

SURFING INSOLVENCY WAVES ON AN OCEAN OF ECONOMIC CHANGE

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I. Introduction: A Red September and the Hunt for a Black October

The year 2008 has seen a swell of varying economic global crises, including the American subprime mortgage lending crisis, the collapse of certain banks, major credit crunches, increased demands for governmental regulation, bailout legislation, and governmental intervention.¹ Where there is economic crisis, bankruptcy and insolvency issues surely follow.

This paper addresses three key issues that could greatly impact the future of bank, bankruptcy, or insolvency law in the United States, with global effects: 1) a comparison of the U.S. presidential candidates' approaches to bankruptcy law; 2) the effects the *Bear-Stearns* decision may have on the ability of global companies to seek Chapter 15 protection; and 3) possible increased involvement of the Federal Deposit Insurance Corporation ("FDIC") in the liquidation and merging of failed banks.

II. Sextant for November: Possible Effects of the U.S. Elections on U.S. Bankruptcy Law

As the U.S. election approaches on Tuesday, November 4, 2008, and the U.S. economy continues in crisis, all eyes are on the prospect of a new President in the United States. This year, perhaps more than ever before, economic issues are on the minds of American voters – and the world. This paper first explores the bankruptcy policies of the Presidential candidates by interpreting their past voting records, platforms, and public statements to determine what November might bring under a new administration.

¹ See Appendix A for a "Calendar of Critical Events"

A. Comparing the Candidates' Voting Records

Past positions are no assurance of future political performance. Yet one way to ascertain where a candidate might lead in the future is to look at his or her voting record on the relevant issues. Senators John McCain (“McCain”) and Barack Obama (“Obama”) were both present for the vote on the amendments to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”), and on the act itself in 2005. These votes provide insight into the policy differences between the two candidates as they relate to bankruptcy law. A review of the votes on the amendments to BAPCPA shows that McCain and Obama were divided on bankruptcy policy. Of the twenty-eight amendment votes, Obama and McCain voted for opposing positions twenty-four times and found themselves in agreement only four times.

1. Four Points of Agreement on BAPCPA Amendments

Of the four points of agreement, two amendments passed by unanimous consent and were, unsurprisingly, not contentious. Both candidates voted to pass an amendment that restricted access to certain personal information in bankruptcy documents, thereby limiting the personal information that a creditor may publicly file with the bankruptcy court. Both candidates voted in favor of an amendment to increase bankruptcy filing fees to pay for the additional duties of United States trustees and the new bankruptcy judges added by BAPCPA.

Senators Obama and McCain also agreed to vote against a limit to the amount of interest that can be charged on any extension of credit to 30 percent. McCain has not publicly expressed whether he views this interest rate as too high or too low. Obama’s presidential platform states that he supports capping interest rates at 36% for all Americans. Both candidates voted for an amendment that protects disabled veterans from means testing in bankruptcy under certain circumstances.

2. Twenty-Four Remaining Points of Disagreement

Of the votes where Obama and McCain disagreed, Obama voted for (while McCain voted against) twenty-three out of twenty-four of the amendments. In general, Senator Obama supports bankruptcy law changes that aid individuals, small business owners, and consumers. The amendments that he voted for would benefit service-members and veterans, medical patients, their caregivers, victims of identity theft, and divorced persons not receiving alimony and/or child support. Senator McCain voted against these amendments.

For example, Senator Obama voted for (and Senator McCain against), the following amendments:

- a. to protect service-members and veterans from means testing in bankruptcy, to disallow certain claims by lenders charging usurious interest rates to service-members, and to allow service-members to exempt property based on the law of the State of their pre-military residence;
- b. to exempt debtors whose financial problems were caused by serious medical problems from means testing and to provide protection to medical debt homeowners;
- c. to preserve existing bankruptcy protections for individuals experiencing economic distress as caregivers to ill or disabled family members;
- d. to exempt debtors from means testing if their financial problems were caused by identity theft;
- e. to discourage predatory lending practices;
- f. to limit the exemption for asset protection trusts;
- g. to strike certain bankruptcy provisions in the bill that could be adverse to small businesses;
- h. to exempt debtors whose financial problems were caused by failure to receive alimony or child support, or both, from means testing; and
- i. to limit claims in bankruptcy by certain unsecured creditors.

Senator McCain voted for (and Obama against) an amendment to clarify the safe harbor with respect to debtors who have serious medical conditions or who have been called or ordered to active duty in the Armed Forces and low income veterans. However, this language did not appear in the bill ultimately adopted by the U.S. Senate.

