agencies began supervising financial institutions many years ago. The United States government and the financial regulatory agencies have made valuable contributions to develop, regulate, and maintain an optimal economy. Over time, the financial regulatory agencies, specifically the FDIC, have had an important role in the different scenarios of the financial institutions that they regulate. As one can see, the FDIC has been working with at least three methods to resolve the situation of banks' failures. After the Lehman case, the United States government and the financial regulatory agencies managed the Financial Crisis of 2007-2009 in different ways, including bailouts, the Emergency Stabilization Act of 2008 and, finally, the Dodd-Frank Act of 2010.

In addition, some issues of Dodd-Frank like section 210 (h) and subsequent sections were discussed in relation with the corporate governance aspects. The relevance of this article is to point out the actions and duties of the board of directors, the corporate governance, and the fiduciary duties of the board of directors during the process of Title II, section 210 (h). Although the process of orderly liquidation is regulated by Dodd-Frank, we understand there is a loophole or area that is not completely clear in the process.



In respect to the board of directors, it is indispensable to know: What elements and characteristics does the FDIC use to select board members? Where do they get these candidates? Should they have a code of ethics? Lastly, what are the professional credentials assessed in choosing the members of the board? These are just some of the questions to which we need the answers.

Another point of view is the scope of board authority and its discretion to resolve any matters concerning OLA procedures. The importance of this is to know what the board actually has the power to do. In general, the board needs to prepare and execute good corporate governance and other matters in order to comply with all duties and responsibilities. Moreover, one cannot forget the difference between applicable state corporate law as complementary law in the process. Due to the combination of Dodd-Frank, other federal laws, and state corporate law, it is difficult to establish a uniform process, but we believe that the FDIC can draft and disclose basic guidelines.

On one hand, we understand the bridge financial company will have a due date to work with all requirements of OLA, but Dodd-Frank and/or FDIC do not have guidelines or instructions with more details. This is necessary in order to establish uniform procedures for financial institutions, financial markets, academics, lawyers, and anyone who is interested in this process, which is essentially for the benefit of American taxpayers. On the other hand, we cannot forget that the United States Congress has passed the FIBA, which could be the final result in the legislative process to oversee the bankruptcy of financial institutions. If the FIBA is approved, it would amend the Bankruptcy Code.

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## Notes

- [1] In the Financial Crisis of 2007, the OCC had a participation in the discussion and collaborated to attend the financial crisis, but probably it did not have the same role and impact that the FDIC suffered, although all regulators were essential parts of the discussion and the proactive system to manage the situation.
- [2] The Dodd-Frank Act states: “Upon the creation of a bridge financial company under subparagraph (A) with respect to a covered financial company, such bridge financial company may— (i) assume such liabilities (including liabilities associated with any trust or custody business, but excluding any liabilities that count as regulatory capital) of such covered financial company as the Corporation may, in its discretion, determine to be appropriate; (ii) purchase such assets (including assets associated with any trust or custody business) of such covered financial company as the Corporation may, in its discretion, determine to be appropriate; and (iii) perform any other temporary function which the Corporation may, in its discretion, prescribe in accordance with this section.” (2010, 124 stat. 1496)
- [3] Section 210 h (B) states that upon its establishment, a bridge financial company shall be under the management of a board of directors appointed by the corporation.
- [4] Section 210 (G) (I)—Capital not required—Notwithstanding any other provision of Federal or State law, a bridge financial company, may, if permitted

by the Corporation, operate without any capital or surplus, or with such capital or surplus as the corporation may in its discretion determine to be appropriate.