September 26, 2008

OVERVIEW OF THE FDIC AS CONSERVATOR OR RECEIVER

This memorandum is an overview of the receivership and conservatorship authority of the Federal Deposit Insurance Corporation (the "FDIC"). In view of the many and complex specific issues that may arise in this context, this memorandum is necessarily an overview, but it does give particular reference to counterparty issues that might arise in the case of a relatively large complex bank such as a significant regional bank and outlines elements of the FDIC framework which differ from a corporate bankruptcy.

This memorandum has three parts: (1) background on the legal framework governing FDIC resolutions, highlighting changes and developments since the 1990s; (2) an outline of six distinctive aspects of the FDIC approach with comparison to the bankruptcy law provisions; and (3) a final section illustrating issues and uncertainties in the FDIC resolutions process through a more detailed review of two examples – treatment of loan securitizations and participations, and standby letters of credit.[1]

Relevant additional materials include: the pertinent provisions of the Federal Deposit Insurance (the "FDI") Act[2] and FDIC rules[3], statements of policy[4] and advisory opinions;[5] the FDIC Resolution Handbook[6] which reflects the FDIC's high level description of the receivership process, including a contrast with the bankruptcy framework; recent speeches of FDIC Chairman

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1 While not exhaustive, these discussions are meant to be exemplary of the kind of analysis that is appropriate in analyzing any transaction with a bank counterparty.

2 Esp. Section 11 et seq., http://www.fdic.gov/regulations/laws/rules/1000-1200.html#1000sec.11

3 Esp. Part 360, http://www.fdic.gov/regulations/laws/rules/2000-7800.html

4 http://www.fdic.gov/regulations/laws/rules/5000-4300.html#5000statementop12;http://www.fdic.gov/regulations/laws/rules/5000-3500.html#5000statementop8;http://www.fdic.gov/regulations/laws/rules/5000-3900.html#5000statementop11;http://www.fdic.gov/regulations/laws/rules/5000-2800.html#5000statementop6.

5 E.g., http://www.fdic.gov/regulations/laws/rules/4000-7990.html#400093-10; http://www.fdic.gov/regulations/laws/rules/4000-6230.html#400091-24; http://www.fdic.gov/regulations/laws/rules/4000-5120.html#400089-48.

6 http://www.fdic.gov/bank/historical/reshandbook/

Sheila Bair;[7] and press releases and notes with respect to failure cases.[8] In addition to the links below, the full range of documents is available on the FDIC website. http://www.fdic.gov/index.html

In view of unfolding events, these materials should be viewed both as a work in progress and as a point of departure for in depth and comprehensive analysis. Even this overview underscores the importance of credit analysis and rigor of documentation and legal risk mitigation in connection with potentially troubled financial institution counterparties. Any party assessing a particular relationship with a potentially troubled insured bank counterparty should assume that the FDIC will be zealous in the event of bank failure in seeking to minimize cost and maximize recovery with respect to a receivership.

Several points are worthy of special note at the outset.

First, our experience in dealing with the FDIC over an extended period of time, as well as our experience in litigating Resolution Trust Corp. ("RTC") and "goodwill" cases, makes it clear that outcomes are highly fact specific and that precision and care are rewarded. Two parties who believe they have done the same deal may achieve different outcomes depending on their degrees of care.

Second, changes in law, notably codification and more rigorous implementation of the "least cost" test and enactment of a revised priority of claims, have further underscored the risks associated with not getting it right and the need for rigorous risk assessment.

Third, while the FDIC has taken steps to provide market participants with "safe harbors" and guidance to enhance predictability, it is clear that in other areas the FDIC has continued past policies, even when rebuked in the courts.

Finally, in recent months, the FDIC has been preparing for large bank failures. This is reflected in the recently promulgated regulation with respect to depositor processing of deposits in the failure of a large bank and discussion of internal table top exercises regarding large bank failures. The FDIC seizure of IndyMac Bank, a $32 billion dollar institution, in July and now the Washington Mutual closure provide unfolding case studies of this framework in operation.

In this light, patterns of interaction with depository counterparties that are of particular concern or where outcomes are unclear should be analyzed in-depth analysis in the

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[7] E.g., Bair speech on September, 4, 2008: http://www.fdic.gov/news/news/speeches/chairman/spsept042008.html

[8] E.g., re Washington Mutual (three releases): http://www.fdic.gov/news/news/press/2008/pr08085b.html; http://www.fdic.gov/news/news/press/2008/pr08085a.html; http://www.fdic.gov/bank/individual/failed/wamu.html

short-run. Further, because precedent may not be an accurate predictor of outcomes, it may be useful to have discussions with the FDIC with respect to particular patterns of transactions of concern. Note, the goal of government prior to failure is to assure market stability; the goal after failure is to minimize cost to the FDIC fund.

I. Background Concerning FDIC Failed Bank Resolutions

Due to the importance of stabilizing the nation's economy and alleviating the public's fear of bank failures, Congress established the FDIC and granted it special powers for the disposition of the assets and liabilities of failed FDIC-insured depository institutions. The FDIC's authority, role and procedures for acting as a receiver are distinct and defined by the FDI Act, as amended. *See* Section II of the FDI Act. 12 U.S.C. § 1821.

The FDI Act provides the framework for resolving the troubled institution, including marshalling and liquidating its assets and satisfying claims on the failed institution, and using interim devices such as bridge banks and conservatorships. When the FDIC is appointed receiver or conservator, [9] it acts in a separate capacity distinct from its corporate capacity as insurer, regulator or supervisor of insured banks.[10]

Pursuant to Section 11(c) of the FDI Act, the FDIC is appointed as receiver by a federal or state chartering authority in order to liquidate or wind up the affairs of a failed depository institution (an "institution") or as conservator to preserve the going concern value of the institution returning it to health or ultimately resulting in a receivership. While the FDIC's receivership process is analogous to that of bankruptcy and includes many of the same legal concepts and rules, it differs in material respects. It should be noted that the FDIC's powers as conservator largely parallel its distinctive receivership authority, e.g., its contract repudiation authority.

In responding to banks in danger of failing, the FDIC has a range of statutory options for resolution: open bank assistance (rarely used), a conservatorship or bridge bank as intermediate steps, and then either a purchase and assumption ("P&A") transaction with a healthy acquirer (together with a receivership for assets and liabilities not transferred) or a liquidation-depositor payoff of the institution through a receivership. In recent years, the FDIC has been creative through the use of a bridge bank or conservatorship as an interim step permitting the disposition of a failed institution to one or more purchasers. In all but rare cases, a receivership is also used. As reflected in the IndyMac Bank conservatorship, the FDIC is now much less willing to provide 100% coverage to uninsured depositors through a P&A and imposes an upfront haircut on them.

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[9] An institution's charter determines which agency appoints the receiver for the institution in the case of failure.

[10] Indeed, this duality of roles has the consequence that the FDIC may be adverse in litigation to a receivership in its corporate capacity and two receiverships may be adverse o each other. Also, an FDIC conservatorship is subject to the supervision of the bank's primary regulator.

The wave of thrift and bank failures in the late 1980s and early 1990s led the FDIC, the Congress and the courts, respectively, to re-examine the legal regime for dealing with the insolvency of federally insured depository institutions. In the midst of this crisis, with substantial input from the FDIC, Congress enacted the Financial Institutions Recovery, Reform and Enforcement Act of 1989 ("FIRREA") that made major revisions in the receivership provisions in the FDI Act. Faced with an unprecedented scale and scope of banking failures, the FDIC had the task of both adopting policies concerning banking receiverships and in conjunction with the RTC, making thousands of day-to-day decisions affecting the disposition of the assets and liabilities of failed institutions. Parties aggrieved with FDIC and RTC decisions, in turn, sought review by the courts. The current body of law concerning the disposition of failed institutions and the claims of their counterparties thus was substantially fashioned in the crucible of the 1990s.

Historically, for most large financial institutions, the preferred resolution was an assisted P&A transaction whereby an acquiring bank would assume all the deposits and certain other liabilities of the failing bank and acquire some or all of the assets of the bank, plus cash from the FDIC (generally, the acquiring bank would receive the clean assets of the bank or acquire loans with a put to the receivership). In this case, the FDIC would then liquidate the remaining assets in the receivership and pay claims on the receivership including its own claim for insured deposits paid and any funds advanced to the receivership. This approach was viewed as providing the greatest possible stability to the failing bank's customers and community.

