Restructuring and liquidation of US financial institutions

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No single, uniform law governs the restructuring and liquidation of US financial institutions. The restructuring or liquidation of a US financial group can be quite complex because, in most cases, the component institutions will be subject to different statutory insolvency schemes. The parent holding company, as well as most subsidiaries other than banks, thrifts and insurance companies, are subject to the US Bankruptcy Code. Bank and thrift subsidiaries are subject to a specialised insolvency regime under Sections 11 and 13 of the Federal Deposit Insurance Act if their deposits are insured by the Federal Deposit Insurance Corporation (FDIC), as almost all are. Broker dealers that are members of the Securities Investor Protection Corporation, as almost all are, are subject to the Securities Investor Protection Act in addition to the Bankruptcy Code. The rehabilitation or liquidation of insurance companies is governed by specialised state insurance insolvency codes, which differ from state to state. These specialised laws for 'resolving' – to use FDIC terminology – troubled or insolvent banks, thrifts, broker dealers and insurance companies have very different avoidance powers, priorities and distribution schemes that can significantly affect the rights of creditors and other stakeholders as compared to the Bankruptcy Code.

We would hardly be able to scratch the surface if we tried to describe all these different legal regimes. Therefore, in order to write something meaningful and timely, we have focused this chapter on Sections 11 and 13 of the Federal Deposit Insurance Act.

There are several reasons for this choice. First, compared to the Bankruptcy Code, very little has been written about this specialised law. Second, we are in the midst of the largest wave of bank and thrift failures in the United States since the US savings and loan crisis ended in the early 1990s. This specialised law has recently been used to 'resolve' major depository institutions such as Washington Mutual and Indymac. It has served as the basis for many of the unusual programmes adopted by the federal government during the current economic crisis. This law will be used to restructure or liquidate many other US banks and thrifts before the current financial crisis is over. Third, the United States has created or proposed specialised 'resolution' codes for a variety of other financial institutions, all of which draw heavily on the principles set forth in Sections 11 and 13 of the act. For example, the Housing and Economic Recovery Act of 2008 created a specialised code modelled on these provisions for Freddie Mac and Fannie Mae, the giant entities that had securitised or facilitated the securitisation of about half the outstanding residential mortgage loans in the United States, as well as the Federal Home Loan Banks. These new provisions were used to put Fannie and Freddie into federal conservatorship in September 2008. Bills have also been introduced in Congress that would create a similar resolution code for US nationally chartered insurance companies. The Treasury recently proposed a specialised resolution law for 'systemically important' financial groups also modelled on Sections 11 and 13. Finally, other countries have considered or enacted specialised resolution laws for financial institutions modelled on these provisions, such as the UK Banking Act 2009.

We first provide general background on FDIC-insured banks and thrifts. We then describe the extraordinary control the FDIC has over the resolution process, its inherent conflict of interest and the lack of legal certainty about many important issues. We identify the regulatory tools designed to prevent troubled banks and thrifts from failing. Next, we describe the resolution process, including the process for closing an insured institution, the appointment of the FDIC as conservator or receiver and the claims process. We also discuss the FDIC's policy of attempting to preserve the healthy portion of a failed institution's business by transferring some or all of it to a third-party bank or a 'bridge bank' in order to preserve the healthy portion of the banking business of the failed bank on an uninterrupted basis. Finally, we describe the FDIC's extraordinary powers as conservator or receiver to avoid, set aside or otherwise limit the claims of creditors and other stakeholders.

1. Legal background

1.1 US insured banks and thrifts

Banks and thrifts, otherwise known as depository institutions in the United States, may be chartered under US federal law or under the laws of any state. All federally chartered depository institutions and virtually all state-chartered institutions are required to be FDIC insured. This means that their deposits are insured by the FDIC up to certain statutory caps. At the present time, these caps are generally $250,000 per person per institution. The FDIC is an independent government agency. It maintains a deposit insurance fund comprised of assessments imposed on insured institutions throughout the United States. In addition to the fund itself, the FDIC has a line of credit from the Treasury, which it can use to honour deposit insurance claims and provide assistance to troubled or failed depository institutions if the fund is insufficient to cover these expenses. The obligations of the FDIC are presumed to be 'full faith and credit' obligations of the United States, even though as a technical matter funds would need to be appropriated to meet the obligations were the resources of the FDIC to be insufficient.

1.2 Key issue

The overarching issue affecting the rights of creditors and other stakeholders in connection with a failed US bank or thrift is the FDIC's extraordinary powers to administer the receivership process, with little input from creditors or other claimants and virtually no judicial review. The FDIC succeeds to all rights, powers and interests of the failed depository institution, its officers, directors and shareholders, and is given plenary power to administer its affairs. Unlike a proceeding under the Bankruptcy Code, there are no creditors' committees and no trustees, and no court oversees the FDIC's activities. Any claims against the failed institution must first be submitted to the FDIC for its own administrative determination, and only after the FDIC considers the claim will a claimant be permitted to assert its claim before a court.