With respect to the ultimate vote on BAPCPA, Senator McCain voted for the new law, while Senator Obama voted against it. Prior to the vote, Senator McCain called the bill, "... an important step toward a fair and balanced approach to restoring personal responsibility to our federal banking system." During the January 2008 debates, when he was asked a question about the 2001 and 2005 bankruptcy bills, Senator Obama responded, "I opposed them both. I think they were bad ideas, because they were pushed by the credit card companies, they were pushed by the mortgage companies, and they put the interest of those banks and financial institutions ahead of the interests of the American people. And this is typical." This voting record of the two candidates reveals the contrast between Senator McCain who tended to favor bankruptcy laws that benefit banks and corporations while Senator Obama primarily sought to protect individuals as consumers and borrowers.

B. Comparing the Platforms of the Presidential Candidates

Similarly useful, the candidates' personal platforms, found on each of their websites, provide some insight into where they might take bankruptcy law in the future.² Only Senator Obama's campaign platform actually addresses bankruptcy directly, while Senator McCain's platform does not mention bankruptcy. According to Senator Obama's campaign website, "Obama will reform our bankruptcy laws to protect working people, ban executive

² The candidates' platforms regarding their planned initiatives, should they be elected president, are available at their respective websites. *See* <http://www.barackobama.com/issues/economy/#bankruptcy> (Barack Obama's platform); <http://www.johnmccain.com/Issues/jobsforamerica/> (John McCain's platform).

bonuses for bankrupt companies, and require the disclosure of all pension investments.” To do so, Senator Obama’s platform focuses on these issues:

- **Cap Outlandish Interest Rates on Payday Loans and Improve Disclosure:**

Obama supports extending a 36 percent interest cap to all Americans. Obama would require lenders to provide clear and simplified information about loan fees, payments and penalties, which is why he’ll require lenders to provide this information during the application process.

- **Encourage Responsible Lending Institutions to Make Small Consumer Loans:**

Obama would encourage banks, credit unions and Community Development Financial Institutions to provide affordable short-term and small-dollar loans and to drive unscrupulous lenders out of business.

- **Reform Bankruptcy Laws to Protect Families Facing a Medical Crisis:**

Obama would create an exemption in bankruptcy law for individuals who can prove they filed for bankruptcy because of medical expenses. This exemption will create a process that forgives the debt and lets the individuals get back on their feet.

Senator Obama has also spoken out against Senator McCain’s economic policy.

In a speech outside of Atlanta Senator Obama criticized Senator McCain by saying “He [McCain] would continue to allow the banks and credit card companies to tilt the playing field in their favor, at the expense of hardworking Americans.” And “Like the president he hopes to succeed, Senator McCain does not believe the government has a real role to play in protecting Americans from unscrupulous lending practices.” (July 8, 2008 Speech, Toledo, Ohio)

III. Does Chapter 15 Provide A Safe Harbor after the *Bear Stearns* decision?

Chapter 15 of the Bankruptcy Code strives to let bankruptcy proceedings around the globe work together, rather than in competition. But, is it working? In the post-*Bear-Stearns* world, courts have announced that recognition that a company can exercise its right to invoke the protections of Chapter 15 will not come without tough scrutiny.

A. Chapter 15 Overview

Chapter 15 of the Bankruptcy Code was enacted as part of the comprehensive BAPCPA reforms in 2005. The Chapter governs cross-border bankruptcy and insolvency cases. Under Chapter 15, a duly accredited representative of a foreign debtor may file a petition in a U.S. Bankruptcy Court seeking recognition of a foreign proceeding. A foreign proceeding may be recognized as either a “main” proceeding or a “non-main” proceeding. The classification of a foreign proceeding depends upon the determination of the debtor’s “center of main interest” (“COMI”). A case pending in any given country that contains the debtor’s COMI will be recognized as a main proceeding, while a case pending in a country where the debtor has a “mere establishment” will be recognized as a non-main proceeding.³ Recognition of a foreign

³ § 1521 of the Bankruptcy Code sets forth the following relief available upon recognition as a foreign main or foreign non-main proceeding:

(a) Upon recognition of a foreign proceeding, whether main or nonmain, where necessary to effectuate the purpose of this chapter and to protect the assets of the debtor or the interests of the creditors, the court may, at the request of the foreign representative, grant any appropriate relief, including—

(1) staying the commencement or continuation of an individual action or proceeding concerning the debtor’s assets, rights, obligations or liabilities to the extent they have not been stayed under section 1520 (a);