The basic P&A model for handling failed institutions has been modified by changes arising from the failures in the late 1980s-early 1990s. Most important were changes in the resolution process--"least-cost resolution,"[11] that is, determining the most cost-effective form of resolution; and "depositor preference,"[12] which provides statutory priorities for depositors over other unsecured claimants. With larger institutions particularly, including currently with IndyMac Bank, the FDIC has made effective use of its "bridge bank" and conservatorship authority to act rapidly to take over a troubled bank or thrift while it determines how best to sell its assets or businesses of the institution to one or more buyers. More recently, the FDIC has reviewed its process for handling depositor claims in the failure of a large and often complex institution and just adopted amended regulations.[13] Finally, litigation arising from the resolutions in the 1990s has produced a body of cases reviewing FDIC polices and procedures, and in a significant number of cases rejecting the FDIC position. We will elaborate briefly on these significant changes.

<u>Least-cost resolution.</u> In determining how to dispose of a failed institution, the FDIC is subject to a statutory mandate not to take actions that would increase losses to any insurance

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[11] *See* 12 C.F.R. § 360.1.

[12] *See* 12 U.S.C. § 1821(d)(11); 12 C.F.R. § 360.3.

[13] *See* FIL-2-2008 (Jan. 14, 2008) and RIN3064-AD26 (June 17, 2008).

fund by protecting depositors for more than their insured deposits or by protecting creditors more than depositors. This requirement thus calls for the FDIC to choose the resolution alternative in which the total expected FDIC expenditure (including any immediate or long-term obligation and any direct or contingent liability for future payment) is the least costly to the deposit insurance fund of all possible resolution methods. The FDIC makes this determination by evaluating the possible resolution alternatives and computing costs on a net present value basis, using a realistic discount rate. This calculation includes a number of factors:

- The difference between total book value of assets and liabilities of the bank;
- The levels of uninsured and insured liabilities;
- The premium paid by the acquirer;
- Losses on contingent claims;
- The realized value of assets placed in liquidation by the FDIC; and
- Cross guarantee provisions against affiliated institutions.

Least-cost resolution has helped foster varied types of P&A transactions. The FDIC can override the "least cost" test in the case of a systemic significant institution. However, Congress has made this exception substantively and procedurally difficult to effect by requiring a finding that use of least-cost "would have serious adverse effects on economic conditions or financial stability." 12 U.S.C. § 1823(c)(4)(G)(i)(I).

Depositor Preference. The "depositor preference" regime enacted in the 1990s (as discussed more fully in Part II) elevates the claims priority of a failed institution's depositors over general creditors. The greatest beneficiary is the FDIC itself as the insurer-subrogee to the insured depositors (for example, in the IndyMac failure, $18 billion of the bank's $19 billion of deposits were insured). Because uninsured depositors also get preference over general creditors, this policy tends to increase their ultimate recovery as well.

Depositor claimants are sometimes issued an advance dividend based on the projected recovery value of the failed institution’s assets. Advance dividends usually range between 50 cents and 80 cents on the dollar of receivership claims. The just-completed rulemaking concerting deposits of large banks updates procedures for this part of the process. It should be noted that provisions not technically part of the depositor-preference regime address (and give first priority to) claims from Federal Home Loan ("FHL") Banks and secured claims.[14]

Bridge Bank. The FDIC can transfer some or all of the failed institution's assets and liabilities to a newly chartered institution, either as a "bridge" bank to continue its operations,

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[14] *See* 12 C.F.R. § 360.2.

and manage its assets and liabilities, or as a vehicle to transfer all insured deposits and other selected assets and liabilities to an existing depository institution. A bridge bank is a full-service national bank chartered by the Office of the Comptroller of the Currency and controlled by the FDIC. It can be operated for two years, with three one-year extensions. A bridge bank provides the FDIC time to arrange a permanent transaction and is especially useful in situations where the failing bank is large or unusually complex. It should be noted that in the case of a failed savings association, such as IndyMac, a conservatorship is used as the vehicle for this interim arrangement because the statutory "bridge bank" provisions do no encompass savings institutions.

The use of a conservatorship in the case of IndyMac Bank is an illustration of this approach. The FDIC is serving as conservator for the new operating successor, IndyMac Federal Bank FSB, which succeeded to all insured deposits (about $18 billion) and "substantially all" of the assets of its predecessor, and as receiver of the failed IndyMac Bank, FSB.[15] At the same time, the FDIC as receiver of the failed bank is providing uninsured depositors (representing about $1 billion of deposits) an "advance dividend" equal to 50% of their deposits, pending complete resolution of the failure.

Litigation. While cases reviewing FDIC actions as receiver have largely upheld the FDIC's approaches, the courts in a significant number of cases rejected the FDIC position on particular consequential issues, such as whether claims involving a degree of "contingency" are compensable following a contractual repudiation and what are appropriate methods for measuring the amount of damages. See Part II.D, below. It is striking that despite this litigation the FDIC has left policies adopted in the 1990s in place and thus left areas of significant uncertainty with respect to the handling and outcome of claims in future insolvencies. The discussion below regarding standby letters of credit in Part III.B, below, is a graphic illustration of this phenomenon.

II. Distinct Features of an FDIC Receivership or Conservatorship

The FDIC receivership regime has been fashioned by Congress with a view to minimizing the ultimate cost to taxpayers of bank failures and to provide for an efficient resolution process under the FDIC. Particular features of this regime are :

- the broad administrative discretion of the FDIC as the "hands-on" receiver or conservator and the corresponding limitation of the judicial role to review of FDIC actions and decisions;

- the documentary requirements to facilitate FDIC decisions based on the books and records of the failed institution;

[15] See the FDIC press releases at Exhibit 39 and 34.

- the priority given depositors over general creditors under the "depositor preference" regime;
- the broad authority of the FDIC to repudiate (breach) any contract, with certain statutory exceptions, and the corollary that an affected claimant must prove its damages in order to be compensated;
- FDIC authority to avoid fraudulent conveyances; and
- FDIC authority to stay litigation.

Each of these features is outlined below, with a corresponding outline of the contrasting powers of a bankruptcy trustee (please note that the section references in the bankruptcy sections are to sections of the federal Bankruptcy Code, in Title 11 of the U.S. Code.).

A. The Claims Process: FDIC Discretion Without Ongoing Judicial Oversight

1. FDIC's general administrative discretion as receiver or conservator

Unlike the regime established in the federal Bankruptcy Code, which provides for the receiver to act under ongoing supervision and action of the bankruptcy court, an FDIC receivership and conservatorship are administrative proceedings. The broad discretion delegated to the FDIC to dispose of a failed institution's affairs as it deems best is not significantly limited by the specified judicial review of particular claims matters, nor by the ultimate ability of aggrieved parties to bring lawsuits against the FDIC as receiver or conservator under the general rules applicable to any suit against a federal agency.

This regime and the FDIC powers are set forth in Section 11 of the FDI Act (see Exhibits 1 to 3), codified at 12 U.S.C. § 1821. Although the FDIC has issued a regulation in Part 360 of its rules (Exhibits 5 to 12), a number of policy statements (Exhibits 13 to 17) and interpretations (Exhibits 18 to 23), these provisions supplement the statute by addressing discrete issues, such as "qualified financial contracts" and securitization and participation transactions. The often terse terms of the statute itself thus provide the principal reference and guidance concerning how an FDIC receivership or conservatorship may be conducted. Moreover, even though a number of cases have rejected the FDIC position stated in its polices, as discussed in the example of letters of credit in Part III.B, below, the FDIC in its discretion often has not revised its policies to reflect the outcome of the cases.

The FDIC's first step as conservator or receiver is to take possession of all of the closed institution's books and records and assets and loans.[16] It will bring all accounts forward to the

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[16] Section 1821(d)(2) provides the FDIC "shall, as conservator or receiver, and by operation of law, succeed to-- (i) all rights, titles, powers, and privileges of the insured depository

[Footnote continued on next page]

closing date and then notify other banks of the closing. It will also create two sets of inventory books containing explanations of the disposition of the failed institution's assets and liabilities, with one set going to the assuming institution, if applicable, and one for the receiver.

Next the FDIC will, in the case of any liquidation or winding up, notify the institution's creditors that they must submit their claims (along with applicable proof of the claims) by a specified date that is no less than 90 days after such notice.[17] This notice must be made via publication and mail. A further notice must be published one and two months after the initial notice.

Review of claims. The FDIC is granted the power to allow or disallow any claims within the 180-day period beginning on the date the claim is filed with the FDIC as receiver. This substantial power allows the FDIC to generally disallow any portion of a claim by a creditor or a claim of security or preference if such a claim is not proved to the satisfaction of the FDIC.