This extraordinary role creates substantial frustrations for creditors and other parties affected by the failure of a bank or thrift. In one sense, everyone other than the FDIC is a passive observer, without direct access or input to the FDIC as it performs its functions. Part of this frustration arises from the FDIC's inherent conflict of interest; it is not only the sole administrator of the receivership process, but also frequently the largest creditor of the receivership estate. The FDIC has a statutory obligation to insure deposits of failed institutions up to certain statutory limits. When it does, it becomes subrogated to the claims of insured depositors and is therefore a creditor against the failed institution.

Although in its role as conservator or receiver of a closed institution the FDIC is supposed to function as the neutral arbiter of the receivership process, its interest as the largest creditor is often pitted against the interests of competing creditors. It has a strong incentive to use its extraordinary powers to deny, avoid or set aside conflicting creditor claims. In addition, the statutory framework gives favourable treatment to the FDIC's subrogated deposit claims priority over the claims of general creditors.

Further, unlike the extensive body of case law, legal commentary and other guidelines that exists with respect to reorganisations and liquidations under the Bankruptcy Code, there is a very limited body of legal guidance supplementing the statute governing depository institution resolutions. The FDIC has not promulgated a comprehensive body of regulations to implement the statute and has issued only a relatively small number of advisory opinions, policy statements and other guidelines to supplement it. The FDIC also takes the position that advisory opinions issued by its staff, including its general counsel, are not binding on it. In addition, the FDIC reserves the right to withdraw any of its policy statements at any time, potentially with retroactive effect. As a result, there is uncertainty surrounding how various issues would be resolved in the conservatorship or receivership of an insured institution.

There is also very little case law and legal commentary because depository institution failures tend to occur in waves with much lower frequency than insolvencies governed by the Bankruptcy Code. For example, it has been nearly 20 years since the US savings and loan crisis, which marked the last wave of US bank and thrift failures. There have been few cases and almost no demand for legal commentaries in the intervening period. As a result, the case law is sparse and there has been little economic incentive to invest time and effort into a body of legal commentary that seems irrelevant for long periods of time.

2. Regulatory tools to prevent failure

2.1 Supervision, examination and enforcement

The FDIC and the other federal (and, where appropriate, state) banking regulators are granted extensive supervisory powers over depository institutions and their holding companies. This supervision is designed to address the safety and soundness of the institution and monitor compliance with laws and regulations. The supervisory powers include both on-site and off-site examination and evaluation of the institution.

When the regulatory authorities determine that a bank may be operating in an unsafe or unsound manner, may be violating a law, rule or regulation or is otherwise engaging in behaviour determined to pose a risk to the depository institution, the regulators will engage in either informal or formal enforcement actions designed to have the bank address and remedy the problems. Informal tools range from simple discussions between the institution and its regulator as part of the supervisory process, to memoranda of understanding, to written agreements. The Federal Deposit Insurance Act also grants the regulators authority to use a variety of formal enforcement tools, such as cease and desist orders, civil money penalties or removal and prohibition orders. Cease and desist orders are available not only to prohibit certain actions, but also to mandate corrective action on the part of the institution or those individuals or entities participating in the affairs of the institution. Civil money penalties can conceivably run up to $1 million per day per violation under certain circumstances. The removal and prohibition powers can preclude an individual from participating in the affairs of any insured depository institution.

2.2 Prompt corrective action

Long before an insured depository institution fails and is placed in conservatorship or receivership, under Section 38 of the act the appropriate federal banking agency has the power to require the institution to take "prompt corrective action" to prevent it from failing.

Prompt corrective action powers are triggered if an insured institution becomes undercapitalised, is found to be in an unsafe or unsound condition or is found to be engaging in an unsafe or unsound practice. Depending on the severity of the circumstances, the appropriate federal banking agency has the authority to take a number of actions in response to a triggering event, including:

- requiring the insured institution to adopt a capital restoration plan that, in order to be acceptable, must be guaranteed by its parent (up to a maximum exposure of 5% of the insured institution's total assets);
- imposing restrictions on dividends by the insured institution or its parent;
- restricting the insured institution's growth or requiring it to terminate certain activities or sell certain assets;
- requiring the insured institution or any affiliate to be divested;
- imposing limits on the interest rates payable on deposits; or
- imposing limits on executive compensation or requiring the insured institution's board or senior management to be replaced.

The prompt corrective action provisions also create a regulatory presumption that critically undercapitalised institutions will be placed in receivership.

These prompt corrective action tools are designed to force the insured institution and its owners to take remedial action to rehabilitate a weakened institution before it becomes insolvent. However, notwithstanding these provisions, insured institutions continue to fail since the capital measurements that trigger the prompt corrective action restrictions are often a lagging indicator of the true health of the institution.