(2) staying execution against the debtor’s assets to the extent it has not been stayed under section 1520 (a);

(3) suspending the right to transfer, encumber or otherwise dispose of any assets of the debtor to the extent this right has not been suspended under section 1520 (a);

(4) providing for the examination of witnesses, the taking of evidence or the delivery of information concerning the debtor’s assets, affairs, rights, obligations or liabilities;

(5) entrusting the administration or realization of all or part of the debtor’s assets within the territorial jurisdiction of the United States to the foreign representative or another person, including an examiner, authorized by the court;

(6) extending relief granted under section 1519 (a); and

(7) granting any additional relief that may be available to a trustee, except for relief available under sections 522, 544, 545, 547, 548, 550, and 724 (a).

(b) Upon recognition of a foreign proceeding, whether main or nonmain, the court may, at the request of the foreign representative, entrust the distribution of all or part of the debtor’s assets located in the United States to the foreign representative or another person, including an examiner, authorized by the court, provided that the court is satisfied that the interests of creditors in the United States are sufficiently protected.

insolvency proceeding as a main proceeding triggers the automatic stay provision under § 362 of the Bankruptcy Code and provides various other forms of relief to the international debtor. However, if the court does not recognize the foreign proceeding under Chapter 15 as either main or non-main, the entity is not able to take advantage of these beneficial forms of relief included in the chapter. See 11 U.S.C. § 1521.

B. A New Approach: Illustrating the Differences in Section 304 and Chapter 15, and Limiting Access to United States Courts

Under Section 304 of the Bankruptcy Code, before it was amended to add Chapter 15, access to the United States' Bankruptcy Courts by a foreign debtor was determined by subjective factors influenced by comity. Chapter 15 of the Code changed all that. Under Chapter 15, a foreign debtor must seek a court's ruling, or "recognition," regarding whether the nature of its operations qualify it for Chapter 15 protection, which is evaluated through objective criteria.

1. Trends and Developments in Chapter 15 Prior to *Bear-Stearns*

Cases prior to *Bear-Stearns* considered recognition of a foreign proceeding as foreign main or foreign non-main via a determination of COMI. See In re SPhinX, Ltd., 351 B.R. 103, 117-121 (S.D.N.Y. 2006) (first case involving a dispute over COMI

(c) In granting relief under this section to a representative of a foreign nonmain proceeding, the court must be satisfied that the relief relates to assets that, under the law of the United States, should be administered in the foreign nonmain proceeding or concerns information required in that proceeding.

(d) The court may not enjoin a police or regulatory act of a governmental unit, including a criminal action or proceeding, under this section.

(e) The standards, procedures, and limitations applicable to an injunction shall apply to relief under paragraphs (1), (2), (3), and (6) of subsection (a).

(f) The exercise of rights not subject to the stay arising under section 362 (a) pursuant to paragraph (6), (7), (17), or (27) of section 362 (b) or pursuant to section 362 (n) shall not be stayed by any order of a court or administrative agency in any proceeding under this chapter.

under Chapter 15; holding that Cayman Island proceedings were entitled to recognition as foreign nonmain proceedings, despite statutory presumption that COMI is the debtor's place of registration or incorporation) affirmed In re SPhinX, Ltd, 371 B.R. 10 (S.D.N.Y. 2007).

However, *Bear-Stearns* was the first case to illustrate just how much Chapter 15 had changed the game.

2. *Bear-Stearns* – A Pivotal Chapter 15 Case

Bear-Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. and Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd (collectively “Bear Stearns Funds” or “Funds”) are Cayman Islands’ LLCs. Although the Bear Stearns Funds had registered offices in the Cayman Islands, a Massachusetts corporation administered the Funds, served as the funds’ registrar and transfer agent, and provided day-to-day administrative services. Moreover, the books and records of the Funds were maintained by the administrator in Delaware. Likewise, the Funds’ investment manager was incorporated in New York, and the funds managed by that manager were located in New York. Indeed, most if not all of the Funds’ other assets were located in New York.

By May 2007, the Funds suffered significant devaluation as a result of the volatility in the markets triggered by the subprime-mortgage crisis. Eventually, the board of directors of the Funds authorized filing of winding-up petitions in the Cayman Grand Court. The liquidators filed Chapter 15 petitions in New York seeking recognition of the Cayman winding-up proceedings as “main proceedings,” and emergency injunctive relief was granted on August 9, 2007. See In re Bear Stearns Funds., 2007 WL 2479483 (Bankr. S.D.N.Y. 2007), amended and superseded by 374 B.R. 122 (Bankr. S.D.N.Y. 2007).