- Pursuant to Section 11(d)(6) of the FDI Act, if a claim is disallowed by the FDIC, the claimant can file for a review of such a claim by the applicable agency or judge within 60 days after the earlier of (i) the end of the 180-day review period or (ii) the date the claim was disallowed. If the claimant requests an administrative review, and the FDIC agrees to the request, the FDIC will carry out the review and its final determination will be subject to judicial review. Alternatively, the claimant can either file the claim in the U.S. District Court for the district within which the institution's principal place of business is located or the U.S. District Court for the District of Columbia. Note that the FDIC is also permitted to establish other alternative dispute resolution procedures.

- Finally, it should be noted Section 11(d)(8) of the FDI Act provides that an expedited determination of claims is available to those claimants who claim (i) they possess a legally valid and enforceable or perfected security interests in the assets of the

[Footnote continued from previous page]
institution, and of any stockholder, member, accountholder, depositor, officer, or director of such institution with respect to the institution and the assets of the institution; and (ii) title to the books, records, and assets of any previous conservator or other legal custodian of such institution." The statute does not specifically address the determination of what assets should be viewed on the institution's book at the time of failure and thus what assets constitute the receivership estate, for example, whether assets subject to a previous sale or transfer transaction were completely removed from the institution's books. State law controls matters left unaddressed in FDI Act. See *FDIC v. Houde*, 90 F.3d 600, 604 (1st Cir. 1996) (citing *O'Melveny & Myers v. FDIC*, 512 U.S. 79 (1994)). Therefore, case law that has developed in insolvencies of entities not subject to federal bank regulation may govern of whether a particular asset would be considered part of the receivership estate and therefore subject to the powers granted to the receiver.]

[17] 12 U.S.C. §§ 1821(d)(3)(B) and 1821(d)(3)(C).

institution and (ii) irreparable injury will occur if the routine claims procedure described above is followed. If this expedited claim is denied, however, the statute of limitations for seeking review of such decision is also shortened to 30 days.

No ongoing judicial oversight Pursuant to Section 11(d)(13)(D) of the FDI Act, except as otherwise provided, no court has primary jurisdiction over any claims or action for payment from, or actions seeking a determination with regards to, an institution for which the FDIC has become a receiver. Further this provision also limits courts' ability to engage in a review of any claims relating to acts or omissions of the institution or the FDIC as receiver. Under Section 11(d)(13)(C) of the FDI Act, no court may issue an attachment or execution over the assets that are in the possession of the FDIC as receiver.

Judicial review of FDIC receivership actions. Apart from the judicial review of denied claims noted above, any aggrieved person may file suit under standard rules to challenge any final action of the FDIC as receiver.

2. Bankruptcy Law Provisions: Judicial Management and Oversight

Generally, creditors have a limited period to file claims in bankruptcy, which in a chapter 11 case will be set by an order of the court setting a bar date. The trustee will review the claims but, if the trustee does not agree with a claim, the trustee will object to the claim and the objection starts a court process which will terminate with a decision of the Bankruptcy Court on the validity and amount of the claim, which decision is subject to appeal to the District Court or Bankruptcy Appellate Panel, the Court of Appeals and the Supreme Court.

- Although Section 502(b) of the Bankruptcy Code provides that certain claims are not allowed, the trustee has no power to disallow claims. The various time limits for filing, objecting to claims, and determining the claims are normally set by a court scheduling order and there are no specific periods in the statute. A filed claim is considered valid unless an objection is filed as is a claim listed in the schedules as undisputed. Normally, matters relating to the allowance of claims and the resolution of objections are heard in the Bankruptcy Court, although in some cases one of the parties may seek to have the matter resolved in another federal or state court (although such a request is rarely granted).

- The trial of personal injury claims must take place before the District Court rather than the Bankruptcy Court. In rare cases, courts will enforce a pre-bankruptcy arbitration agreement to arbitrate matters relating to the claims.

There are no special provisions for determining claims arising under enforceable security agreements, although the parties can seek expedited relief on a showing of a need for such relief. *See* Sections 502, 28 U.S.C. 157. Governmental agencies must file proofs of claim to recover from the bankrupt estate and, by doing so, waive sovereign immunity relating to the claim and compulsory counterclaims. *See* Section 106.

The Bankruptcy Court has jurisdiction over all assets of the debtor wherever located, and any attempt by a creditor to attach or execute on such assets would be a violation of the automatic stay and could constitute a contempt of court.

B. FDIC Documentary Requirements

The FDI Act embodies a general policy that the rights of claimants are to be determined based upon the written records of the institution and related documents and records in the hands of private parties, as they exist at the time of failure.

1. FDI Act and the *D'Oench* Doctrine

The Supreme Court first recognized a federal policy of protecting the FDIC from unrecorded schemes or arrangements that would mislead banking authorities in the case of *D'Oench, Duhme & Co. v. FDIC.*[18] In essence, the *D'Oench* Doctrine sought to protect the FDIC from post-insolvency efforts to give claimants superior rights to assets of the institution based on an unrecorded agreement by disallowing claims by a party who asserted a claim without meeting clear documentary requirements scheme. The documentation requirements are set out in Section 13(e) of the FDI Act.[19] If the *D'Oench* requirements as described in the statute and rules are not met, the FDIC can refuse the claims pursuant to Section 11(d)(9)(A) of the FDI Act.

Section 13(e), 12 U.S.C. § 1823(e), provides that no agreement is valid against the FDIC's interest as receiver in an asset unless the agreement:

- is in writing;

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[18] 315 U.S. 447 (1942).

[19] The FDIC further enunciated its policy with regards to unrecorded agreements in its Statement of Policy Regarding Federal Common Law and Statutory Provisions Protecting FDIC, as Receiver or Corporate Liquidator, Against Unrecorded Agreements or Arrangements of a Depository Institution Prior to Receivership (February 28, 1997). See Exhibit 14. In that policy statement the FDIC indicates that it believes Congress intended that Sections 1823(e) and 1821(d)(9)(A) should be interpreted in a manner consistent with the policy concerns underlying the *D'Oench* Doctrine and that, therefore, these sections bar claims that do not meet the enumerated recording requirements set forth in Section 1823(e), regardless of whether a specific asset is involved, to the same extent as such claims would be barred by the *D'Oench* Doctrine. The FDIC also outlined certain guidelines in its policy statement for aiding in the review of matters where the assertion of the *D'Oench* Doctrine or the relevant statutory provisions are at issue, and it indicated that, as a matter of policy, it will not seek to bar claims which by their very nature do not lend themselves to the enumerated requirements of section 1823(e). Although reaffirming the principles of *D'Oench*, this policy is also parallel to the somewhat more flexible application of the *D'Oench* Doctrine in the context on modern commercial transactions reflected in court cases.

- was executed by the depository institution and any person claiming an adverse interest thereunder contemporaneously with the acquisition of the asset by the depository institution;

- was approved by the board of directors of the institution or its loan committee, and such approval is reflected in the minutes of the board or committee; and

- has been, continuously, from the time of its execution, an official record of the depository institution.

    - Note, however, that there is an exception for (1) Qualified Financial Contracts, which are not deemed invalid solely because they were not executed contemporaneously with the acquisition of the collateral or because of pledges related to, delivery, or substitution of the collateral made in accordance with such agreement and (2) securitizations and participations, (as provided in Section 360.6, discussed in Part III.A below).

D'Oench-related issues have been extensively litigated, with the result that in recent years courts have moved away from a mechanistic approach. In view of the purpose of the *D'Oench* doctrine to protect the FDIC fund, *D'Oench* for many years fostered a generally formalistic approach in the courts, particularly in the context of agreements involving a single loan and pledge of collateral, to interpret this requirement to mean that execution of the agreement and receipt of the pledged assets must occur at exactly the same time. *See, e.g., Langley v. FDIC*, 484 U.S. 86, 92 (1987); *RTC v. Dubois*, 771 F. Supp. 154, 156 (M.D. La. 1991). If this strict view is followed, any agreement involving a feature under which assets are transferred at various times after the execution of the agreement, for example, would always fail to satisfy the *D'Oench* Doctrine contemporaneousness requirement. The trend in the U.S. Courts of Appeals in the 1990s has been to read the statutory requirements in light of commercial realities and standard business practices. *See, e.g., FDIC v. Manatt*, 922 F.2d 486 (8th Cir.), *cert. denied*, 501 U.S. 1250, 111 S. Ct. 2889, 115 L. Ed. 2d 1054 (1991); *RTC v. Midwest Fed. Sav. Bank of Minot*, 4 F.3d 1390 (9th Cir. 1993) & 36 F.3d 785 (9th Cir. 1993); *Duraflex Sales & Serv. Corp. v. W.H.E. Mech. Contractors*, 110 F.3d 927, 933-34 (2d Cir. 1997). *See also* Galves, *Might Does Not Make Right: The Call for Reform of the Federal Government's D'Oench, Duhme and 12 U.S.C. § 1823(e) Superpowers in Failed Bank Litigation*, 80 Minn. L. Rev. 1323 (1996).

