FDIC Resolution And Receivership Of Failed Banks: Pitfalls And Opportunities For Landlords And Real Estate Investors

By Dana I. Schiffman

This article describes the Federal Deposit Insurance Corporation resolution and receivership process that is used to close failed financial institutions, pay depositors or arrange for takeover by a healthy bank, liquidate any assets and distribute the proceeds. In addition, the author discusses the disposition of FDIC retained assets and provides tips for landlords, letter of credit beneficiaries, and investors involved in this process.

According to the Federal Deposit Insurance Corporation (''FDIC'') which insures and monitors the nation's 8,305 banks and savings associations, 33 bank failures have already occurred in 2009. By way of comparison, 25 bank failures occurred in 2008. Putting these numbers in perspective, the number of failed banks in 2008 alone equals the total bank failures that took place over the previous seven years. Despite capital infusions, government stimulus and market making efforts to stem the tide of bank closures, financial industry experts predict the number of bank failures to grow and for the failures to occur more rapidly.

The FDIC resolution and receivership process is used to close failed banks, pay depositors or arrange for takeover by a healthy bank, liquidate any assets and distribute the proceeds. The resolution occurs prior to closure of the failed bank and the receivership and related asset sales follow.

Landlords with bank tenants, beneficiaries of letters of credit issued by teetering banks and investors seeking distressed real estate assets all have reasons to become familiar with the FDIC failed bank resolution and receivership process. Landlords of weak or failed banks will find it helpful to understand the key differences between FDIC receivership and bankruptcy. Holders of letter of credit security (''LOC'') issued by weak banks need to be aware of potential limitations on collection following the issuer's failure. Finally, investors in distressed real estate may discover investment opportunities by becoming familiar with the FDIC's sale procedures.

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Purchase and Assumption

A key objective of the FDIC resolution process is to identify and implement the disposition of the failed bank's assets that is least costly to the deposit insurance fund. This requires the highest recovery from the assets of the failed bank. Historically, the FDIC has found that some form of purchase and assumption transaction usually provides the least costly alternative. A purchase and assumption agreement is a closed bank transaction whereby a buyer (the assuming entity) purchases some or all of the assets and assumes some or all of the bank's liabilities. Those liabilities include, at a minimum, the insured deposits of the failing bank. The buyer usually pays a premium for the assumed deposits, representing the franchise value of the failing bank, thereby decreasing the FDIC's total resolution costs. The buyer in a purchase and assumption will typically be a healthy bank and such transaction will either close concurrent with the closure of the failed bank or, if a bridge bank is involved, after closure of the failed bank.

In situations where the circumstances do not allow the resolution process to take place prior to closure, such as in the case of sudden or severe liquidity problems, the FDIC has several methods to address the immediate concern of the bank's deposits and later address the sale of the assets and liabilities of the failed bank. One method is to form a bridge bank as was done in the recent failure of IndyMac Bank (a bridge bank is a new temporary bank controlled by the FDIC which is designed to bridge the gap between the bank failure and the time an acceptable acquisition can be arranged). Another option is paying off insured depositors and then selling the assets of the failed bank, however, such option is usually not the least costly alternative.

As a critical first step, the FDIC determines an estimated liquidation value of the subject assets. Typically, even though the FDIC requires separate bids for deposits (sometimes referred to as the franchise value) and for the assets, many bidders link their franchise and asset bids and the failed bank is sold to one bidder along with at least a substantial part of its assets. Such a buyer must be an approved healthy bank or an adequately funded private investor engaged in the process of obtaining a charter to create a new bank.

Because the process of obtaining a new charter can be difficult to complete within the timeframe for resolving a failed bank (being 90 to 120 days), the opportunity for private investors to participate in the bidding of a purchase and assumption transaction may be limited. In addition, the FDIC must also approve the investor's charter application so that the new bank's deposits can be insured. Additionally, a private investor would need to consider the effect of the Bank Holding Company Act. Under the Bank Holding Company Act, any company that directly or indirectly ''controls'' a bank is prohibited from having interests in certain commercial activities and investments. When such control exists, registration as a bank holding company is also required and the investor is subject to additional supervision and regulation including capital requirements and limitations on debt. Until recently, an investor could be regarded as having ''control'' with as little as a 10 percent voting ownership interest or a 25 percent interest in total equity. In an effort to encourage private equity investment in banks, the Federal Reserve raised this threshold to a 15 percent voting interest and 33.3 percent total equity interest and has loosened related rules regarding such investors' representation on the board of directors of the banking organization.