On August 30, 2007, the Bankruptcy Court issued a ruling finding that the Cayman proceedings qualified as neither a foreign main nor foreign nonmain proceeding to be

recognized under Chapter 15. Id. The court found that the Bear Stearns Funds' COMI was in the United States rather than the Cayman Islands. Indeed, the court held that, “[t]he only adhesive connection with the Cayman Islands that the Funds have is that they are registered there.” Id. Therefore, the court found that the presumption that the COMI is the place of the registered offices had been effectively rebutted. Moreover, the court found that the Cayman Islands proceedings were not nonmain proceedings because the liquidators had not proved that the Funds had even an “establishment” in the Cayman Islands. The liquidators appealed this ruling to the District Court.

On May 22 or 27, 2008, the District Court affirmed the Bankruptcy Court's ruling. In re Bear Stearns Funds, 389 B.R. 325 (S.D.N.Y. 2008). The District Court emphasized that recognition of a foreign proceeding under Chapter 15 “turns on the strict application of objective criteria.” Id. The District Court then concluded that the evidence presented below did not constitute “substantive economic activity in the Cayman Islands,” as required for foreign main recognition, and emphasized that the absence of any objection to the recognition is irrelevant. Id. Moreover, the District Court found that the Bankruptcy Court properly found insufficient evidence of an “establishment” in the Cayman Islands, as required for recognition of a foreign nonmain proceeding.

The Bear-Stearns Funds liquidators elected not to appeal the District Court's ruling.

3. Out to Sea Again: Trends and Developments Since *Bear-Stearns*

The District Court's ruling is decidedly adverse for offshore hedge funds that are shell organizations in foreign jurisdictions but carry out substantially all of their business in the United States. Under *Bear-Stearns*, these companies should not be able to rely on the provisions of Chapter 15, and instead must pursue in the United States the specific protections of a Chapter

7 or Chapter 11 bankruptcy filing. This marks a decided change from the former rules under Section 304, where access to United States' Bankruptcy Courts by a foreign debtor was not dependent upon recognition, but rather was determined on subjective factors influenced by comity.

In the post-*Bear Stearns* era, one thing is clear: courts continue to refuse to rubber stamp a finding of foreign main or foreign nonmain proceedings. Rather, even absent an objection from the parties, courts will conduct a serious factual inquiry into the operations of the corporation to discern where the debtor's COMI *really* lies. See, e.g., In re Basis Yield Alpha Fund, 381 B.R. 37, 40 (S.D.N.Y. 2008) (finding genuine issue of material fact as to whether foreign debtor that had registered under Cayman Islands Company Law only as an "exempted company," under provision that applied to companies whose business was to be conducted "mainly outside the Islands" nonetheless had the Cayman Islands as its COMI, and reaffirming that "recognition under section 1517 is not a rubber stamp exercise."); In re Tradex Swiss AG, 384 B.R. 34, 43 (D. Mass. 2008) (holding that corporation's COMI was in Massachusetts, and therefore foreign proceeding was a foreign non-main proceeding, despite the fact that the corporation's registered office was in Switzerland).

As of the date of the preparation of this paper, October 2, 2008, Lehman Brothers had not yet invoked any relief under Chapter 15, notwithstanding the filing of Chapter 11 proceedings in the Bankruptcy Court of the Southern District of New York for Lehman Brothers, Inc. and Lehman Brothers Private Equity Funds, in addition to United Kingdom insolvency proceedings entered for its United Kingdom subsidiaries, namely Lehman Brothers International (Europe), Lehman Brothers Limited, LB Holdings PLC, and LB UK RE Holdings Limited.

C. **Fog Horns in the Mist: Judicial Communication**

In addition to the recent developments regarding COMI, Chapter 15 also brings to the forefront issues of judicial communication. There are numerous occasions when judges from courts in different countries addressing cross-border bankruptcy issues may want to communicate with each other in order to avoid inconsistent rulings. Chapter 15 is intended to facilitate these discussions through the recognition of foreign proceedings. Such discussions could be instrumental in determining COMI, preventing conflicts in jurisdiction, and preventing parallel litigation. Indeed, this cross-border judicial communication can enable courts to reach a compromise that would have been otherwise impossible. One example of such a compromise is Judge Rakoff's conditional approval of an Ontario court's order. In re Ephedra Products, 349 B.R. 333 (S.D.N.Y. 2006). Judge Rakoff approved the Ontario court's order on the condition that it be modified to provide for additional procedural requirements. When Judge Rakoff communicated with the Ontario court, the Ontario court consented to the additional procedural requirements.