2. Bankruptcy Law Provisions

There is no specific record-keeping requirement for a claim to be valid except to the extent that the absence of proper records may provide a defense to the claim under applicable law or raise issues regarding the validity of the claim.

As noted earlier, the holder of a claim must file a proof of claim unless it is listed as undisputed, but the underlying claim itself does not have to be in writing. A claim is not valid, however, if it is "unenforceable against the debtor and property of the debtor, under any agreement or applicable law . . . ." (Section 502(b)(1)). This provision has generally been interpreted to incorporate state substantive law, including state statutes of fraud. The Supreme

Court has held that the validity of claims is generally governed by the underlying substantive law giving rise to the claim--*i.e.*, usually, state law.

Claims may be disallowed if not valid under the underlying substantive law. This would include situations where the claim is not valid because of lack of power to incur the obligation, lack of authority, or failing to obtain the approvals required under applicable law (e.g., by the board of directors).

C. Priority of Claims

1. FDIC Depositor Preference

Under the FDI Act, insured depositors are covered by FDIC deposit insurance (with the FDIC as subrogee taking the place of those depositors), claims of FHL Banks receive priority treatment, and secured claims are satisfied based upon the governing security documents. As the term suggests, "depositor preference" elevates the claims priority of depositors over unsecured creditors. Under these provisions, claims are paid in the following order:

1. Administrative expenses of the receiver,

2. Deposit liability claims (the FDIC claim takes the position of the insured deposits),

3. Other general or senior liabilities of the institution,

4. Subordinated obligations, and

5. Shareholder claims.

The implementation of depositor preference is being amply demonstrated in the IndyMac case. See Exhibits 37 to 40.

2. Bankruptcy Law Priorities

1. Any secured claims are paid "off the top" up to the value of collateral. If fully secured, the creditor also gets post petition interest and fees/expenses. If partially secured, the creditor gets only the value of its collateral without post petition interest and fees/expenses. Any deficiency is an unsecured claim. Section 506.

2. Administrative claims--expenses of running the estate including any expenses incurred to run the business post petition, and the legal and other professional expenses of the case. There are a variety of other administrative expenses by statute such as claims for creditors who sold goods within 20 days of the petition, reclamation claims and creditors who provided a "substantial contribution" to the case. Sections 503(b), (b)(9), 507(a)(2), 546(c). There is also a special superpriority for situations where the debtor has provided adequate protection to a secured creditor as a condition to continuing the stay

or using collateral, and the adequate protection proves inadequate; in such cases, the creditor's superpriority is the amount of the loss. Section 507(b). Note that there is a superpriority for domestic support obligations (e.g., alimony, child support), but this does not arise in business cases. Section 507(a)(1).

3. Priority claims in a specified order. The most significant priority claims are certain wages and employee benefit claims (subject to a cap), certain claims of creditors against operators of grain storage facilities and fish processing storage facilities (subject to a cap), consumer deposits (subject to a cap), the most recent tax obligations (e.g., filing of the return was not more than three years before the filing of the bankruptcy petition), unsecured claims based on a commitment to a Federal depository or regulatory agency to maintain the capital of an insured depository institution (ninth priority), and claims for death or personal injuries if the debtor was intoxicated. *See* Section 507(b)(3)-(10).

4. Allowed unsecured claims. See section 502. As discussed previously, the validity of claims is generally determined by state law, although certain claims are completely or partially disallowed by statute. For example, claims for post petition interest are disallowed, and claims of landlords and employees are subject to a cap with the remainder disallowed. Section 502(a). The statute also permits estimation of contingent or other unliquidated claims. Section 502(c). A special rule disallows claims of creditors who have received avoidable transfers (e.g., preferences or fraudulent transfers), until they surrender the transfer. Section 502(d). Special rules also deal with situations where two creditors may assert claims for the same obligation such as a creditor and a surety and essentially prevent two creditors each asserting claims for the same obligation. Sections 502(e), 509. There are also special rules regarding the determination of tax claims which essentially give the bankruptcy court the power to determine certain tax claims. Section 507. Note that if two or more creditors have a subordination agreement, that agreement will be enforced between the parties, and the share of the subordinated creditor will be paid to the senior creditor until the senior creditor is paid in full. Section 510(a).

5. Subordinated claims. Section 510. Most important are claims arising from the purchase or sale of securities (purchase and sale are broadly interpreted to apply to any transaction with the creditor took an equity type risk or sought an equity type return), and claims which should be subordinated under "principles of equitable subordination" (generally creditor misconduct toward other creditors). Closely related to the latter is recharacterization of debt to equity, which essentially is a determination that the obligation was not really debt at all.

6. Shareholder claims, generally in the order of priority as between shareholders.

Note that these rules are for a single debtor. If there are multiple debtors, the same rules apply unless the court grants the substantive consolidation of the various debtors. The governing case law indicates that substantive consolidation should only be granted in special situations where there was no creditor reliance or it is required as a practical matter (e.g., it is impossible or prohibitively expensive to segregate assets) but, in practice, substantive consolidation is more frequent than the case law would lead one to expect. If the estates of multiple debtors are consolidated, this means that each creditor has a single claim against the consolidated pot of assets (even if it had claims against two or more debtors for the obligation, e.g., one debtor owed the obligation and another debtor was a guarantor), and all intercompany claims are eliminated.

D. Contract Repudiation Authority

1. FDIC Repudiation and Compensatory Damages

Section 11(e) of the FDI Act permits the FDIC as receiver to repudiate or disaffirm any of the failed institution's contracts. The statute provides:

> (1) In addition to any other rights a conservator or receiver may have, the conservator or receiver for any insured depository institution may disaffirm or repudiate any contract or lease-- (A) to which such institution is a party; (B) the performance of which the conservator or receiver, in the conservator's or receiver's discretion, determines to be burdensome; and (C) the disaffirmance or repudiation of which the conservator or receiver determines, in the conservator's or receiver's discretion, will promote the orderly administration of the institution's affairs.
>
> (2) TIMING OF REPUDIATION.--The conservator or receiver appointed for any insured depository institution in accordance with subsection (c) shall determine whether or not to exercise the rights of repudiation under this subsection within a reasonable period following such appointment.
>
> (3) CLAIMS FOR DAMAGES FOR REPUDIATION.--
>
> (A) IN GENERAL.--Except as otherwise provided in subparagraph (C) and paragraphs (4), (5), and (6), the liability of the conservator or receiver for the disaffirmance or repudiation of any contract pursuant to paragraph (1) shall be-- (i) limited to actual direct compensatory damages; and (ii) determined as of-- (I) the date of the appointment of the conservator or receiver; or (II) in the case of any contract or agreement referred to in paragraph (8), the date of the disaffirmance or repudiation of such contract or agreement.
>
> (B) NO LIABILITY FOR OTHER DAMAGES.--For purposes of subparagraph (A), the term "actual direct compensatory damages" does not include-- (i) punitive or

exemplary damages; (ii) damages for lost profits or opportunity; or (iii) damages for pain and suffering. [20]

Section 11(e)(12) of the FDI Act provides that the FDIC is not permitted to avoid any legally enforceable or perfected security interest in any of the institution's assets, so long as the interest was not taken in contemplation of the institution's insolvency or with the intent to hinder, delay or defraud the institution or its creditors.

When the FDIC repudiates a contract, the FDI Act limits the damages for which it can be liable.[21] The damages are limited to actual compensatory damages determined as of the date of the appointment of the FDIC as receiver. Further, the FDI Act specifically excludes any damages for lost profits, pain and suffering or punitive damages. These determinations have given rise to significant litigation based on the FDIC's strict reading of the statute, a view often rejected by the courts, as discussed below.

Section 11(e)(8) of the FDI Act provides detailed specific treatment for "Qualified Financial Contracts" ("QFCs") (which include securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements and similar agreements, all of which are further defined within the FDI Act) and outlines the rights of the parties to such contracts. The FDIC also has issued a Statement of Policy on Qualified Financial Contracts[22]). These provisions address the handling of QFCs in substantial detail (beyond the scope of this memorandum) and evidence a general policy to give effect to these agreements, but repudiation is also a possibility.

