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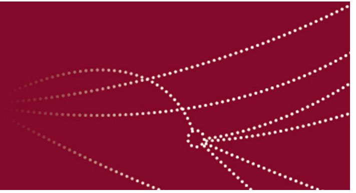
Bankruptcy/Insolvency Alert



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Dust Off Your Files: The FDIC Is Back in Town

The recent appointment of the Federal Deposit Insurance Corporation ("FDIC") as conservator of IndyMac Bank and receiver of the First National Bank of Nevada and First Heritage Bank, N.A. (collectively, "FNBN") has caused many lawyers to recall from storage their files on the role of the FDIC and the now defunct Resolution Trust Corporation ("RTC") in the liquidation of thousands of failed banks and thrifts over 15 years ago. FDIC and RTC were often a source of unmitigated pain to the failed institutions they liquidated and the counterparties to contracts that were in effect at the time the institutions failed. At the same time, FDIC and RTC presented unsurpassed opportunities for those with cash to purchase loans and assets from their receiverships. Those who have servicing or other contracts with IndyMac and FNBN are experiencing post-appointment stress syndrome, wondering how they will be affected by its failure. Those with cash are lining up for the perceived opportunity to buy origination and servicing platforms, servicing rights and whole loans. Indymac and FNBN will certainly not be the only federally insured institutions to fail in the current environment.

This Alert will provide a brief overview of the law applicable to FDIC as receiver or conservator of a failed bank and a sampling of the types of material issues that arose with FDIC and RTC in the past in the belief that the intervening fifteen years have not fundamentally changed the issues. More specifically, we want to address two issues in this Alert: the ability of FDIC to repudiate contracts and the anticipated protections FDIC might be willing to provide in its sales agreements. And while we use mortgage-related assets as an illustrative example of doing business with FDIC, the laws that apply and the contractual protections that FDIC is likely to give should not depend on the asset class.

I. FDIC as Conservator or Receiver

A. Bank Insolvency

The United States Bankruptcy Code governs proceedings relating to the insolvency of businesses and individuals. The Bankruptcy Code does not, however, apply to banks, thrifts, credit unions, and domestic insurance companies. 11 U.S.C. § 109(b)(2). Banks have traditionally been viewed as being more important to the functioning of our economy than nonfinancial businesses and therefore in need of special insolvency laws. When a bank in the United States fails, the process for closing it and winding up its affairs is overseen by its bank regulators. The FDIC is empowered to act as receiver or conservator for any FDIC "insured depository institution."

The determination that a bank is insolvent is normally made by its primary bank regulator (*i.e.*, the state bank supervisor for state chartered banks, the OCC or OTS respectively for federally chartered banks or thrifts, or the Federal Reserve for its member banks). Once the primary regulator determines a bank to be insolvent, FDIC steps in to "resolve" it by accepting appointment as its receiver or conservator to value its assets and oversee their disposition in an orderly manner so that insured depositors are protected and public confidence in the safety and soundness of the banking system is maintained. Neither a bank itself nor its creditors have the ability to initiate a receivership or conservatorship under bank insolvency laws. Nor do its shareholders or creditors have any rights to participate in the receivership or conservatorship.

Upon appointment as receiver or conservator of a failed bank, FDIC succeeds to all rights of the failed bank and has the general authority to operate its business, exercise all the failed bank's corporate powers and even merge it with another bank or transfer its assets to a new "bridge bank" as occurred with IndyMac. 12 U.S.C. § 1821(d). FDIC, as receiver, has authority to determine the validity of creditors' claims of a failed bank. 12 U.S.C. § 1821(d)(3). Following the passage of the National Depositor Preference Amendment in 1993, all deposits in a failed bank (including uninsured deposits) are given a statutory priority and preference over other unsecured claims. This means that the failed bank's depositors will be paid before its general unsecured creditors. In most FDIC receiverships, those general unsecured creditors can expect to receive no dividend on their unsecured claims.

B. Powers and Purposes of a Receiver[1]

Once appointed as receiver, FDIC has a number of special powers to facilitate disposition of the failed bank's assets, including the power to:

1. repudiate burdensome contracts entered into prior to its appointment within a "reasonable time" after its appointment. 12 U.S.C. § 1821(e).

2. enforce any contract, other than for directors and officers liability insurance or a depository institution bond, irrespective of any clauses purporting to authorize the termination, default, acceleration, or other exercise of rights based solely upon the failed bank's insolvency or the appointment of a conservator or receiver. 12 U.S.C. § 1821(e)(12).