No matter how well-intentioned cross-border judicial communications can also raise issues of appropriateness. For example, when a United States court sought direct communication with a court in the United Kingdom in order to estimate future asbestos liability of a debtor, the United Kingdom court held that it would not participate in the communication because there was a risk of pre-judging or appearing to pre-judge the possible future English proceedings. In re T&N Ltd., 2004 EWHC 2878. The English court held that a case-by-case balancing of the desirability of inter-court communication with other relevant factors was appropriate. With these concerns in mind, the question remains as to whether Chapter 15's intention for cross-border judicial communication is a practical solution in the real world.

IV. Welcoming Back the Federal Deposit Insurance Corporation: A Lighthouse in the Fog?⁴

The recent appointments of the Federal Deposit Insurance Corporation (“FDIC”) as conservator of IndyMac Bank, as receiver of the First National Bank of Nevada and First Heritage Bank, N.A. (collectively, “FNBN”) and as facilitator in the sale of Washington Mutual, Inc., to JP Morgan Chase (“WaMu”) and in the possible sale of other banks have caused many lawyers to revisit the role of the FDIC and the experience of the now defunct Resolution Trust Corporation (“RTC”) in the liquidation of failed banks and thrifts over 15 years ago. The FDIC and the RTC liquidated the failed institutions and resolved issues with counterparties to contracts in effect at the time the institutions failed. At the same time, FDIC and RTC presented opportunities for those with cash to purchase loans and assets from their receiverships. Those who have servicing or other contracts with failed financial institutions may be concerned about the impact on their relationships, claims, and remedies. Purchasers will seek to buy origination and servicing platforms, servicing rights and whole loans.

We provide here a brief overview of the law applicable to FDIC as receiver or conservator of a failed bank and a sampling of the types of material issues that arose with FDIC and RTC in the past in the belief that the intervening fifteen years have not fundamentally changed the issues. More specifically, we will address two issues: the ability of the FDIC to repudiate contracts and the anticipated protections FDIC might be willing to provide in its sales

⁴ This discussion is based on a K&L Gates LLP Client Alert for Bankruptcy and Insolvency, “Dust Off Your Files: The FDIC Is Back in Town,” prepared by Laurence E. Platt, Eric T. Moser, Richard S. Miller, Stanley V. Ragalevsky, dated August 4, 2008, that can be found at: <http://www.klgates.com/newsstand/Detail.aspx?publication=4807>.

agreements. Although we use mortgage-related assets as an illustrative example of doing business with the FDIC, the laws that apply and the contractual protections that FDIC is likely to give should not depend on asset class.

A. FDIC As Conservator or Receiver

1. Bank Insolvency

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

The determination that a bank is insolvent is normally made by its primary bank regulator (i.e., the state bank supervisor for state chartered banks, the Office of the Comptroller of the Currency ("OCC"), or the Office of Thrift Supervision ("OTS"), respectively for federally chartered banks or thrifts, or the Federal Reserve for its member banks). Once the primary regulator determines a bank to be insolvent, FDIC steps in to "resolve" the insolvency by accepting appointment as the bank's receiver or conservator to value and dispose its assets in an orderly manner so that insured depositors are protected and public confidence in the safety and soundness of the banking system is maintained. Neither a bank itself nor its creditors has the ability to initiate a receivership or conservatorship under bank insolvency laws. Its shareholders or creditors do not have rights to participate in the receivership or conservatorship. Upon appointment as receiver or conservator of a failed bank, FDIC succeeds to all rights of the failed

bank and has the general authority to operate its business, exercise all the failed bank's corporate powers and even merge it with another bank or transfer its assets to a new "bridge bank" as occurred with IndyMac. 12 U.S.C. § 1821(d). FDIC, as receiver, has authority to determine the validity of creditors' claims of a failed bank. 12 U.S.C. § 1821(d)(3). Following the passage of the National Depositor Preference Amendment in 1993, all deposits in a failed bank (including uninsured deposits) are given a statutory priority and preference over other unsecured claims. This means that the failed bank's depositors will be paid before its general unsecured creditors. In most FDIC receiverships, those general unsecured creditors should ordinarily not expect to receive a distribution on their unsecured claims.