- Under this subsection of the FDI Act, the FDIC is not permitted to stay or prohibit any person from exercising a right to terminate, liquidate or accelerate Qualified Financial Contracts which arises upon the FDIC's appointment as receiver (subject to certain timing restrictions outlined in Section 11(e)(10)(B) of the FDI Act and restrictions if the QFC are transferred to another institution, as set out in the FDIC Statement of Policy on Qualified Financial Contracts. If the FDIC transfers the assets

[20] 12 U.S.C. § 1821(e)(2).

[21] 12 U.S.C. § 1821(e)(3).

[22] This policy statement provides that the right to terminate, liquidate or accelerate can be stayed or prohibited if a party to the QFC is notified by the receiver by the close of business on the business day following the receiver's appointment that the receiver transferred to a single insured institution (a) all QFCs between the failed depository institution and such party and its affiliates; (b) all claims of the party and its affiliates under such QFC against the failed depository institution (other than claims subordinated by any such QFCs to the claims of general unsecured creditors); (c) all claims of the failed depository institution against the party and its affiliates under such QFCs; and (d) all property securing claims under such QFCs.

of the institution in receivership, and such transfer includes QFCs, it is required by Section 11(e)(9) of the FDI Act to transfer all or none of the QFCs between a counterparty, its affiliates and the failed institution.

- If repudiated, damages are determined as of the date of the repudiation of the contract (not the date of the appointment of the FDIC as receiver). Recoverable damages for QFCs also expressly include the cost of cover.

- Although the FDIC is barred by Section 11(e)(8)(C)(i) of the FDI Act from avoiding any transfer of money or property in connection with a QFC with an insured depository institution, it is permitted to do so if it determines that the transferee's intent was to defraud the institution for which the FDIC has been appointed receiver, or any of such institution's creditors.

- The FDI Act provides that a counterparty to a QFC can not have their rights under security arrangements stayed or prohibited from taking effect.

- Under Section 11(d)(12) of the FDI Act, the FDIC will have the ability to request a stay of 90 days in the case of any suit brought against the FDIC by a holder of a QFC who is trying to enforce or give effect to such contract.

Since enactment of FIRREA, the courts have considered a variety of cases challenging the actions of the FDIC under the repudiation authority provided by the barebones provisions of Section 11(e) and addressed the nature of the claims that are provable because they give rise to "actual compensatory damages." In cases not involving a claim under a lease, the courts have considered, and consistently rejected, a number of arguments made by the FDIC that damages arising from post-receivership events are not "actual compensatory damages" because, *e.g.*, damages had to be known and fixed as of the date of its appointment as receiver, that contracts involving post-receivership performance were "contingent" and thus did not present a provable claim, and that an *ipso facto* clause could not operate to accelerate a claimant's right to receive damages.

The courts have often rejected the FDIC's position as too restrictive. The consensus among the Courts of Appeals that have considered this issue is that a claimant has a provable claim for actual compensatory damages as long as the contract giving rise to the claim existed pre-insolvency and sufficiently defined the rights and obligations of the parties under that agreement. As the Eleventh Circuit court has stated: "A claim exists before insolvency if it is based upon a pre-insolvency contract which requires payment upon a stated event." *McMillian, supra*, 81 F. 3d 1041,1048 (11th Cir. 1996). The D.C. Circuit has similarly stated that a claim is "sufficiently provable" if the "insolvent bank's promise was 'binding and enforceable under contract law'" at time of insolvency. *Nashville Lodging Co. v. RTC*, 59 F.3d 236 (D.C. Cir. 1995).

The body of post-FIRREA cases demonstrates a judicial respect for binding contractual agreements to which the bank was a party before going into receivership. These cases consistently hold that such agreements give rise to a provable claim for actual compensatory damages unless those damages represent lost profits or opportunity or are governed by paragraphs in Section 11(e) specifically directed at certain types of contracts such as leases. Moreover, the post-FIRREA courts have used the panoply of contract law methods in the effort to determine damages that would make whole the parties to contracts repudiated—breached—by the FDIC. *E.g., Howell, supra*, 986 F. 2d at 571 (“repudiation is treated as a breach of contract that gives rise to an ordinary contract claim for damages, if any”); *McMillian, supra,* 81 F.3d at 1055 (“those damages, flowing directly from the repudiation, which make one whole”); *Nashville Lodging Co. v. RTC, supra*, 59 F.3d 236 (D.C. Cir. 1995) (reliance or expectation interest compensable under FIRREA); *Parkway Executive Office Ctr.*, *supra,* 1998 WL 18204 (“damages for diminution in value are 'actual compensatory damages'“); *Citibank (S.D.), N.A., supra*, 857 F.Supp. at 983 (repudiation of non-compete agreement compensable based on the “enhanced capacity to compete” of the party benefiting from the breach); *Employees' Retirement Sys. of Ala. v. RTC*, 840 F.Supp. at 985-993 (damages are the market value of repudiated securities at the time of repudiation)[23]; *DPJ Co. Ltd., supra,* 30 F. 3d at 249 (reliance damages compensable). These cases nevertheless illustrate the untidiness of the FDIC receivership process and the range of legal issues that can arise when the FDIC has repudiated contracts.

2. Bankruptcy Law Provisions

The trustee (which also includes the debtor in a chapter 11 case) can assume or reject executory contracts (i.e., performance due on both sides), and has virtually unlimited discretion to do so. This right must be exercised within 60 days of filing in a chapter 7 liquidation and until plan confirmation in a chapter 11 case, although the time period can be shortened by court order. As to real estate leases in a chapter 11 case, the debtor has 120 days after filing, subject to extensions up to an outside period 210 days from filing to assume or reject the lease. *See* Section 365, especially 365(d).

The provisions dealing with the types of contracts which constitute contracts similar to those of Qualified Financial Contracts are summarized in brief below:

- The debtor has limited power to assume these contracts.
- The counterparty (a) can enforce an ipso facto clause (i.e., a bankruptcy termination provision) notwithstanding usual bankruptcy rules which generally do not permit such clauses to be enforced, (b) is not subject to the automatic stay but can enforce the termination provisions of the contract and close it out even though a bankruptcy petition has been filed and (c) is not subject to provisions of bankruptcy law dealing with preferences and fraudulent transfers (other than intentionally fraudulent transfers). *See* Sections 362(b)(7), (17), (27), 546(e), (f), 555, 556, 559, 560, 561, 562.

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[23] Note that Gibson, Dunn & Crutcher LLP represented the retirement plan plaintiffs in this case.

- This essentially takes most of such contracts out of the bankruptcy case and other provisions of bankruptcy law, and experience suggests that counterparties generally close out these contracts as soon as possible upon a filing.

There is no concept of "wrongful" repudiation since rejection of contracts must be approved by the court (unless it is automatic by the passage of time) and this issue has not arisen in bankruptcy cases.

D. Fraudulent Conveyances

Although both the FDI Act and the Bankruptcy Code embody similar principles concerning fraudulent conveyances, they differ in particulars, such as the FDI Act's specific provisions on insider transactions.

1. FDIC Authority

As noted above, the FDIC has the power pursuant to Section 11(e)(12) of the FDI Act to avoid any otherwise legally enforceable or perfected security interest in any of the institution’s assets if such interest was taken in contemplation of the institution’s insolvency or with the intent to hinder, delay or defraud the institution or its creditors.

Further, under Section 11(d)(17) of the FDI Act, the FDIC can avoid certain transfers of interest of an institution-affiliated party, or any person whom the FDIC determines is a debtor of the institution in receivership, in property, or any obligation incurred by such person, that was made within five years of the FDIC’s appointment as receiver. In order to be avoidable, such transfers must have been made, or such liability incurred, with the intent to hinder, delay or defraud the institution that is in receivership, the FDIC or any other federal banking agency. If the FDIC avoids the transfer, the FDIC can recover the property transferred or the value of the property from either the initial transferee or any immediate transferee of the initial transferee. It should further be noted that the FDIC can not recover from any transferee that takes for value, including satisfaction or securing of a present or prior debt, in good faith or any immediate good faith transferee of such transferee. Finally, these avoidance rights of the FDIC are superior to any rights of a trustee or any other party.

2. Bankruptcy Law Provisions

The trustee and debtor may avoid perfected security interests if the transfer was not for a reasonably equivalent value, and the debtor was insolvent, had unreasonably small capital or expected to incur debts beyond the ability to pay. However, under bankruptcy law, the securing of a previously unsecured debt is considered to be for a reasonably equivalent value and generally cannot be avoided as a fraudulent transfer (except, sometimes, when granted to insiders). *See* Sections 510(c), 547, 548.