3. request a stay of legal actions or proceedings for 90 days. 12 U.S.C. § 1821(d)(12).

4. avoid fraudulent transfers made within five years of its appointment if the transfer was made to hinder, delay or defraud the failed bank, the receiver, or any other federal banking agency. 12 U.S.C. § 1821(d)(17).

5. merge the failed bank with another insured depository institution and transfer all of the failed institution's assets and liabilities without the prior approval of any contract counterparty, court, or government agency. 12 U.S.C. § 1821(d)(2)(G).

6. allow, disallow, and settle claims against the failed bank. 12 U.S.C. § 1821(d)(3).

7. marshal the failed bank's assets and use the proceeds to pay creditors in accordance with the priority scheme established by 12 U.S.C. § 1821(d)(11).

8. liquidate the failed bank or transfer some or all of its assets to an acquiring institution. 12 U.S.C. § 1821(d)(2)(E)-(G).

II. Repudiation of Contracts

A. Scope of Repudiation Rights

Among the wide-ranging powers granted to the FDIC, it is the power to repudiate contracts that sends shivers up the spines of counterparties to insured institutions. Generally speaking, FDIC may repudiate or disaffirm any contract to which a failed bank is a party if it: (1) deems performance of the contract or lease to be "burdensome"; and (2) finds that repudiation would promote the orderly administration of the receivership estate. 12 U.S.C. § 1821(e). FDIC's repudiation power is similar to – but broader than -- the power of a debtor in possession or bankruptcy trustee to reject burdensome executory contracts, since the FDIC's power is not necessarily limited to executory contracts.

B. Effects of Repudiation

The repudiation of a contract by FDIC as receiver or conservator terminates the failed bank's obligation to render any future performance required under the contract. The FDIC's power to repudiate a contract in a bank receivership is a particularly potent weapon for a number of reasons:

1. FDIC can repudiate a contract or lease by letter to the affected counterparty without court approval and with no prior notice.

2. In the traditional bankruptcy proceeding, only "executory" contracts can be avoided by a trustee in bankruptcy. FDIC can, however, repudiate any contract it finds "burdensome." This makes it possible for FDIC to repudiate revolving lines of credit, partially funded construction loans and letters of credit.

1 The powers accorded to FDIC as conservator are similar, though the purposes of a conservatorship are slightly different. Unlike a receivership, which is designed to liquidate a failed bank, a conservatorship is intended to allow FDIC to continue operating a distressed financial institution and to preserve, administer, and protect its assets until it can be rehabilitated or closed.

3. The damages recoverable against FDIC for repudiating a contract in a bank receivership are limited to the counterparty's actual direct, compensatory damages. Consequential damages for lost profits, punitive damages and pain and suffering are barred. Furthermore, damages against FDIC as receiver are generally cut off under the "fixed and certain" rule set forth in 12 U.S.C. § 1821(e)(3)(A) as of the date of the receivership. Any damage claim allowed by the FDIC is paid in the form of a "receiver's certificate". Since claims of unsecured creditors are, under the 1993 National Depositor Preference Amendment, subordinate to depositor claims, the likelihood of a dividend being paid out on such a certificate is remote.

4. While a trustee in bankruptcy cannot reject one part of a contract and assume the rest, in a bank receivership, FDIC can bifurcate the respective assets and liabilities in contracts by rejecting unfunded commitments on construction loans and suing the borrowers for funds advanced under the notes prior to the date of the receivership.

FDIC uses its power to repudiate contracts frequently and in a number of different contexts. Borrowers frequently learn the hard way that their existing line of credit, construction loan facility, or unsecured letter of credit at a failed bank has been rejected as of the receivership date. Vendors providing services to a failed bank can be terminated abruptly with little recourse. If, however, a vendor continues to provide the same services to FDIC subsequent to the receivership, it may have a priority administrative claim under 12 U.S.C. § 1821(e)(7)(B) and be paid for those services. Loan participation agreements and intercreditor agreements have previously been repudiated by FDIC although current FDIC policy seems to be not to reject such agreements.

