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Post-Election Update: Financial Services - Dodd-Frank Orderly Liquidation

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Dodd-Frank has now survived a mid-term election, a presidential election and Hurricane Sandy. Governor Romney repeatedly indicated on the campaign trail that if elected president he would repeal Dodd-Frank and replace it with different, more practical, and - most importantly - clear regulations. However, given President Obama's re-election, all that remains to be seen is whether Dodd-Frank will survive a pending constitutional attack brought by various states and third parties.1

Specifically, the lawsuit challenges the creation of certain agencies under Dodd-Frank as well as the orderly liquidation authority established by Title II. By way of background, Title II of Dodd-Frank authorizes the dissolution of financial institutions which have been deemed to be systemically risky and a threat to the stability of the US economy. This determination is made by the Secretary of the Treasury, following recommendations from the FDIC and the Board of Governors, after considering:

1. whether the financial company is in default or is in danger of default,
2. the effect that the default of the financial company would have on financial stability in the US,
3. a recommendation regarding the nature and the extent of actions to be taken under this Act with respect to the financial company,
4. the likelihood of a private sector alternative (presumably such as a consensual restructuring),
5. whether or not a case under the Bankruptcy Code is appropriate, and
6. the effects of the financial company's failure on creditors, counterparties, shareholders, and other market participants.

Following a determination to wind up the financial company, the Secretary of the Treasury will notify the financial company (such companies are then referred to as a "covered financial company"). If the board of directors of the company consents to the appointment of a receiver, then the FDIC takes over. If the board of directors does not consent, then the Secretary files a petition under seal with the U.S. District Court for the District of Columbia. The fact that the liquidation provisions of Dodd-Frank contemplate court involvement, however, provides a false sense of checks and balances on the Secretary and the other regulators – a situation that is largely the focus of the pending constitutional challenge. Specifically, the lawsuit deems these limitations on court review to be "draconian." We may be a bit biased in agreeing with the lawsuit as we expressed similar views back in 2010 shortly after Dodd-Frank was passed. See Renée Dailey & Katherine Lindsay,The Dodd-Frank Act: The New World of Systemically Risky Financial Companies and What It Means for Creditors, Bank. Law R. Vol. 22, No. 36, P. 1283-87 (Sept. 23, 2010).

In particular, the lawsuit alleges, among other things, that the following provisions of Title II violate the principles of due process:

1. First, the Act does not permit review over all aspects of the Secretary's liquidation determination, but rather limits judicial review to only one of the factors: the Secretary's determination that the financial company is in default or in danger of being in default.

2. Second, the standard of review of such determination is arbitrary and capricious. Arbitrary and capricious is a highly deferential standard of review and means that in order to reverse the Secretary's determination, the District Court has to conclude that the Secretary's finding that the financial company is in default or in danger of being in default has no reasonable basis.

3. Third, if the District Court does not rule on the petition within 24 hours of receipt, the Secretary's petition is deemed to be granted as a matter of law and the FDIC is appointed as receiver.

4. Fourth, while a financial company can appeal the decision of the District Court, no stay of the receivership pending appeal is permitted and each of the appellate courts review the lower court decision on the same arbitrary and capricious standard.

5. Fifth, all of the foregoing is done on a sealed and expedited basis, without notice to creditors or other stakeholders. On such a timeline, it is difficult to imagine that the covered financial company could prepare detailed opposition papers. As an aside, secrecy of the Secretary's determination and of the pending petition is deemed so important that the Act provides for criminal penalties for recklessly disclosing the Secretary's determination or the filing of the petition with the District Court.

As a result of the lawsuit, the District Court will be called upon to determine the constitutionality of the orderly liquidation provisions of Title II and the establishment of certain agencies. While the driving goal of Dodd-Frank - the stabilization of the economy - is certainly an admirable goal, it should not come at the expense of the fundamental constitutional principle of due process. We would expect any decision by the lower court to be appealed, ultimately to the Supreme Court. Accordingly, the fate of certain provisions of Dodd-Frank will remain unsettled for quite some time.