2. Powers and Purposes of a Receiver⁵

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

- a. repudiate burdensome contracts entered into prior to its appointment within a "reasonable time" after its appointment. 12 U.S.C. § 1821(e);
- b. enforce any contract, other than for directors and officers liability insurance or a depository institution bond, irrespective of any clauses purporting to authorize the termination, default, acceleration, or other exercise of rights based solely upon the failed bank's insolvency or the appointment of a conservator or receiver. 12 U.S.C. § 1821(e)(12);
- c. request a stay of legal actions or proceedings for 90 days. 12 U.S.C. § 1821(d)(12);

⁵ The powers accorded to the FDIC as a conservator are similar, but the purposes of a conservatorship are slightly different. Unlike a receivership, which is designed to liquidate a failed bank, a conservatorship is intended to allow the FDIC to continue operating a distressed financial institution and to preserve, administer, and protect its assets until it can be rehabilitated or closed.

- d. avoid fraudulent transfers made within five years of its appointment if the transfer was made to hinder, delay or defraud the failed bank, the receiver, or any other federal banking agency. 12 U.S.C. § 1821(d)(17);
- e. merge the failed bank with another insured depository institution and transfer all of the failed institution's assets and liabilities without the prior approval of any contract counterparty, court, or government agency. 12 U.S.C. § 1821(d)(2)(G);
- f. allow, disallow, and settle claims against the failed bank. 12 U.S.C. § 1821(d)(3);
- g. marshal the failed bank's assets and use the proceeds to pay creditors in accordance with the priority scheme established by 12 U.S.C. § 1821(d)(11); and
- h. liquidate the failed bank or transfer some or all of its assets to an acquiring institution. 12 U.S.C. § 1821(d)(2)(E)-(G).

B. Repudiation of Contracts

1. Scope of Repudiation Rights

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

2. Effects of Repudiation

The repudiation of a contract by the FDIC as receiver or conservator terminates the failed bank's obligation to render any future performance required under the

contract. The FDIC's power to repudiate a contract in a bank receivership is a particularly potent weapon for a number of reasons:

- a. The FDIC can repudiate a contract or lease by letter to the affected counterparty without court approval and with no prior notice.
- b. In the traditional bankruptcy proceeding, only "executory" contracts can be avoided by a trustee in bankruptcy. The FDIC can, however, repudiate any contract it finds "burdensome." The FDIC can repudiate revolving lines of credit, partially funded construction loans and letters of credit.
- c. The damages recoverable against the FDIC for repudiating a contract in a bank receivership are limited to the counterparty's actual direct, compensatory damages. Consequential damages for lost profits, punitive damages and pain and suffering are barred. Furthermore, damages against the FDIC as receiver are generally cut off under the "fixed and certain" rule set forth in 12 U.S.C. § 1821(e)(3)(A) as of the date of the receivership. Any damage claim allowed by the FDIC is paid in the form of a "receiver's certificate". Since claims of unsecured creditors are, under the 1993 National Depositor Preference Amendment, subordinate to depositor claims, the likelihood of a dividend being paid on such a certificate is remote.
- d. While a trustee in bankruptcy cannot reject one part of a contract and assume the rest, in a bank receivership, the FDIC can bifurcate the respective assets and liabilities in contracts by rejecting unfunded commitments on construction loans and suing the borrowers for funds advanced under the notes prior to the date of the receivership.

The FDIC uses its power to repudiate contracts frequently and in a number of different contexts. Borrowers learn that their existing line of credit, construction loan facility, or unsecured letter of credit at a failed bank has been rejected as of the receivership date.

Vendors providing services to a failed bank can be terminated abruptly with little recourse. If, however, a vendor continues to provide the same services to FDIC subsequent to the receivership, it may have a priority administrative claim under 12 U.S.C. § 1821(e)(7)(B) and be paid for those services. Loan participation agreements and intercreditor agreements have

previously been repudiated by FDIC although current FDIC policy seems to be not to reject such agreements.

3. Qualified Financial Contracts

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

4. Selected Issues Regarding Repudiation

Questions abound about the scope and implications of the FDIC’s repudiation power. For example, is a secured creditor at risk that its collateral will be stripped away, effectively converting its secured obligation into an unsecured one? Can a counterparty to a repurchase agreement liquidate its position following the appointment of a receiver as it could in a bankruptcy context? Is a loan servicer at risk that its servicing agreement will be unilaterally

terminated without payment of a termination fee? Will a loan servicer be reimbursed for outstanding advances? Will the answer be different depending on whether the advances are made before or after the appointment of a receiver? Should a servicer continue to perform under the servicing agreement pending a determination by the conservator regarding whether to repudiate?

Without writing a treatise on the powers of the FDIC as a conservator or receiver, there are certain important points to highlight.