Prior to closure or after closure and succession by a bridge bank, FDIC-approved purchase and assumption bidders must deliver a confidentiality agreement and then attend an informational meeting. An informational package with financial data, a description of the options being offered (e.g., different asset pools — owned real estate rarely is included in the purchase and assumption transaction), the due diligence process, bidding procedures, the terms of the asset sales (discussed further herein) and legal documentation is provided. Interested parties are then given an opportunity to perform limited due diligence. Other than in the case of a sale of a bridge bank's assets, confidentiality is maintained during the resolution process to minimize disruption with the ongoing operation of the failing bank. If no investor bids an amount at least equal to the liquidation value of the subject asset pool, the subject assets remain with the FDIC to liquidate as receiver. The specific assets covered and the terms of the purchase and assumption transactions will vary with the circumstances of the failed bank. Given the emphasis on the least cost resolution (which is more likely to be obtained when the number of bidders is maximized), particularly in the case of larger failed banks, complex purchase and assumptions transaction have evolved to include options and puts on certain assets, asset pools and loss sharing. Loss sharing arrangements can be complex and require additional administrative efforts but are favored for their ability to limit losses and downside risk associated with collateral whose value is difficult to evaluate. In the past, loss sharing has been utilized to address commercial real estate portfolios. Presumably, loss sharing could also be used in connection with the sale of lower quality residential loan pools held by a failed bank.

Avoiding Pitfalls—What Landlords Should Know About FDIC Receivership

The duration of the receivership process varies depending on individual circumstances. Excluding the administration of loss sharing agreements, it is usually completed in six to 12 months after closure of the failed bank. While many of the concepts and procedures are similar, the Federal Deposit Insurance Act (the ''Act'') grants the FDIC receivership powers that are substantially broader and stronger than those of a bankruptcy trustee—think ''Super Receiver.'' Some of the critical differences include:

- *Nature of Proceeding*. Unlike bankruptcy, an FDIC receivership is not a proceeding filed in a court. The FDIC steps in as receiver for a failed bank under its congressionally-granted powers, as opposed to being appointed in a court proceeding. The FDIC administers and disposes of the failed bank's assets as described above without advance notice to creditors or a public hearing. Review of the FDIC's actions as receiver by a court is only available in very limited circumstances.
- *Stay of Action*. Unlike bankruptcy, the stay of judicial actions and proceedings against the failed bank is not automatic. The FDIC must request a stay and the court handling the legal proceeding must grant it for 90 days. Unlike the automatic stay in bankruptcy, the stay available in a FDIC receivership is not limited to the failed bank, but applies to all parties to the proceeding. Non-judicial actions by creditors against the failed bank are not stayed. The Act does not expressly authorize extensions of the stay.
- *Repudiation and Termination Damages*. A bankruptcy trustee may only reject executory contracts within the relevant time period provided under the Bankruptcy Code. For commercial leases, the time period is 120 days, unless extended for 90 days by the bankruptcy court. In contrast, the FDIC as receiver may repudiate any contract within a ''reasonable'' period of time so long as the receiver deems the contract burdensome and repudiation would promote the orderly administration of the receivership estate. ''Reasonableness'' will vary with the circumstance but several published decisions regard 90 to 180 days to be acceptable. Although the receiver will be liable for damages, except for certain types of financial contracts, those damages will be limited to direct damages. There are no accelerated, consequential or loss of profit damages. In the case of a repudiated lease, the landlord may only claim rent which was due as of the receiver's appointment and rent accruing thereafter until repudiation. In contrast to bankruptcy rules which generally allow a claim for up to one year of future rent, no claim for rent accruing after repudiation is allowed. Because of the priority given to depositors, in most cases the receivership will not generate sufficient funds to pay general unsecured claims, including those for unpaid rent accruing prior to repudiation. Furthermore, as discussed below, there may be a question regarding whether a claim for rent accruing after the appointment of FDIC as receiver is entitled to administrative priority. Note, however, that only leases not included in the sale of the failed bank (i.e., included with the purchase and assumption agreement for the failed bank) would be candidates for repudiation.
- *Letters of Credit.* LOCs are not exempt from repudiation. It has been the FDIC's long standing position that standby LOCs are contingent obligations that do not support an allowable claim unless the right to draw occurred prior to the receivership. If the right to draw precedes the receivership, the beneficiary will have either a unsecured claim or, if the LOC was collateralized, a secured claim. If the right to draw occurs after the receivership, the FDIC may not allow the claim even if the LOC is collateralized; however, in such event, the beneficiary may be able to argue that the LOC should be honored to the extent of the collateral because doing so would not be burdensome to the receivership and repudiation would interfere with the intended security.
- *Administrative Priority.* In a bankruptcy, the debtor's obligations under a lease that arise post-petition, such as rent, must be paid current by the bankruptcy trustee, and therefore have priority over other unsecured claims. Although expenses which the FDIC considers to be administrative are also given payment priority, the rental owed after the filing of receivership and before repudiation of the lease is not necessarily an administrative expense of an FDIC receivership. ''Administrative expenses of the receiver'' only include expenses incurred by the receiver ''that the receiver determines are necessary and appropriate to facilitate the smooth and orderly liquidation or other resolution of the bank.'' Presumably, keeping rent current on leases which are part of a valuable retail bank branch network or support office or which have ''bonus'' value due to below market rents would qualify. To the extent a claim for rent is not an administrative expense, it is a general unsecured claim. Because the Act gives priority to depositors over other general unsecured creditors, and most liabilities of a failed bank are deposit liabilities, the practical effect of the depositor priority is to eliminate recovery for other general unsecured creditors in most situations.
- *The Claims Process*. In a bankruptcy, the interests of the bankruptcy estate, debtor and creditors are separately represented and the bankruptcy judge applies congressionally-passed bankruptcy statutes and rules to the interests of all parties, who receive advance notice and the opportunity to express their concerns. In contrast, in many regards, the FDIC as receiver functions as lawmaker, judge, trustee and debtor. The FDIC as

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receiver both makes and implements the rules which govern its review of claims, is not subject to judicial supervision and, with limited exceptions, its decisions are not reviewable by any court. Claimants have limited ability to object and most objections must be pursued by separate court action or dispute resolution. In many cases, a separate court action to contest the FDIC's determination is cost prohibitive.

The claims process consists of notice of the receivership, a period for filing claims and a period for review by the FDIC. Specifically, the requirement for notice is limited to a local publication for three consecutive months of a notice of the receivership. There are no specific requirements regarding the circulation of the publication used or the size or placement of the notice. A specific mail notice is required only if the creditor's address appears in the books of the failed bank or if such information is discovered by the receiver. The FDIC has no duty to confirm delivery. If the claim is not proven to the satisfaction of the FDIC, it is disallowed. Claims filed after the cut-off which is set by the FDIC (which must be at least 90 days after the initial publication) are disallowed. Even if the FDIC failed to provide specific notice to the creditor's address in the failed bank's books, a late claim may be disallowed if distributions have already been made. The FDIC is required to provide to claimants notice of whether the claim has been allowed or disallowed. The only recourse with respect to a disallowed claim is for the creditor, within 60 days after disallowance, to seek administrative review (which requires the FDIC's consent), alternative dispute resolution per procedures established by the FDIC or to file a suit on such claim in U.S. District Court.