2.3 Source of strength obligations

Closely related to the prompt corrective action tools is the 'source of strength' obligation that the Federal Reserve imposes on bank holding companies. According to the Federal Reserve, a bank holding company's failure to assist a troubled or failing bank or thrift subsidiary would generally be viewed as an unsafe or unsound practice.[1] The Federal Reserve has generally treated this obligation as unlimited. In other words, this obligation is not subject to a cap in the same way as the guarantee of a capital restoration plan. Notwithstanding the Federal Reserve's position, it is not clear that a court would be willing to require holding companies to inject capital into insolvent bank subsidiaries.[2] Accordingly, the source of strength obligation is more likely to be a subject of discussion and regulatory pressure than a strict legal obligation.

While neither the Office of the Comptroller of the Currency nor the FDIC has historically imposed source of strength obligations on other depository institution holding companies, from time to time both have imposed them contractually on owners of depository institutions that are not otherwise subject to the Bank Holding Company Act. They have typically done so as a condition to certain regulatory action in connection with acquisitions of specialised institutions, such as trust companies, credit card banks or industrial banks, where the owner may not be subject to the Federal Reserve's oversight. Similarly, the Office of Thrift Supervision has imposed net-worth maintenance obligations by contract in connection with certain transactions.

2.4 Discount window and other emergency lending facilities

The Federal Reserve has authority to help prevent insured institutions from failing as a result of a lack of liquidity by providing them with secured credit through its discount window. Historically, the Federal Reserve has discouraged the use of the discount window by stigmatising and imposing a penalty rate on its use. However, early on during the financial crisis the Federal Reserve took several steps to eliminate the stigma and encourage insured institutions to borrow from the discount window as needed during the financial crisis.

The Federal Reserve also has the authority to help prevent any institutions from failing as a result of a liquidity squeeze by providing secured credit under Section 13(3) of the Federal Reserve Act. Section 13(3) authorises the Federal Reserve to provide emergency secured credit to a wide range of institutions under "unusual and

1 See Policy Statement on the Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks, 52 *Federal Register* 15707 (April 30 1987).

2 See *Mcorp Financial, Inc v Board of the Governors of the Federal Reserve System*, 900 F 2d 852 (5th Cir 1990), reversed in part on procedural grounds, 502 US 32 (1991).

exigent circumstances". It was enacted in 1932 but had not been invoked until the current financial crisis, where it has been used extensively. Indeed, it has been the source of authority for almost all of the Federal Reserve's emergency assistance programmes, including its rescue of AIG, its participation in the asset guarantee programmes for Citigroup and Bank of America and its non-recourse Term Asset-Backed Securities Loan Facility.

2.5 Troubled Asset Relief Programme

The Treasury does not have standing authority to provide financial assistance to troubled banks and thrifts to help prevent them from failing. However, Congress gave it temporary authority to invest up to $700 billion in certain assets and instruments of financial institutions pursuant to the Emergency Economic Stabilization Act of 2008. The Treasury has used this authority for various financial assistance programmes during the financial crisis, including its programme to provide capital to various bank holding companies and thrift holding companies and its Public-Private Investment Programme, which will focus on legacy loans and securities held by depository institutions.

2.6 Open bank assistance by the FDIC

Under Section 13(c) of the Federal Deposit Insurance Act, the FDIC also has the authority to provide financial assistance to troubled banks or thrifts to prevent them from failing. This type of assistance is called open bank assistance because it is provided before an institution is closed. Such assistance can take a variety of forms, including loss-sharing arrangements on troubled assets, where the FDIC agrees to bear a certain percentage of the losses (eg, 80%) and the bank retains the rest of the losses. This was the authority used by the FDIC to bail out Continental Illinois and other troubled banks during the savings and loan crisis of the late 1980s and early 1990s.

Congress reacted to what it perceived as the FDIC's misuse of its open bank assistance power during the savings and loans crisis by amending Section 13(c). The provision now imposes a 'least cost resolution' condition on the exercise of the power. The FDIC is no longer permitted to provide open bank assistance unless it can show that such assistance would be the least costly alternative to the deposit insurance fund, in particular compared to closing the institution and placing it in conservatorship or receivership. As the FDIC has various 'super powers' to disallow a wide variety of claims upon its appointment as conservator or receiver, it can virtually never satisfy the least cost condition for providing open bank assistance. The FDIC was also precluded from using open bank assistance to benefit shareholders of depository institutions. As a result of these restrictions, until late 2008 the FDIC had not provided open bank assistance since 1992, shortly after the least cost resolution provision went into effect.