- a. The FDIC is limited in its ability to repudiate secured loans. It cannot avoid a legally enforceable and perfected security interest, unless the interest was taken in contemplation of the institution's insolvency or with the intent to “hinder, delay, or defraud” the institution or its creditors. 12 U.S.C. § 1821(e)(11); see also FDIC Statement of Policy Regarding Treatment of Security Interests After Appointment of The Federal Deposit Insurance Corporation As Conservator Or Receiver, 58 Fed. Reg. 16833, March 31, 1993 (the “1993 Repudiation Policy Statement”).
- b. The FDIC may avoid the payment of a termination fee under a servicing agreement if the agreement fails to meet the requirements of 12 U.S.C. § 1823(e), which codifies the holding of *D’Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942), and provides that an agreement will only be enforceable against the FDIC in a bank receivership if it is (1) in writing, (2) executed by both the depository institution and any person claiming an adverse interest under the agreement, (3) approved by the depository institution’s board of directors or loan committee, and (4) an official record of the depository continuously since its execution. Under the so-called *D’Oench Duhme* doctrine, which is codified at 12 U.S.C. § 1823(e), agreements between a failed bank and a counterparty not appearing in the official records of the failed bank or meeting certain other documentation requirements are not enforceable as claims or defenses against FDIC. The protection against unrecorded side agreements of this sort eliminates many lender liability claims against failed banks. *D’Oench, Duhme* protection has also been determined to extend to subsequent purchasers of loans from FDIC receiverships and similarly insulate those purchasers against claims by borrowers that the failed bank breached an agreement.

- c. To the extent a counterparty continues to provide services pending the FDIC's decision to repudiate, it is entitled to be paid for the full contract value of those services as an administrative expense of the receivership. 12 U.S.C. § 1821(e)(7)(B); *see also McAllister v. RTC*, 201 F.3d 570, 579 (5th Cir. 2000); *U.S. Bank Nat'l Ass'n v. First Nat'l Bank of Keystone*, 394 F. Supp. 2d 829, 835 (S.D. W. Va. 2005). FDIC's acceptance of performance prior to repudiation does not, however, bar the FDIC from later repudiating the contract. 12 U.S.C. § 1821(e)(7)(C).
- d. As a matter of policy, the FDIC will not "reclaim, recover or recharacterize" any financial assets of an insured depository institution transferred in connection with a securitization or participation, provided that the insured depository institution received adequate consideration for the transfer and the underlying documents evidence the intent to treat the transaction as a true sale and not a secured loan. *See* 12 C.F.R. § 360.6.
- e. Common law set off rights can be valuable to holders of accounts at a failed bank with balances in excess of applicable FDIC insurance limits. The uninsured amount of a deposit at a failed bank can be offset against a performing loan the depositor owes the bank. The FDIC is generally more hospitable to offsets than trustees in bankruptcy. Set off rights, however, can be adversely affected if the FDIC as receiver transfers its loan asset to a bridge bank or third party and thereby destroys the reciprocal nature of the corresponding debts.

C. Sale Procedures: Designs for a New Safe Harbor?

Questions arise regarding the process to purchase assets from failed institutions in which the FDIC is the conservator or receiver. Although the FDIC will develop contemporary policies and procedures for asset sales, those used by the now defunct RTC may be instructive. What follows is not based on written policies and procedures that can be accessed on FDIC websites or in FDIC manuals, but a review of purchases of mortgage companies, servicing rights and whole loans in the early 1990's is instructive.

As a threshold matter, sales were conducted by auction based on standardized formats for bid letters and purchase agreements. The RTC relied on financial advisors or brokers whom the agency retained with a special preference for minority and women-

owned businesses. While a purchaser could propose changes to the promulgated form of the bid letter and purchase agreements, RTC's representative would control the document and had limited authority to make changes without senior management approvals. In the case of depository institution sales, the strong preference was for the purchaser to retain as many employees as possible, and any evaluation of the bids included an accounting for the financial impact of shut down costs if a buyer proposed to purchase only selective assets.

Although the FDIC certainly has the authority to sell assets or stock on an "as is, where is" basis, its desire to maximize sales proceeds may cause it to give enforceable representations and warranties in connection with its sales. Transparency is essential.