C. Qualified Financial Contracts

A contract between a failed bank and a counterparty that meets the definition of a "Qualified Financial Contract" under 12 U.S.C. § 1821(e)(8)(D) receives certain protections against the FDIC as receiver. Qualified Financial Contracts ("QFC") include a "securities contract, forward contract, repurchase agreement, swap agreement" or equivalent. These special protections (a) allow counterparties to a QFC with a failed bank to enforce provisions in their agreements allowing the termination and liquidation of the QFC and enforcement of set off and netting rights; provided, however, that the right to terminate or liquidate the QFC is temporarily suspended from the time the receiver is appointed until the earlier of: (i) the time the counterparty receives notice that the contract has been transferred; or (ii) 5:00 p.m. (ET) on the business day following the date of the appointment of the receiver. 12 U.S.C. § 1821(e)(10)(B)(i); (b) allows FDIC to dispose of QFC's only in a manner that will preserve the counterparty's cross-collateralization, set off and netting rights; and (c) gives the counterparty a more favorable measure of damages determined as of the actual date of repudiation (and not appointment of FDIC as receiver) and including cost of cover in the event FDIC repudiates a QFC.

D. Selected Issues Regarding Repudiation

Questions abound about the scope and implications of FDIC's repudiation power. For example, is a secured creditor at risk that its collateral will be stripped away, effectively converting its secured obligation into an unsecured one? Can a counterparty to a repo agreement liquidate its position following the appointment of a receiver as it could in a bankruptcy context? Is a loan servicer at risk that its servicing agreement will be unilaterally terminated without payment of a termination fee? Will a loan servicer be reimbursed for outstanding advances, and is the answer different depending on whether the advances are made before or after the appointment of a receiver? Should a servicer continue to advance under the servicing agreement pending a determination by the conservator regarding whether to repudiate?

While the purpose of this alert is not to write a treatise on the powers of FDIC as conservator or receiver, there are some important points to highlight.

1. FDIC is limited in its ability to repudiate secured loans. It cannot avoid a legally enforceable and perfected security interests, unless the interest was taken in contemplation of the institution's insolvency or with the intent to "hinder, delay, or defraud" the institution or its creditors. 12 U.S.C. § 1821(e)(11); see also FDIC Statement of Policy Regarding Treatment of Security Interests After Appointment of The Federal Deposit Insurance Corporation As Conservator Or Receiver, 58 Fed. Reg. 16833, March 31, 1993 (the "1993 Repudiation Policy Statement").

2. The FDIC may avoid the payment of a termination fee under a servicing agreement if the agreement fails to meet the requirements of 12 U.S.C. § 1823(e), which codifies the holding of D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447 (1942), and provides that an agreement will only be enforceable against FDIC in a bank receivership if it is (1) in writing, (2) executed by both the depository institution and any person claiming an adverse interest under the agreement, (3) approved by the depository institution's board of directors or loan committee, and (4) an official record of the depository continuously since its execution. Under the so-called D'Oench Duhme doctrine, which is codified at 12 U.S.C. § 1823(e), agreements between a failed bank and a counterparty not appearing in the official records of the failed bank or meeting certain other documentation requirements are not enforceable as claims or defenses against FDIC. The protection against unrecorded side agreements of this sort eliminates many lender liability claims against failed banks. D'Oench, Duhme protection has also been determined to extend to subsequent purchasers of loans from FDIC receiverships and similarly insulate those purchasers against claims by borrowers that the failed bank breached an agreement.

3. To the extent a counterparty continues to provide services pending the FDIC's decision to repudiate, it is entitled be paid for the full contract value of those services as an administrative expense of the receivership. 12 U.S.C. § 1821(e)(7)(B); see also McAllister v. RTC, 201 F.3d 570, 579 (5th Cir. 2000); U.S. Bank Nat'l Ass'n v. First Nat'l Bank of Keystone, 394 F. Supp. 2d 829, 835 (S.D. W. Va. 2005). FDIC's acceptance of performance prior to repudiation does not, however, bar FDIC from later repudiating the contract. 12 U.S.C. § 1821(e)(7)(C).

4. As a matter of policy, the FDIC will not "reclaim, recover or recharacterize" any financial assets of an insured depository institution transferred in connection with a securitization or participation, provided that the insured depository institution received adequate consideration for the transfer and the underlying documents evidence the intent to treat the transaction as a true sale and not a secured loan. See 12 C.F.R. § 360.6.

5. Common law set off rights can be very valuable to holders of accounts at a failed bank with balances in excess of applicable FDIC insurance limits. The uninsured amount of a deposit at a failed bank can be offset against a performing loan the depositor owes the bank. FDIC is generally much more hospitable to offsets than trustees in bankruptcy. Set off rights, however, can be adversely affected if FDIC as receiver transfers its loan asset to a bridge bank or third party and thereby destroys the reciprocal nature of the corresponding debts.