- Note, however, that securing previously unsecured debt can be avoided as a preference if the transfer is within 90 days of the petition, or for insiders, within one year of the petition. The bankruptcy court does not have the power to avoid a security interest taken in contemplation of insolvency as a fraudulent transfer, although sometimes the debtor may seek to recharacterize or subordinate the debt and therefore as a practical matter avoid the security interest.

- Further, a transfer with the specific intent to hinder, delay or defraud creditors can be set aside.

There are no specific provisions dealing with insiders except, as noted above, there is a one year period for avoiding preferences to insiders and, in addition, most cases involving recharacterization of debt or subordination, involve insiders. As above, transfers with the intention to hinder, delay or defraud creditors can be avoided as a fraudulent transfer. Note, also, that the trustee can avoid any transfer which could be avoided under applicable state law, which permits the trustee to take advantage of any state avoidance provisions that are broader than those in the Bankruptcy Code and, also, any longer state law statute of limitations. See section 544(b).

E. Stay of Litigation

The FDIC's ability to stay litigation is not automatic with the creation of the receivership or conservatorship, but is broader in scope than in bankruptcy.

1. FDIC Authority

Section 11(d)(12) of the FDI Act gives the FDIC the power to temporarily suspend, or "stay," ongoing litigation. These provisions are meant to give the FDIC the ability to assess and evaluate the facts of each case. This ability to stay litigation is not limited to matters filed prior to the entry into receivership or conservatorship and covers litigation filed after the institution's failure.

- The stay is not automatic but has to be requested by the FDIC. Assuming the FDIC was appointed as a receiver, as opposed to a conservator, the stay can be for up to 90 days.

- It is important to note that pursuant to Section 11(d)(12)(B) of the FDI Act the court does not have discretion as to the granting of the stay, it is must be granted upon the receiver's request.

If the FDIC, acting as a receiver, chooses to bring litigation against another party, a special statute of limitations applies. In that case the statute of limitations, which begins to run on the date the claim accrues, will be:

- for contract claims, the longer of (i) six years or (ii) the period applicable under the relevant state law; and

- for actions in tort, the longer of (i) three years or (ii) the period applicable under the relevant state law.[24]

- In either of these cases, the date on which the claim accrues is determined to be the latter of the date the FDIC is appointed as receiver or the date on which the cause of action accrues.

- Further, certain tort actions, whose statues of limitation may have run out within the five year period prior to the FDIC's appointment as receiver may be revived by the FDIC without regards to a state's statute of limitations.

2. Bankruptcy Law Provisions

There is an automatic stay of the commencement or continuation of litigation against the debtor, and the debtor has the power to seek a stay of other litigation which might adversely affect the estate. Generally, litigation in which the debtor is a plaintiff is not stayed, but it would be stayed in the event of counterclaims or third party claims against the debtor. The plaintiff may seek relief from the stay for cause, which is largely discretionary with the court, but relief is rarely granted if the litigation involves claims against the estate or matters which would interfere with the administration of the estate or the plan process in a chapter 11 case. *See* Sections 105, 362.

The statute of limitations on any actions brought by the debtor (if not already expired when the bankruptcy petition is filed) is extended for the longer of (i) the period available under non-bankruptcy law and (ii) two years after filing. For avoidance actions (e.g., preferences, fraudulent transfers) the statute of limitations is the longer of two years from filing of the case or one year after the appointment or election of a trustee. *See* Sections 108(a), 546(a). Generally, even if a statute of limitations has expired, a debtor can use the claim defensively against a claim by the non-bankrupt party. There is no provision to revive expired statutes of limitations which have expired before the filing of the bankruptcy petition.

III. Examples of areas of uncertainty under FDIC rules

In assessing potential exposures as a counterparty to a failed regional institution, a first-cut triage of potential claims may be useful, that is, a review to determine which would be clearly covered, or not, within the terms of the statute, rules and policies, and thus to identify those for which potential FDIC treatment is uncertain. Careful planning and analysis with respect to these uncertain potential claims may improve decision-making regarding how to proceed regarding such claims.

The FDIC has adopted policy statements and rules with respect to repudiation of contracts for particular types of transactions to provide market participants greater certainty and

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[24] 12 U.S.C. § 1821(d)(14).

facilitate structuring of transactions. These actions include the adoption of rules concerning the treatment of loan participations and securitizations under Section 360.6 of the FDIC rules, and policy statements concerning qualified financial contracts, secured transactions, sales or transfers of loans, and letters of credit. These rules and statements necessarily raise questions about how transactions not squarely covered within the terms of these rules and policy statements would be treated in an FDIC receivership—whether the same result could be achieved for transactions that appear to be substantively parallel to protected transactions, but include variations on specific matters such as recourse or timing of transaction performance, that by their terms would not satisfy 100% of the stated FDIC requirements. As discussed below, in connection with its Section 360.6 rulemaking concerning loan securitization or participation transactions, the FDIC has indicated that its rules and policies do not exclude all transactions not within the four corners of the rule's safe harbor.

A second type of uncertainty arises from litigation. As indicated above, there is a significant body of cases in which the courts rejected some or all of the position taken by the FDIC (or RTC) under FDIC policies concerning repudiation of contracts and compensation of the affected parties. Even though these cases cast doubt on FDIC policies, the FDIC has not revised those policies to take judicial views into account—with the result that the effect that parties should give to stated FDIC policies is uncertain, particularly in cases where the policies indicate that a particular type of proposed transaction may be problematic.[25]

In this section, we discuss, first, the FDIC's Section 360.6 rulemaking concerning the treatment of loans participations and securitizations, and then the FDIC's policy statement

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[25] Since many FDIC policies are set forth in policy statements and interpretations, not rules adopted after notice-and-comment rulemaking, it is not clear what level of deference courts would give the FDIC in future cases in which standards for judicial deference to agency actions that have evolved since the 1990s would be applied. In FIRREA, Congress authorized the FDIC to issue “regulations” regarding receiverships, but it did not authorize the FDIC to issue “interpretations” that have the force of law. 12 U.S.C. § 1821(d)(1); *cf.* Heimmermann v. First Union Mortgage Corp., 305 F.3d 1257, 1261-62 (11th Cir. 2002); Schuetz v. Banc One Mortgage Corp., 292 F.3d 1004, 1012 (9th Cir. 2002). The deferential approach endorsed in Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984) (“Chevron”), and its progeny applies only when an agency interpretation carries the force of law under the agency’s statute or has been issued through a notice-and-comment proceeding. *United States v. Mead Corp.*, 533 U.S. 218, 226-27 (2001). FDIC policy statements do not carry “the force of law,” and accordingly is entitled only to “power to persuade” deference under *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944). See Mead, 533 U.S. at 227; Christensen v. Harris County, 529 U.S. 576, 587 (2000); Wells Fargo, N.A. v. FDIC, 310 F.3d 202, 208 (D.C. Cir. 2002). Under Skidmore, a court would not be compelled to follow the FDIC’s policy statement and more likely would follow prior judicial precedent construing the statute. See *Neal v. United States*, 516 U.S. 284, 295 (1996); *Lechmere, Inc. v. NLRB*, 502 U.S. 527, 536-37 (1992); *Maislin Indus., U.S., Inc. v. Primary Steel, Inc.*, 497 U.S. 116, 131 (1990).

concerning treatment of standby letters of credit and letter of credit cases to illustrate areas of uncertainty. These examples underscore the potential benefits of careful analysis of particular transactions that would be affected by a regional bank failure.

A. The example of the FDIC rulemaking concerning exercise of its repudiation authority with respect to a securitization or participation transaction

In the late 1990s, prompted by changes in accounting standards concerning a “sale” of assets, the FDIC amended its receivership rules with a view to providing market participants greater certainty with respect to receivership issues related to asset transfers by depository institutions in connection with loan securitizations and participations. In this revision, the FDIC set out a safe harbor from potential repudiation for asset sales meeting specified requirements, but also recognized that other transactions nevertheless might not be subject to repudiation under Section 11 of the FDI Act. In addition to the section 360.6 rule "safe harbor," on the application of the *D'Oench* Doctrine contemporaneousness rule in such transactions was included.

This rulemaking and related statements by the FDIC reflect its efforts to provide greater certainty to market participations, as well as the limits. Advance analysis of specific types of transactions that do not fall squarely within the rule may be useful in determining the extent of receivership-related risk in the event a counterparty insured institution were to fail.

