GIBSON, DUNN & CRUTCHER LLP

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FINANCIAL MARKETS IN CRISIS: OVERVIEW OF FDIC'S AUTHORITY WITH RESPECT TO BANK FAILURES

To Our Clients and Friends:

The Gibson, Dunn & Crutcher Financial Markets Crisis Group is tracking closely government responses to the turmoil that has catalyzed dramatic and rapid reshaping of our capital and credit markets.

We are providing updates on key regulatory and legislative issues as well as information on legal issues that we believe could prove useful as firms and other entities navigate these challenging times.

This update focuses on the receivership and conservatorship authority of the Federal Deposit Insurance Corporation (the "FDIC"). It is an executive summary of a longer memorandum available on our website. In view of the many and complex specific issues that may arise in this context, even the longer 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 elements of the FDIC framework which differ from a corporate bankruptcy.

This summary provides a brief overview of key issues and background on the legal framework governing FDIC resolutions and the FDIC's methods for handling receiverships The longer memorandum goes into greater detail, comparing six distinctive aspects of the FDIC approach with the bankruptcy law provisions; and illustrating issues and uncertainties in the FDIC resolutions process by discussing in greater depth two examples – treatment of loan securitizations and participations, and standby letters of credit.

Relevant additional materials include: the pertinent provisions of the Federal Deposit Insurance (the "FDI") Act[1] and FDIC rules[2], statements of policy[3] and advisory opinions;[4] the FDIC Resolution Handbook[5] which reflects the FDIC's high level description of the receivership process, including a contrast with the bankruptcy framework; recent speeches of FDIC Chairman Sheila Bair;[6] and press releases and notes with respect to failure cases.[7] 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.

Points Worthy of Special Note.

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.

In this light, clients should review patterns of interaction with depository counterparties that are of particular concern or where outcomes are unclear, and do in-depth analysis as appropriate. Further, because precedent may not be an accurate predictor of outcomes, it may be well 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.

Background Concerning FDIC Failed Bank Resolutions

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, [8] it acts in a separate capacity distinct from its corporate capacity as insurer, regulator or supervisor of insured banks.[9]

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. It should be noted that the FDIC's powers as conservator largely parallel its distinctive receivership authority, e.g., its contract repudiation authority.

Historically, for most large financial institutions, the preferred resolution was an assisted purchase and assumption ("P&A") transaction with 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.

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,"[10] that is, determining the most cost-effective form of resolution; and "depositor preference,"[11] which provides statutory priorities for depositors over other unsecured claimants. Least-cost resolution has helped foster varied types of P&A transactions, as demonstrated by the FDIC resolution of bank failures in recent months. The FDIC can override the "least cost" test in the case of a systemic significant institution. The "depositor preference" regime 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.

With larger institutions particularly, 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. 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, 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 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.

Overview of FDIC Authority as Receiver or Conservator

1. FDIC's General Administrative Discretion

This regime and the FDIC powers are set forth in Section 11 of the FDI Act, codified at 12 U.S.C. § 1821. The often terse terms of the statute itself provide the principal reference and guidance concerning how an FDIC receivership or conservatorship may be conducted.

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. It will bring all accounts forward to the 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.

Under section 11(d)(3)(B) and (C), claimants must submit their claims (along with applicable proof of the claims) by a specified date that is no less than 90 days after FDIC notice. 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.

2. 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, <u>as they exist at the time of failure</u>. Under the doctrine set forth in *D'Oench, Duhme & Co. v. FDIC* and now codified, the FDIC is protected 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.

3. Claims Preference

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

4. Contract 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. However, subsection (e)(12) 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, section 11(e)(3) limits the damages for which it can be liable. 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 in the longer memorandum).

Section 11(e)(8) 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 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.

5. Fraudulent Conveyances

The FDIC has the power pursuant to Section 11(e)(12) 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.

6. 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. Section 11(d)(12) 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.

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

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

[3] 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.

[4] 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.

[5] http://www.fdic.gov/bank/historical/reshandbook/

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

[7] 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

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

[9] 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.

[10] *See* 12 C.F.R. § 360.1.

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

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Gibson Dunn has assembled a team of experts who are prepared to meet client needs as they arise in conjunction with the issues discussed above. Please contact Michael Bopp (202-955-8256, mbopp@gibsondunn.com) in the firm's Washington, D.C. office or any of the following members of the Financial Markets Crisis Group:

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