The least cost resolution condition contains a systemic risk exception. This exception allows the FDIC to provide open bank assistance even if the least cost resolution condition is not satisfied. However, in order to rely on this exception, the secretary of the Treasury, upon written recommendation from two-thirds of the FDIC board and two-thirds of the Federal Reserve board, must have determined (in consultation with the president) that open bank assistance is needed to avoid or mitigate serious adverse effects on economic conditions or financial stability.

The systemic risk exception has been invoked several times during the current financial crisis. It was first invoked in connection with the proposed Citigroup/Wachovia transaction, where the FDIC agreed to provide Citigroup with protection against certain potential losses on a portfolio of troubled Wachovia assets. The FDIC also invoked this exception as authority for its Temporary Liquidity Guarantee Programme, its participation in the special asset guarantee programmes for Citigroup and Bank of America, and the legacy loan portion of the Public-Private Investment Programme.

3. Resolution process

If all these tools for preventing the failure of a troubled insured institution do not save the institution, its chartering authority will issue an order to close it. The FDIC must be appointed as the failed institution's conservator or receiver. If it is not, the FDIC has the power to appoint itself as conservator or receiver, which overrides or pre-empts the appointment of any other state or federal agency.

3.1 Appointment as conservator or receiver

The grounds for closing and appointing the FDIC as receiver or conservator are extremely open-ended and may occur well before insolvency. Indeed, some of the grounds overlap with the grounds for prompt corrective action. Thus, the FDIC and an institution's appropriate federal banking agency have considerable discretion in deciding whether to close an institution or to subject it to prompt corrective action. The grounds that allow the FDIC to be appointed conservator or receiver of an insured institution include where:

- the institution is unable to pay obligations in normal course of business;
- the institution is in unsafe or unsound condition;
- the board or shareholders consent;
- the institution is critically undercapitalised;
- the institution engages in an unsafe or unsound practice likely to weaken its condition;
- there is wilful violation of a cease and desist order;
- books, papers, records or assets are concealed; or
- the institution is found guilty of a federal criminal anti-money laundering offence.

The FDIC can serve as either conservator or receiver of an insured institution. A conservator takes control of an insured institution with the intent and ability to operate the institution as a going concern. Generally, the conservator does not engage in wholesale liquidation of the business, although it may sell assets, cease lines of business or take other similar actions. In contrast, a receiver generally operates as the liquidator of an insured institution.

Conservatorships have been extremely rare. Indeed, most historical examples of conservatorships have been limited to so-called 'pass-though conservatorships'. In reality, these conservatorships are more like receiverships with a bridge bank than a true conservatorship because the original institution is left behind and liquidated rather than conserved. They are sometimes more accurately referred to as pass-through receiverships. Many of the savings and loan associations handled by the Resolution Trust Corporation (the specialised agency established during the savings and loan crisis of the late 1980s to handle failed thrifts) were operated as conservatorships for a period of time, until the Resolution Trust Corporation was prepared to commence liquidation of the failed institution. Indymac, which failed in 2008, also involved a pass-through conservatorship, although in that case the original institution was placed into receivership and the FDIC as receiver transferred the assets and many of the liabilities to a newly chartered institution which was immediately placed into conservatorship. Before the assets of this new institution were sold to an investor group, it was placed into receivership and the FDIC effected the resolution transaction.

Freddie Mac and Fannie Mae are possibly the only genuine conservatorships, and their conservatorships were effected under analogous provisions of the Housing and Economic Recovery Act of 2008. However, the FDIC might use a genuine conservatorship in the case of a systemically important bank. Conservatorship could be coupled with open bank assistance, as they were effectively combined in the case of Fannie and Freddie.

The distinction between conservatorships and receiverships can appear fuzzy. However, in general, the FDIC uses conservatorships to operate institutions until such time as it is prepared to effect a resolution transaction. The receivership is typically used by the FDIC to effect the sale of the assets of the failed institution to a third party or to effect a liquidation.

3.2 Effect of appointment

When the FDIC is appointed as conservator or receiver of an institution, it succeeds by operation of law to all rights, titles, powers and privileges of the insured institution and its stockholders, members, directors, officers, accountholders and depositors, subject to the provisions of the Federal Deposit Insurance Act. According to the Supreme Court in *O'Melveny & Myers v FDIC*,[3] this provision of the act effectively "places the FDIC in the shoes of the insolvent [institution], to work out its claims under state [and other applicable] law, except where some provision in [the Federal Deposit Insurance Act's] extensive framework specifically provides otherwise".

As noted above, the FDIC is given both extraordinary and plenary power to administer the affairs of the failed institution.

3.3 Timing of appointment

Typically, an insured institution is closed and the FDIC is appointed receiver after the close of business. Closings typically occur on a Friday to minimise disruption to customers and facilitate the transfer of assets and liabilities to a new acquirer, giving

3 512 US 79 (1994).

the new acquirer the weekend to prepare for a Monday re-opening. In the case of a systemically important institution with an international business, the deadline is typically the opening of the Asian markets on Monday morning (ie, Sunday evening in the United States). While the FDIC will attempt to engage in a transaction that will transfer assets and liabilities to another healthy privately owned banking organisation, on occasion a suitable acquirer cannot be found. In such cases the FDIC may elect to operate the failed institution through a conservatorship or by using its bridge bank authority, or it may be forced to conduct a pay-off of the depositors.