1. Section 360.6 Rule

The FDIC regulation on securitization or participation transactions was prompted by concerns presented by the adoption in 1996 by the FASB of SFAS 125.[26] *See* 12 C.F.R. § 360.6, 65 Fed. Reg. 49189 (Aug. 11, 2000). SFAS 125 provided that in order for a transfer of assets to be accounted for as a “sale” under generally accepted accounting principles (“GAAP”), the transferred assets must be subject to “legal isolation,” including in bankruptcy or receivership. At the end of 1998, the FDIC issued a proposed “Statement of Policy Regarding Treatment of Securitizations and Loan Participations After Appointment of the Federal Deposit Insurance Corporation as Conservator or Receiver” in order to “provide sufficient assurances to permit the transfer of financial assets by insured depository institutions in connection with a securitization or loan participation to be accounted for as a sale under generally accepted accounting principles.” 64 Fed. Reg. 49015 (Sept. 9, 1999).[27] Instead of adopting a policy statement, the FDIC subsequently determined to adopt a rule not only codifying its existing policy and practices with respect to “legal isolation,” but also its existing position on a second receivership issue, which was not addressed in the proposed Statement of Policy, the *D'Oench* Doctrine

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[26] SFAS 140 has been subsequently adopted and supersedes SFAS 125.

[27] The proposed Statement of Policy was issued in December 1998, *see* 63 Fed. Reg. 71926 (Dec. 30, 1998), and then withdrawn in September 1999 at the same time the FDIC released proposed rule 360.6. *See* 64 Fed. Reg. 49015 (Sept. 9, 1999).

"contemporaneousness" requirement under 12 U.S.C. § 1823(e) ("Section 1823(e)"). We discuss these issues in turn.

a. Safe Harbor

The goal of the FDIC in addressing the legal isolation concern was succinctly stated by the FDIC's General Counsel in Financial Institution Letters issued in conjunction with the proposed rule and the final rule as adopted:

> If the transferred assets [in a securitization or loan participation] are not sufficiently isolated from the insured bank or thrift, its creditors or the receiver, the transfers would not qualify for sale treatment under GAAP and the transferred assets would continue to be reported as assets on the [transferor] institution's balance sheet.
>
> The rule responds to those questions by reassuring interested parties that, subject to certain conditions such as fraud, the FDIC - as conservator or receiver - will not seek to reclaim, recover or recharacterize as property of the institution or the receivership financial assets transferred by the institution in connection with a securitization or participation. Accordingly, the rule should resolve the legal isolation issue for insured depository institutions. The rule confirms existing FDIC practice in dealing with securitization and participation transactions.[28]

With respect to the legal isolation issue, the rule provides a safe harbor determination for transactions that fall within its terms.[29] The FDIC rule states:

> (b) The FDIC shall not, by exercise of its authority to disaffirm or repudiate contracts under 12 U.S.C. 1821(e), reclaim, recover, or recharacterize as property of the institution or the receivership any financial assets transferred by an insured depository institution in connection with a securitization or participation, provided that such transfer meets all conditions for sale accounting treatment under generally accepted accounting principles, other than the "legal isolation" condition as it applies to institutions for which the FDIC may be appointed as conservator or receiver, which is addressed by this section.

12 C.F.R. § 360.6(b).

The rules define a "participation" for purposes of the rules to mean:

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[28] FIL-57-2000 (Aug. 19, 2000). *See* FIL-95-99 (Oct. 15, 1999).

[29] The FDIC also stated: "The rule is not intended to describe the exclusive circumstances in which legal isolation may occur." 65 Fed. Reg. at 49191.

> the transfer or assignment of an undivided interest in all or part of a loan or a lease from a seller, known as the "lead", to a buyer, known as the "participant", without recourse to the lead, pursuant to an agreement between the lead and the participant. Without recourse means that the participation is not subject to any agreement that requires the lead to repurchase the participant's interest or to otherwise compensate the participant due to a default on the underlying obligation.

12 C.F.R. §§ 360.6(a)(3), 709.10(a)(4).

The safe harbor raises the issue of the disposition of a participation that does not appear to fall within the express terms of the rules, for example, because of elements of recourse in the transfer. The discussion of the rules by the FDIC in the *Federal Register* releases accompanying adoption of the rules supports the view that other transfers would be safe from potential repudiation It states that: "If the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or receiver for the transferor, then a determination that the transferred assets have been legally isolated [from the receiver] is appropriate." 65 Fed. Reg. at 49189.

With these statements as a predicate, the FDIC preamble further provides:

> [A] transaction that purports to be a sale (not a participation) of all of a financial asset, even if it includes recourse against the seller, which would be characterized as a sale under the general legal view, should not need to be encompassed by the rule; the FDIC would not be able to recover transferred assets as a result of repudiation. In the case of a completed sale, the FDIC would have nothing to repudiate if no further performance is required. Even in the case of a sale transaction that imposes some continuing obligation, a repudiation by the FDIC would relieve the FDIC from future performance, but generally should not result in a recovery of any property that was transferred by the institution before the appointment of the conservator or receiver.

65 Fed. Reg. at 49191.[30] Accordingly, if a transfer of assets to a third party was a "true sale" under applicable state law, this FDIC gloss on section 360.6 indicates that the FDIC could not

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[30] The rule provides that a participation must be "without recourse" in order to qualify for the safe harbor of the rule. The FDIC preamble discusses public comments submitted in connection with the rulemaking for this provision concerning the meaning of "recourse," and the preamble supports the conclusion that "without recourse" is not a simple, bright line concept, but may be compatible with the possible existence of certain types of potential obligations of the transferor to the transferee after the asset transfer has occurred. *See* 65 Fed. Reg. at 49190-91. In its parallel rulemaking, the National Credit Union Administration ("NCUA") discussion of the same issue is somewhat more illuminating. *See* 65 Fed. Reg. at 55440.

reclaim the transferred assets even if it acted to repudiate its future performance under the agreement providing for that transfer.

b. "Contemporaneous"

The second issue addressed by the FDIC rule concerns the statutory codification in 12 U.S.C. §§ 1823(e) and related provisions,[31] of the federal common law receivership rule stated in *D'Oench*. The statutory codifications set forth a number of requirements that agreements with the institution in receivership must meet in order to be enforceable against the FDIC as receiver. The particular statutory provision addressed in the rules requires that the agreement be executed by the insured "institution and any person claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset" by the insured institution. 12 U.S.C. §§ 1823(e)(1)(B) (the "contemporaneousness" requirement). ("Contemporaneousness" is not defined in either *D'Oench* or Section 1823(e).)

Subsection (f) of the rules ("Subsection (f)") provides that the FDIC "shall not seek to avoid an otherwise legally enforceable securitization agreement or participation agreement executed by an insured depository institution *solely because* such agreement does not meet the 'contemporaneous' requirement" of sections 11(d)(9), 11(n)(4)(I), and 13(e) of the FDI Act (12 U.S.C. §§ 1821(d)(9), (n)(4)(I), 1823(e))(emphasis added).

Although we are unaware of any document of the FDIC addressing the contemporaneousness requirement in the context of a securitization or participation prior to the proposal of the FDIC rule, that agency's Law Department had twice addressed it in opinions concerning agreements for collateralized loans. In 1991, the FDIC General Counsel discussed the application of the contemporaneousness requirement in the context of an arrangement in which a bank proposed to enter into an agreement under which it would issue a series of collateralized promissory notes to be held by a trustee for institutional investors. *See* FDIC Advisory Opinion 91-24, April, 2, 1991, by General Counsel A.J.T. Byrne. Even though the agreement in question was entered into at the creation of the arrangement and the timing of the issuance of additional notes and pledge of additional collateral was open-ended, Advisory Opinion 91-24 concluded that the agreement would be enforceable and the FDIC could not avoid the security interest in the pledged collateral based upon lack of contemporaneousness under Section 1823(e). *Id.*

A second FDIC legal opinion addressed circumstances under which FDIC as receiver will not seek to avoid a security interest or collateral pledge under 12 U.S.C. § 1823(e). *See* FDIC Advisory Opinion 93-10 (February 2, 1993), by Michael H. Krimminger, Senior Counsel. This inquiry concerned whether the FDIC as receiver would seek to avoid a security interest in collateral pledged before public deposits to be secured by the pledge were received by the depository bank because of a lack of contemporaneousness in the receipt of the deposit and the security. In response to this inquiry, the Opinion stated:

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[31] 12 U.S.C. §§ 1821(d)(9), 1821(n)(4)(II) .