III. Sale Procedures

The questions are pouring in regarding the process to purchase assets from failed institutions in which FDIC is the conservator or receiver. While the FDIC is sure to develop its own contemporary policies and procedures, those of the RTC may be instructive. What follows is not based on written policies and procedures that can be accessed on FDIC websites or in FDIC manuals; rather, we have attacked some of our old closing binders from purchases of mortgage companies, servicing rights and whole loans in the early 1990's.

As a threshold matter, virtually all sales were conducted on an auction basis based on a standardized format for bid letters and purchase agreements, relying on financial advisors or brokers whom the agency retained with a special preference for minority and women owned businesses. While a purchaser could propose changes to the promulgated form of the bid letter and purchase agreements, RTC's representative would control the document and had limited authority to make changes without approvals from headquarters. In the case of depository institution sales, the strong preference was for the purchaser to retain as many employees as possible, and any evaluation of the bids included an accounting for the financial impact of shut down costs if a buyer proposed to purchase only selective assets.

Assume transparency in the process. While FDIC certainly has the authority to sell assets or stock on "as is, where is" basis, its desire to maximize sales proceeds likely will cause it to give enforceable representations and warranties in connection with its sales.

In our experience, RTC routinely gave generally customary, albeit more limited, loan level representations and warranties about residential mortgage loans and servicing rights. These would include: good title, compliance with laws, accuracy of balances, payment of taxes and insurance,

enforceability of loan documents, completeness of loan files, validity of advances, and compliance with servicing agreements. Of course, the circumstances that gave rise to the failure of the thrifts in the early 1990's had very little to do with allegedly defective residential loan originations, so the representations and warranties that RTC was willing to give then may not extend to FDIC today with respect to subprime and ALT A residential mortgage loans. Indeed, the FDIC website presently states that FDIC makes no representations or warranties in connection with the loans it is offering for sale. In the case of depository institution sales, the purchaser usually entered into ancillary servicing and receivables collection agreements

The remedies available to a purchaser against FDIC included indemnification for actual and direct, out of pocket losses arising out of or resulting from the inaccuracy of any representation or warranty in the purchase and sale agreement, or the failure of seller to perform or observe any term or provision of such agreement; such indemnification generally survived for five years. On a negotiated basis, RTC would indemnify against the credit risk of loss on recourse servicing and VA no bids, with shorter survival periods and ceilings on exposure. The agreements usually contained detailed provisions regarding the obligation of the purchaser to mitigate indemnifiable losses, including the pursuit of loss mitigation strategies such as principal reductions if necessary to reduce RTC's exposure and the filing of third party claims. In many cases, the remedy of loan repurchase was available only at the election of RTC.

The most important element of an RTC sale was the provision of a guarantee agreement by RTC in its corporate capacity. Few buyers had any interest relying on RTC's indemnification obligations when RTC provided such contractual protections as receiver or conservator. A condition precedent to the purchase and sales agreements generally was the delivery of the guarantee agreement. Under the guarantee agreement, RTC in its corporate capacity would guarantee its obligations under the indemnifications provisions of the purchase and sale agreement. Its liability contractually was limited to those amounts: (a) for which seller was liable under the purchase and sale agreement but unable to pay, (b) for which seller would have been liable under the purchase and sale agreement but for seller's discharge or release in bankruptcy or receivership, a disaffirmation or rejection of the purchase and sale agreement or a reduction, modification, impairment or limitation of seller's liability or any remedy of purchaser in connection with or as a result of a bankruptcy or receivership. RTC agreed to pay within five business days of the time frame that the seller was obligated to pay under the purchase and sale agreement. The purchaser was not permitted to assign the guaranty but could pledge it to a creditor that financed the acquisition of the assets or the stock under the purchase and sale agreement; the creditor, as the pledgee, had the right to assign the guaranty agreement to a subsequent purchaser in the event the creditor foreclosed on the collateral and the assignee executed an acknowledgement agreement clarifying the nature of its rights. The form of the guarantee agreement was not negotiable.

RTC's policies on the sale of stock and assets evolved over a few years. It initially hesitated to give full representations and warranties or indemnities, and it had little interest in providing corporate guarantees. Over time, however, RTC realized that such market standard protections were necessary if it hoped to maximize sales proceeds. One would expect FDIC to follow suit in connection with any sales arising out of the current banking crisis.

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