- *Assignment and Assumption.* The FDIC as receiver has the power to transfer any asset of the failed bank without any approval or consent. Thus, unlike the assumption and assignment of an unexpired lease in bankruptcy, the receiver is not constrained by requirements for adequate assurance, the terms of transfer are generally not disclosed, and the landlord has no notice or opportunity to object. Further, there are no cure requirements for assumption. The FDIC may assign a lease in default to an acquiring bank and the landlord is left to pursuing its remedies under the lease against the new tenant. In the shopping center context, it is unclear whether the FDIC's powers allow it to disregard use, radius, tenant mix and exclusivity limitations in the lease. In bankruptcy, leases may not be assumed and assigned in violation of such limitations.
- *Other Critical Differences:*
  Fraudulent Conveyances/Set Aside. The FDIC may set aside any transfer by the failed bank, an affiliated party or a debtor of the failed bank made within five years prior to the receivership if such transaction was made with the intent to hinder, delay or defraud the bank or any financial regulatory authority. In contrast, the reach-back period for fraudulent conveyances in bankruptcy is generally two years from the petition date.
  Statute of Limitations. If longer than the subject state's limitation on bringing an action, the FDIC has six years after accrual of a cause of action to bring a contract claim and three years after the cause of action accrues to bring a tort claim. In addition, the FDIC may revive certain tort claims (such as a fraud claim) so long as such claim expired no more than five years prior to when the receivership was established.
  Special Defenses. Improperly documented and undocumented agreements are not binding on the FDIC as receiver. In addition, no court may enjoin or restrain the FDIC from exercising its powers or functions.

Disposition of FDIC Retained Assets

Following the purchase and assumption, the FDIC liquidates the remaining assets of the failed bank. Loan assets are usually sold in pools through sealed bid or an auction process. The FDIC sales process is a direct, outgrowth of the FDIC and Resolution Trust Corporation (''RTC'') experience of the late 1980s and early 1990s. Typically, loan portfolios are stratified into pools based on various criteria such as area, site, asset type and asset quality. The loan pools are valued using established valuation methodologies. Bidder information packages are then developed describing the loan and due diligence information available, auction procedures and bidder requirements (including an eligibility certification and confidentiality agreement). Reserve prices for loan pools are usually established as a percentage of appraised value of the underlying collateral. An initial deposit of five percent is usually required and the winning bidder must submit an additional deposit with both deposits usually totaling 10 percent of the winning bid amount. The sale documentation is not negotiable and the closing occurs within a short time after the auction or bidding, usually within 10 business days. Seller financing and limited repurchase terms may be available. It is noteworthy that as FDIC and RTC asset inventory levels increased in the early 1990s different types of seller financing became available to stimulate competitive bidding.

Most of the information required to participate in the purchase process can be found on the FDIC's Web site (http://www.fdic.gov) and/or the linked Web sites of its loan or real estate advisors. The FDIC's Web site provides the following well organized information required by investors:

- Sales announcements;

- Links to sales and due diligence information;
- Contact information for the broker or advisors;
- A searchable database;
- Bidding procedures and contract documentation; and
- Answers to frequently asked questions.

The FDIC does not maintain a mailing list of potential purchasers; rather it views its Web site as providing the most useful information in a timely fashion. In addition, sales are advertised in local and regional newspapers. Information is updated by the close of business each Monday. In addition, the FDIC provides useful historical information on failed banks and closed real estate and loan sales. For instance, the FDIC provides data on past loan sales and real estate sales including the annual dollar amount and number of performing and non-performing loan sales and sales price as a percentage of book value and appraised value. Such information may be used by investors to gain insight regarding future FDIC sales. Investors seeking to participate in the purchase of the FDIC controlled real estate and loan pools will find it helpful to become familiar with the FDIC Web site. In addition, such investors will need to develop an effective due diligence and bidding process and the capability to restructure and/or enforce non-performing loans and/or re-position acquired real estate.

Although the FDIC disposition methods described above are most common, additional approaches to FDIC asset sales may evolve. The history of the 1980s and early 1990s indicate that the FDIC used its broad powers to modify the resolution and receivership process to adapt to changing marketplace conditions in order to meet its objectives of maintaining public confidence in the banking system, minimize disruption of markets and minimize the cost of the resolution process. In all likelihood, the FDIC will once again use its powers to facilitate the evolution of disposition strategies best suited to meet its objectives in the context of the number and types of bank failures that are predicted for the next several years. The recently announced Legacy Loan Program is a good example. As such evolution occurs, investors may discover new ways to participate in the recycling of failed bank real estate assets.