> . . . It may be of some assurance to you that where a security interest is evidenced by an agreement in writing, which is signed by the proper parties and approved by the board of directors of the institution, is continuously an official record of the institution, and meets each of the assumptions listed below, *it is the FDIC's position that it would not, pursuant to 12 U.S.C. 1823(e), avoid that security interest solely because the deposit secured or the specific collateral pledged was not acquired by the institution simultaneously with execution and approval of the security agreement, the specific collateral pledged would change from time to time, or the aggregate amount of collateral pledged would increase.* FDIC Advisory Opinion 91-24, attached. (Italics in the original)

Id.

B. The example of standby letters of credit

In 1995, the FDIC issued a the Statement of Policy Regarding Treatment of Collateralized Letters of Credit After Appointment of the FDIC as Conservator or Receiver ("CLC Statement") that set forth policies followed by the FDIC for many years.[32] In essence, the CLC Statement provides that that a standby letter of credit does not generally represent a provable claim in a bank receivership because it is a "contingent obligation" of the failed bank. It states:

> Generally, contingent obligations do not give rise to provable claims against a receivership or conservatorship, and any claims based upon such obligations have no provable damages because the damages are not fixed and certain as of the date of the appointment of the receiver or conservator. Accordingly, no provable claims in a receivership or conservatorship can be based on contingent obligations unless the default by the account party conferring a right to draw under the obligations occurred prior to the appointment of the receiver or conservator.
>
> Reading section 11(e) of the FDI Act, 12 U.S.C. 1821(e), as a whole, it is clear that even secured contracts may be repudiated; that damages are limited to the extent set forth in the statute; and that legally enforceable or perfected security agreements will be honored to the extent of such damages but no further or otherwise. In other words, if there is a repudiation, the collateral securing the contract may be liquidated and the proceeds paid to or retained by the creditor up to the damages allowed by the statute. The remaining collateral or proceeds will be remitted or returned to the conservator or receiver as property of the institution or its estate, or to a bona fide junior lienholder to the extent applicable.

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[32] Statement of Policy adopted May 18, 1995, published at 60 Fed. Reg. 27976 (May 26, 1995).

Id.

The FDIC issued this policy using these terms in the face of U.S. Courts of Appeals decisions since the 1970s that uniformly rejected the FDIC position that a "contingent obligation" could not be a provable claim. *See, e.g.*, *First Empire Bank-New York v. FDIC*, 572 F.2d 1361 (9th Cir. 1978) ("*First Empire*"); *Interfirst Bank-Abilene v. FDIC*, 777 F.2d 1092 (5th Cir. 1985); *FDIC v. Liberty National Bank*, 806 F.2d 961 (10th Cir. 1986).[33] Indeed, at least as far back as the 1978 *First Empire* case, the courts recognized two types of contingent claims: "contingent provable" and "contingent unprovable." Contingent provable claims have "worth or amount [that] can be determined by recognized methods of computation at a time consistent with the expeditious settlement of estates," while contingent unprovable are claims "so uncertain that their worth cannot be ascertained." Id. at 1369 (quoting from *Pennsylvania Steel Co. v. New York City R. Co.*, 198 F. 721, 739-40 [2d Cir. 1912]).

Post-FIRREA courts have rejected FDIC attempts to use "contingency" in a talismanic way in order to defeat claims by parties to repudiated contracts. Indeed, the courts have found a focus on contractual contingency distinctly unhelpful in making determinations under FIRREA's repudiation provision. As the Eleventh Circuit Court of Appeals has said:

> The provability doctrine . . . simply demands that claims must exist before the bank's insolvency (even if contingent) . . . . These cases do not support the proposition that any contingency destroys provability.
>
> * * *
>
> All contracts are to some extent contingent until both parties have performed or breached. The FDIC's interpretation would permit recovery only when a contract had been breached before receivership—a result clearly contrary to the plain language of the statute, Congress' intent, and the common law.
>
> McMillian, *supra*, 81 F. 3d at 1050.

Other courts have agreed with this approach. In *OPIEU*, *supra*, 27 F. 3d at 602, the Court of Appeals for the D.C. Circuit stated that questions of contingency in performance "deal not with whether appellants have a claim but rather how much the claim is worth." The court in *Citibank (S.D.), N.A.*, *supra*, 857 F. Supp. at 791, rejected the FDIC's contention that Citibank's claim was contingent because it did not arise until repudiation and stated that "such claims are

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[33] These cases were decided before enactment of FIRREA. Even though Section 11(e) as amended by FIRREA addresses several specific types of contracts, such as leases and qualified financial contracts, Congress chose not to address letters of credit in Section 11(e) and under standard rules of statutory construction must be viewed as accepting the holdings of those recently decided cases. The post-FIRREA cases discussed herein likewise reject the FDIC position in the CLC Statement.

always contingent on the date of insolvency because a receiver cannot repudiate a contract until after it is appointed." The court in *Bank One, Tex., N.A., supra*, 878 F.Supp. 943, 960, adopted the *First Empire* approach that "contingent provable" claims are compensable. It stated that such claims were "contingent" because they "do not 'accrue' on or before insolvency, but instead mature upon a post-insolvency event," and are "provable" because the "obligation to pay upon an specific event originates prior to insolvency and does not rely upon a new contractual obligation." As these courts have expressly recognized, the contingency of the obligation cannot in itself make a claim noncompensable under Section 11(e).

Moreover, courts have also found that the contingency inherent in a standby letter of credit is not an obstacle to a finding that it gives rise to a provable claim.[34] The D.C. Circuit relied on an analogy to standby letters of credit to support of its award of damages in a severance pay case. The court recognized explicitly that a standby letter of credit necessarily involves contingency: "The FDIC attempts to distinguish these [standby letter of credit] cases [from the severance pay case at issue] by claiming that the holder's rights actually 'vest' when the letters are issued, not when they are presented; the banks had agreed to honor the letters, insolvency or not. Unlike a commercial letter of credit, however, which imposes the absolute right on the bank to pay the face value, a standby letter of credit is payable only if the third party defaults and thus it imposes only a contingent liability on the bank." *OPIEU*, 27 F. 3d 598, 603. Moreover, the *Credit Life* opinion states: "FDIC-Receiver appears to concede that CLIC would have a provable claim [based on its standby letter of credit] under the First Empire doctrine." 870 F. Supp. at 425.

Further, other than in lease and severance pay cases, the principle that a party to a repudiated contract is entitled to actual compensatory damages arising from pre-insolvency commitments has been consistently upheld. Several courts found that when the FDIC repudiated financing commitments that had not been fully performed by the bank pre-insolvency, the borrowing party was entitled to damages under Section 11(e). Accordingly, the First Circuit has held that a party can receive damages for repudiation of a partially performed line of credit commitment letter agreement entered into prior to insolvency. *See DPJ Co. Ltd. v. FDIC,* 30 F. 3d 247, 250 (1st Cir. 1994). In *Nashville Lodging Co. v. FDIC,* 934 F.Supp. 449 (D.D.C. 1996), the district court on remand from the D.C. Circuit held that the party to a repudiated refinancing agreement had a provable claim for damages even though the right to refinancing was contingent upon the borrower's continued performance under the agreement. Similarly, in *FDIC v. Parkway Executive Office Ctr.*, 1998 WL 18204 (E.D.Pa.), the court held that the claimant for repudiation of the undisbursed balance of a construction loan had a "right to funding vested" before the lender's insolvency and that the borrower was entitled to damages from the diminution of the value of the building due to the inability of the contractor to complete the project. In *Citibank (S.D.), N.A. v. FDIC*, 857 F.Supp. 976, 983 (D.D.C. 1993), the repudiation of a non-compete agreement in the sale of credit card receivables to a bank that subsequently became insolvent gave rise to a provable claim for actual compensatory damages. The courts have even found that a party could receive payments for future rents under a lease if the pre-insolvency agreements

[34] We have found no post-FIRREA case that has denied a claim on the ground that it was "contingent."

were structured so that the contractual right to that remedy arose at insolvency under an ipso facto clause and was secured by an enforceable security interest. *See Bank One, Tex., N.A., supra*, 878 F.Supp. 943.

Given the significant doubt that the FDIC should receive judicial deference for decisions based on policy statements,[35] the FDIC's apparent stubbornness in its leaving in place policies rejected in so many cases adds uncertainty to any contract involving a standby letter of credit or containing terms that require actions post-insolvency by the failed institution. Nevertheless, the cases also provide guidance with respect to the types of agreements and arrangements that should either survive an insolvency or give rise to recoveries that fairly compensate the counterparty to the failed institution.

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Gibson, Dunn & Crutcher lawyers are available to assist in addressing any questions you may have regarding these issues. Please contact the Gibson Dunn attorney with whom you work or any of the following attorneys:

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[35] *See* footnote 18, *supra*.