3.4 Resolution transaction

As receiver, the FDIC has the authority to transfer the assets and liabilities to a third party without any consent or approval. It uses this authority to engage in what is typically known as a 'purchase and assumption' transaction – that is, it identifies a third-party bank that will purchase some portion of the assets and assume some portion of the liabilities (typically, just the deposits) of the failed institution. The purchaser must have a bank or thrift charter, although the charter may be granted at the time of the purchase and assumption transaction.

The FDIC has discretion to determine which assets are sold to the acquirer. Since it continues to be governed by the least cost resolution test described above, its determination as to which assets to sell will be based on its analysis of whether the deposit insurance fund is better off transferring the asset to the acquiring institution as part of the purchase and assumption transaction or whether it should sell the asset separately. The assets sold can include cash and securities, performing loans, non-performing loans, buildings, furniture, fixtures and equipment, or any combination thereof. To facilitate the sale, the FDIC can offer loss-sharing or other forms of protection to the purchaser.

The acquiring institution will assume the insured deposits and may elect to assume uninsured deposits as well. On occasion, the acquiring institution will assume certain secured liabilities such as Federal Home Loan Bank advances.

Any assets not purchased by the acquiring institution will be left with the FDIC as receiver, which will liquidate those assets over time. The proceeds of the asset sales, including the proceeds of the sale to the acquiring bank under the purchase and assumption transaction, will be used to satisfy the liabilities of the failed institution.

3.5 Claims process

The FDIC administers the claims process, sorting out valid from invalid claims, determining priorities and administering distributions, which it calls dividends. When the various claims and priorities are sorted out, the FDIC uses the institution's assets to satisfy accepted claims to the extent of such assets. Section 11 authorises the FDIC to conduct the claims process without any court supervision. Indeed, it makes the FDIC's decision to disallow a claim unreviewable by any court, although the validity of a claim is subject to *de novo* judicial consideration following completion of the administrative claims process.

In general, the FDIC notifies potential claimants of the failure. Claimants have 90 days in which to submit a claim and the FDIC has 180 days thereafter to consider the claim. If the FDIC denies the claim, or if the 180-day consideration period lapses without a determination, only then can the claimant obtain judicial consideration of the claim, but the litigation must be filed within 60 days of the earlier to occur of the denial or the lapse of the period. Failure to abide by these time limits will result in a bar of further prosecution of the claim.

One particularly important aspect of the claims process that is an outgrowth of the receivership priorities discussed below is that claims are often worth substantially less than full value, even if valid. Because the assets of a receivership are allocated in accordance with strict priorities, general unsecured claims are rarely paid in full. Indeed, in a majority of bank receiverships, general unsecured creditors will often receive no payment on their claims at all, even if valid.

The FDIC's maximum liability to any claimant is limited to the amount the claimant would have received in a straight liquidation, without any value from a purchase and assumption transaction or a bridge bank. A corollary of this rule is that the FDIC may treat similarly situated claimants unequally, as long as each claimant received at least as much as the claimant would have received in a straight liquidation.

Section 11(d)(11) of the Federal Deposit Insurance Act contains the national depositor preference rule as part of the priority of claims in an FDIC receivership. In particular, it gives priority to deposit liabilities, other than those payable solely outside the United States, over the claims of general creditors. In summary, the priority of claims is as follows:

- administrative expenses of the receiver;
- any deposit liability (other than deposit liabilities payable solely outside the United States);
- any other general or senior liability;
- any obligation subordinated to depositors or general creditors; and
- any obligation to shareholders or members.

3.6 Bridge banks

If the FDIC determines that a bridge bank would facilitate the resolution of a particular institution, the FDIC may request the Office of the Comptroller of the Currency or the Office of Thrift Supervision to charter a new national bank or federal thrift as a bridge banks. The FDIC has the authority to transfer any assets or liabilities from the closed bank to the bridge bank without obtaining anyone's consent. The original bank left behind is liquidated. The FDIC must merge, transfer or terminate and dissolve the bridge bank within two years of its organisation, with the option of three additional one-year periods at the FDIC's discretion. The two-year period is designed to give the FDIC time to find one or more third-party acquirers for all or part of the bridge bank's assets and liabilities, or the bridge bank itself. The FDIC will often enter into loss-sharing agreements or provide other financial assistance to encourage third parties to maximise the net value of the bridge bank's assets and liabilities.