For instance, investors may be able to develop cooperative or strategic relationships with the acquiring banks engaged in the assumption process. Due to the constraints of the FDIC bidding process in a purchase and assumption transaction, some healthy banks may reluctantly acquire certain assets as a means of assuring an overall successful bid for the failed bank or certain critical portions thereof. In such cases, the acquiring bank or investor may have the desire to work with other investors possessing the appetite and resources to acquire certain of the real estate or loan assets of the failed bank. Confidentiality concerns of the ongoing operations of a failing bank might hinder an alliance with the ultimate buyer prior to the closure of the failing bank. However, such arrangements could increase the pool of bidders and/or bid amounts. Given this, it is possible that the FDIC could use its broad rule-making authority to facilitate such arrangements. In addition, because confidentiality considerations are less critical to a bridge bank, there should be less resistance to such arrangements in asset sales by a bridge bank.

Another unique approach was used by the RTC and FDIC at the peak of asset inventory levels in the late 1980s and early 1990s. Partnerships with private investors and asset managers were used to realize a higher recovery on large pools. The RTC or FDIC would typically contribute an asset pool and arranged for financing while the general partner (usually a joint venture between an equity investor and asset management company) provided equity and asset management services. If the inventory levels of the FDIC assets increase and the FDIC determines that such structure will result in the FDIC realizing higher recoveries, the equity partnership program might re-appear. In fact, thus far in 2009, the FDIC has utilized a form of partnership referred to as a structured sale to sell partial interests in loan pools resulting from failed banks that could not be sold in whole or in substantial part to a healthy bank.

Investors may also find that as the crises grows many healthy banks have an increasing interest in quickly disposing of non-performing loans and foreclosed real estate. Developing an ongoing relationship with such lenders may present investors with some of the best and least cumbersome opportunities to participate in distressed real estate.

Conclusion

Unfortunately, the unfolding economic challenges that lay ahead will result in increasing numbers of failed banks and, therefore, increased FDIC repudiation of leases, rejection of LOCs and sales of loan portfolios and owned real estate. Landlords, LOC beneficiaries and investors with a good understanding of the FDIC resolution and receivership process and who heed the following tips will be better positioned to react to these new realities.

Tips for Landlords

In recognition that many of the creditor protections that exist in a bankruptcy proceeding do not exist in a FDIC receivership, landlords of banks weakened by the current economic conditions should be vigilant in monitoring the tenant and diligent in addressing any claims against the tenant in the event their tenant becomes subject to an FDIC receivership. Specifically, such Landlord should:

- Monitor the tenant's status via news sources and periodically check the FDIC Web site that lists failed banks (www.fdic.gov/bank/individual/

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failed/banklist.html). In addition, such landlords should consider utilizing a bank rating service. They should not rely on receiving notice from the FDIC or the bank tenant;

- Monitor payment of rent. Upon the appointment of a receiver for the bank, landlords should immediately seek to clarify with the FDIC whether the post-receivership rent is entitled to an administrative priority;
- Determine the importance of the subject real estate to the bank and possible acquirers;
- If applicable, accelerate the resolution of outstanding claims and disputes; and/or
- If the subject lease is repudiated, file a claim as soon as possible to start the 180-day review period.

Tips for LOC Beneficiaries

Landlords in possession of LOC security should investigate the financial condition of the issuing bank and whether the LOC is collateral backed. If the issuing bank is not financially strong, the landlord should exercise whatever lease rights if may have to cause the tenant to replace the LOC with a cash security deposit, a replacement LOC from an approved bank or to draw the LOC. Landlords should also reevaluate and/or update their LOC lease provisions and their practice of accepting LOCs as security for a tenant's performance.

Tips for Investors

Understanding the FDIC resolution and receivership process will help investors to more effectively participate in the recycling of distressed real estate assets. Some of the steps such investors should consider are:

- Become familiar with the FDIC sales process and the information available through the FDIC Web site, including subscribing to certain FDIC news alerts;
- Develop effective monitoring, due diligence and bidding systems with respect to public auction sales; and
- Seek strategic relationships with existing lenders who may be interested in selling their home grown or acquired non-performing loans.

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