In our Firm's experience, the RTC routinely gave generally customary, albeit more limited, loan level representations and warranties about residential mortgage loans and servicing rights. These typically included: good title, compliance with laws, accuracy of balances, payment of taxes and insurance, enforceability of loan documents, completeness of loan files, validity of advances, and compliance with servicing agreements. The circumstances that gave rise to the failure of the thrifts in the early 1990's had little to do with allegedly defective residential loan originations, so the representations and warranties that RTC was willing to give then may not extend to FDIC today with respect to subprime and American Land Title Association ("ALTA") residential mortgage loans. Indeed, the FDIC website presently states that the FDIC makes no representations or warranties in connection with the loans it is offering for sale. In the case of depository institution sales, the purchaser usually entered into ancillary servicing and receivables collection agreements

The remedies available to a purchaser against the FDIC included indemnification for actual and direct, out of pocket losses arising out of or resulting from the

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

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

but could pledge it to a creditor that financed the acquisition of the assets or the stock under the purchase and sale agreement; the creditor, as the pledgee, had the right to assign the guaranty agreement to a subsequent purchaser in the event the creditor foreclosed on the collateral and the assignee executed an acknowledgement agreement clarifying the nature of its rights. The form of the guarantee agreement was not negotiable.

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

APPENDIX A –
Calendar of Critical Events:
April, 20 2005 – October 3, 2008

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| April 20, 2005 | Chapter 15 adopted as part of the Bankruptcy Abuse and Consumer Protect Act of 2005 (BAPCPA) |
| October 17, 2005 | BAPCPA's effective date |
| July 31, 2007 | Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. and Bear Stearns High-Grade Structured Credits Strategies Enhanced Leverage Master Fund, Ltd. filed Chapter 15 Petitions (SDNY 07-12383, 07-12384) |
| August 30, 2007 | Bear Stearns Bankruptcy Court decision |
| May 27, 2008 | District Court affirmed Bankruptcy Court's ruling in Bear Stearns (Appeal SDNY 07-08730) |
| May 30, 2008 | JP Morgan Chase & Co. acquired The Bear Stearns Companies |
| July 11, 2008 | IndyMac was closed by the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC) was named Conservator |
| July 25, 2008 | First National Bank of Nevada First, was closed by the Office of the Comptroller of the Currency (OCC). Subsequently, the FDIC was named Receiver. First Heritage Bank in California was closed by the OCC. Subsequently, FDIC was named Receiver. |

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| September 5, 2008 | Silver State Bank, Henderson, NV was closed by the Nevada Financial Institutions Division and the FDIC was named Receiver. |
| September 7, 2008 | Freddie Mac and Fannie Mae put in Conservatorship |
| September 14, 2008 | Bank of America acquired Merrill Lynch Lehman Brothers Holdings, Inc. and Lehman Brothers Private Equity Funds filed Chapter 11 Bankruptcy |
| September 15, 2008 | PricewaterhouseCoopers partners appointed joint administrators to Lehman Brothers International (Europe), Lehman Brothers Ltd., LB Holdings PLC, and LB UK RE Holdings Ltd. |
| September 16, 2008 | Federal Reserve Bank of New York agreed to lend up to \$85 billion to AIG and Federal Government received 79.9% equity interest AIG |
| September 17, 2008 | Barclays Plc. agreed to acquire Lehman Brothers Holdings Inc. for \$1.75 billion |
| September 19, 2008 | Treasury Secretary, Henry Paulson, proposed bailout plan, originally called Troubled Asset Relief Program (TARP) |
| September 21, 2008 | Morgan Stanley and Goldman Sachs -- the last two independent major U.S. investment banks -- received approval to convert into bank holding companies. |
| September 25, 2008 | Washington Mutual, Inc. was sold to JPMorgan Chase for \$1.9 billion in a transaction facilitated by OTS and the FDIC |

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| September 28, 2008 | Belgium, the Netherlands and Luxembourg agreed to inject 11.2 billion euros (\$16 billion) into Fortis |
| September 29, 2008 | <p>U.S. House of Representative voted to reject \$700 billion Emergency Economic Stabilization Act of 2008 (EESA). The vote against the measure was 228 to 205.</p> <p>Dow Jones Industrial average dropped 777 point (7%)</p> <p>Citigroup announced its willingness to buy Wachovia. The FDIC agreed to a loss sharing agreement under which Citigroup would absorb up to \$42 billion of losses and the FDIC would absorb additional losses</p> |
| September 30, 2008 | France and Belgium agreed to inject 6.4 billion euros (\$9 billion) into Dexia SA |
| October 1, 2008 | U.S. Senate passed \$700 billion financial-rescue plan, pending House approval |
| October 3, 2008 | <p>U.S. House of Representatives passed \$700 billion financial-rescue plan. The vote for the measure was 263 to 171.</p> <p>Announcement that Wells Fargo will merge with Wachovia after Wachovia rejects Citigroup deal.</p> |