4. FDIC super powers

The FDIC has a variety of extraordinary powers to avoid, set aside or limit the claims of creditors and other stakeholders. With only a few important differences, the FDIC's super powers are the same whether it acts as a receiver or conservator.

4.1 Contingent claims not provable

The FDIC takes the position that claims against an insured institution for contingent obligations are not provable in a conservatorship or a receivership.[4] Thus, the beneficiary of an undrawn line of credit, letter of credit or guarantee has no provable claim to draw down additional amounts or to exercise its indemnification or guarantee rights once the FDIC has been appointed receiver or conservator. Alternatively, the FDIC takes the position that contracts for contingent obligations can be repudiated as 'burdensome', and there are no damages for such repudiation.

On rare occasions the FDIC may include contingent obligations in any assets or liabilities transferred to a third-party bank in a purchase and assumption agreement. If they are transferred the beneficiaries may enforce their rights against the third-party bank. For example, the FDIC transferred the contingent obligations in both the JP Morgan/WaMu and the US Bank/Downey Savings transactions. Whether the FDIC would do so in other large bank failures is uncertain, although we could envision the FDIC doing so in a systemically important institution if it believed such a practice would otherwise further its policy goals for the system.

4.2 High bar to enforceability of contracts

Section 13(e) of the Federal Deposit Insurance Act provides that any agreements with an insured institution that tend to "diminish or defeat the interest of the [FDIC] in any asset acquired by it [as receiver or conservator under the FDIA], either as security for a loan or by purchase or as receiver" are not enforceable against the institution or the FDIC and may not form the basis of a claim against the institution, unless the agreement:

- is in writing;
- was executed by the insured institution and any person claiming an interest under it contemporaneously with the acquisition of the asset by the institution;
- was approved by the board of directors of the insured institution or its loan committee and the approval is reflected in the minutes of the board; and
- has continuously been an official record of the insured institution.

These requirements codify and expand the Supreme Court's decision in *D'Oench Duhme & Co v FDIC*.[5] They defeat the enforceability against an insured institution in receivership or conservatorship of any otherwise enforceable oral contracts. They also create a substantial risk that many otherwise enforceable written contracts will not be enforceable against an insured institution in receivership or conservatorship.

For example, if a creditor had an otherwise enforceable and perfected security interest in certain assets, but the security agreement failed to satisfy one of the

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4 See Statement of Policy Regarding Treatment of Collateralized Letters of Credit After Appointment of the Federal Deposit Insurance Corporation as Conservator or Receiver, 60 Federal Register 27976 (May 26 1995).

5 315 US 447 (1942).

requirements in Section 13(e), the security interest could be unenforceable against the FDIC and would not form the basis of a claim against the institution.

The contemporaneous execution requirement is particularly difficult to satisfy in the context of contractual arrangements that purport to govern a series of transactions over a long period of time before or after the contract is executed, such as a revolving line of credit or a security agreement that grants a security interest in previously or subsequently acquired collateral. The statute contains an exception for agreements for revolving lines of credit from the Federal Reserve or any Federal Home Loan Bank. Such revolving credit agreements are deemed to have been executed contemporaneously with any drawdown. The FDIC has also issued a policy statement on security interests to the effect that the FDIC "will not seek to avoid an otherwise legally enforceable and perfected security interest solely because the security agreement granting or creating such security interest does not meet the 'contemporaneous' requirement of [the Federal Deposit Insurance Act]".[6]

Of course, the FDIC has the right to withdraw its policy statements at any time, potentially with retroactive effect.

4.3 Power to enforce contracts despite *ipso facto* clauses

The FDIC has the power to "enforce any contract entered into by the depository institution notwithstanding any provision of the contract providing for termination, default, acceleration, or exercise of rights upon, or solely because of, insolvency or the appointment of or the exercise of rights or powers by a conservator or receiver".

This means that contractual counterparties are prohibited from accelerating, terminating or otherwise exercising any rights under any contract against the insured institution solely as a result of the appointment of a receiver or conservator for the institution.

There are two exceptions to this rule. First, the rule does not apply to qualified financial contracts in receivership (as distinguished from conservatorship) after a one business day cooling-off period. Second, the rule does not apply to directors' or officers' liability insurance contracts or depository institution bonds in either conservatorship or receivership. Counterparties to such contracts may accelerate, terminate or otherwise exercise the rights solely because of the insolvency or the appointment of a conservator or receiver.

4.4 Repudiation of contracts

The FDIC also has the power to disaffirm or repudiate any contract or lease, including qualified financial contracts, to which the insured institution is a party if the FDIC determines within a reasonable period of time that:

- the contract would be burdensome; and
- the repudiation or disaffirmance of the contract would promote the orderly administration of the institution's affairs.

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6 See Statement of Policy Regarding Treatment of Security Interests After Appointment of the Federal Deposit Insurance Corporation as Conservator or Receiver, 58 *Federal Register* 16833 (March 31 1993).

This power applies to both executory and non-executory contracts, although repudiation of a contact that has been fully executed presents substantial difficulties and to our knowledge has been rarely attempted by the FDIC. The FDIC may cherry pick in exercising this power, even among similar contracts, except in the case of qualified financial contracts, where it must repudiate all or none of the contracts with a particular counterparty.

The statute itself does not define what constitutes a 'reasonable' period of time. However, the FDIC has indicated, in the context of security interests, that a reasonable period of time would generally be no more than 180 days after the FDIC's appointment as receiver or conservator.[7] At least one court has indicated that approximately six months to one year should generally qualify as a reasonable period of time.[8] But a more recent decision states that the amount of time that is 'reasonable' must be determined according to the circumstances of each case.[9] There is also no definition of the term 'burdensome', so the FDIC has wide latitude to interpret that standard provided that its interpretation is reasonable. Indeed, one court has held that the FDIC is not required to make a formal finding as to why a contract is burdensome.[10]

If the FDIC disaffirms or repudiates a contract, it must pay the counterparty damages. But rather than measure damages as the lost benefit of the counterparty's bargain, the Federal Deposit Insurance Act provides that the damages are generally limited to "actual direct compensatory damages determined as of the date of the conservatorship or receivership". This damages formula excludes punitive or exemplary damages, damages for lost profits or opportunity or damages for pain and suffering. The act contains a special rule for qualified financial contracts, under which damages include the cost of cover and are determined based on industry standards.

As noted, the damages are generally measured as of the date the FDIC was appointed as conservator or receiver. The act does not require the FDIC to pay interest for the period between appointment and repudiation. Thus, for instance, if the FDIC repudiated a debt obligation, the institution would be required to pay the counterparty damages in the form of principal plus accrued interest until the date of appointment, but not until the date of repudiation or the original maturity date of the debt obligation. The FDIC is not required to pay post-appointment interest. In the case of qualified financial contracts, damages are measured as of the date of disaffirmance or repudiation, which eliminates the post-appointment interest issue through the later date but does not preserve the benefit of the original bargain.

There are special rules for leases, governing both cases where the failed institution was lessor and cases where it was lessee. In general, when the institution is lessee the FDIC will pay rent until the effective date of repudiation. This is particularly

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7 See Statement of Policy Regarding Treatment of Security Interests After Appointment of the Federal Deposit Insurance Corporation as Conservator or Receiver, 58 *Federal Register* 16833 (March 31 1993).

8 See *Texas Co v Chicago & AR Co*, 36 F Supp 62, 65 (ED Ill 1940), reversed on other grounds, 126 F 2d 83, 89-90 (7th Circuit 1942).

9 See *Resolution Trust Corp v CedarMinn Bldg Ltd P'ship*, 956 F 2d 1446, 1455 (8th Circuit 1992).

10 See *1185 Ave of the Americas Associates v Resolution Trust Co*, 22 F 3d 494, 498 (2nd Circuit 1994).

important for leased bank premises, where the FDIC or third-party acquirer will take a period of time to determine whether it wishes to continue use of the property. Generally, if repudiated, the FDIC will not be obligated to pay future rent or be subject to acceleration or other penalties associated with unpaid future rent.

4.5 Special treatment for qualified financial contracts

Qualified financial contracts are a special class of contract that receives special treatment in receivership and, to a far lesser extent, in conservatorship. Qualified financial contracts include securities contracts, commodities contracts, forward contracts, repurchase agreements, swap agreements and master agreements for any of the foregoing. They are basically the same as the list of protected contracts under the Bankruptcy Code.

The enforceability of *ipso facto* clauses in qualified financial contracts is different depending on whether the institution is in receivership or conservatorship. If in receivership, counterparties have the right to exercise any contractual rights to terminate, liquidate, close out, net or resort to security arrangements upon the appointment of the FDIC as receiver, subject to a one business day cooling-off period. This right overrides the general prohibition against the enforceability of *ipso facto* clauses by counterparties. During the one business day cooling-off period, the FDIC has the option to transfer all, but not less than all, of the qualified financial contracts with a particular counterparty to a single third-party financial institution. If the FDIC exercises this option, the counterparty is not permitted to terminate, accelerate or otherwise exercise its rights with respect to the transferred qualified financial contracts.

In a conservatorship, the general rule against the enforceability of *ipso facto* clauses applies. Counterparties may not terminate, close out or net qualified financial contracts solely on account of the insolvency, financial condition or appointment of the conservator. This, in effect, continues all relationships under their existing contractual provisions.

If the FDIC repudiates any qualified financial contracts, it is not permitted to cherry pick with respect to a particular counterparty. It must repudiate all or none of the qualified financial contracts with a particular counterparty. Damages for repudiated qualified financial contracts are determined as of the date of repudiation, and may include the cost of cover, and are calculated in light of industry practices.

The Federal Deposit Insurance Act prohibits the enforceability of walkaway clauses, even in qualified financial contracts, in both conservatorship and receivership.

4.6 Security interests

Notwithstanding the FDIC's general repudiation power, the Federal Deposit Insurance Act protects legally enforceable and perfected security interests from being avoided for any reason, unless:

- the underlying security agreement does not satisfy the requirements of Section 13(e);
- the security interest was taken in contemplation of the institution's insolvency; or

- the security interest was taken with the intent to hinder, delay or defraud the institution or its creditors.

Because all security interests are in some sense taken "in contemplation of an institution's insolvency", depending on how it is interpreted the second exception could swallow the rule. The FDIC has provided no guidance on how the second exception would be interpreted generally, but has not attempted to avoid security interests taken in the normal course of business. However, in 2005 the act was amended to delete the second exception for collateral securing qualified financial contracts. Such security interests are avoidable only if taken with the intent to defraud, and not merely because they were taken in contemplation of an institution's insolvency.[11]

4.7 Super-priority over fraudulent transfers by insider or debtor

As conservator or receiver of an insured institution, the FDIC has the right to avoid and recover any fraudulent transfer by an insider or debtor of the insured institution to a third party that occurs within five years of appointment. The FDIC's claim is senior to any claim by a trustee in bankruptcy or other person (except another federal agency) in a proceeding under the Bankruptcy Code. But the transfer must have been made with the intent to hinder, delay or defraud the insured institution or the receiver or conservator. The FDIC may recover from any immediate or mediate transferee, except for a transferee who took as a good-faith purchaser for value.

4.8 Cross-guarantees

The FDIC has the right to recover any losses incurred in assisting or resolving any insured institution from any other insured institution under common control with the first institution. Institutions are deemed to be under common control if they are controlled by the same company or if one depository institution is owned by another depository institution. The FDIC's claim may be estimated and assessed in advance of any expenditure of funds and is subordinated to general creditors and depositors, but senior to the claims of shareholders and affiliates.

4.9 Statute of limitations, tolling and removal powers

The FDIC enjoys special powers with respect to litigation and claims involving failed institutions.

First, any ongoing litigation against the failed institution will be stayed and the claimant will be required to file an administrative claim that will be handled by the FDIC, as described above. Only after the claims review process has been concluded will the claimant be permitted to resume the litigation. When a claimant files an administrative claim under the claims procedure, it will be deemed to have commenced an action for applicable statute of limitations purposes, even though the plaintiff may be precluded from actually commencing litigation in court until the administrative process concludes.

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11 See Krimminger, *Adjusting the Rules: What Bankruptcy Will Mean for Financial Markets Contracts*, available at www.fdic.gov/bank/analytical/fyi/2005/101105fyi.html (2005).

Second, the FDIC will have the power to remove most actions pending in state court to federal court.

Third, with respect to claims that the FDIC might wish to assert as receiver, the FDIC enjoys a special statute of limitations of six years for contract claims and three years for tort claims or, if longer, the statute provided by state law. The statute of limitations does not begin to run until the date of the FDIC's appointment as conservator or receiver or, if later, the date the cause of action accrues. Accordingly, unless a cause of action has expired as of the date of conservatorship or receivership, the FDIC has the benefit of an entirely new statutory period within which to bring claims. Indeed, for claims of fraud or intentional misconduct resulting in unjust enrichment or substantial loss to the institution, unless the cause of action accrued more than five years from the date of appointment, the FDIC is entitled to take advantage of the special statute of limitations.

These litigation powers are extremely important. In addition to having to address litigation to which the failed institution was a party, as receiver the FDIC will both initiate and be subject to multiple claims. For instance, following a failure it routinely investigates director and officer liability claims and professional malpractice claims. The extended statute of limitations provides ample opportunity for the FDIC to conduct investigations and bring claims without having to worry about rapidly expiring state statutes of limitation.

5. Conclusion

There is no single law governing the restructuring or liquidation of US financial institutions. Sections 11 and 13 of the Federal Deposit Insurance Act, which govern the resolution of US insured depository institutions, are increasingly being used as a model for specialised insolvency codes for other financial institutions both in and outside the United States. The FDIC, an independent federal agency, has virtually unlimited control over the resolution process under the act. It is not subject to the supervision of any court in carrying out its duties and there is only limited judicial review of its actions. The FDIC has a range of super powers that allow it to avoid, set aside or limit the claims of creditors and other stakeholders that go well beyond those under the Bankruptcy Code. Nevertheless, the FDIC has typically behaved as if it had a duty to preserve the healthy part of a failed bank's business on an uninterrupted basis for the benefit of depositors, secured creditors, customers and other stakeholders. However, the lack of clarity and certainty with respect to its actions creates substantial uncertainty on the part of all those affected by a failure of an insured depository institution.

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