Restructuring and liquidation of US financial institutions

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

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

There are several reasons for this choice. First, compared to the Bankruptcy Code, very little has been written about this specialised law. Second, we are in the midst of the largest wave of bank and thrift failures in the United States since the US savings and loan crisis ended in the early 1990s. This specialised law has recently been used to 'resolve' major depositary institutions such as Washington Mutual and Indymac. It has served as the basis for many of the unusual programmes adopted by the federal government during the current economic crisis. This law will be used to restructure or liquidate many other US banks and thrifts before the current financial crisis is over. Third, the United States has created or proposed specialised 'resolution' codes for a variety of other financial institutions, all of which draw heavily on the principles set forth in Sections 11 and 13 of the act. For example, the Housing and Economic Recovery Act of 2008 created a specialised code modelled on these provisions for Freddie Mac and Fannie Mae, the giant entities that had securitised about half the outstanding residential mortgage loans in the United States, as well as the Federal

Home Loan Banks. These new provisions were used to put Fannie and Freddie into federal conservatorship in September 2008. Bills have also been introduced in Congress that would create a similar resolution code for US nationally chartered insurance companies. The Treasury recently proposed a specialised resolution law for 'systemically important' financial groups also modelled on Sections 11 and 13. Finally, other countries have considered or enacted specialised resolution laws for financial institutions modelled on these provisions, such as the UK Banking Act 2009.

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

1. Legal background

1.1 US insured banks and thrifts

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

1.2 Key issue

The overarching issue affecting the rights of creditors and other stakeholders in connection with a failed US bank or thrift is the FDIC's extraordinary powers to administer the receivership process, with little input from creditors or other claimants and virtually no judicial review. The FDIC succeeds to all rights, powers and interests of the failed depositary institution, its officers, directors and shareholders, and is given plenary power to administer its affairs. Unlike a

proceeding under the Bankruptcy Code, there are no creditors' committees and no trustees, and no court oversees the FDIC's activities. Any claims against the failed institution must first be submitted to the FDIC for its own administrative determination, and only after the FDIC considers the claim will a claimant be permitted to assert its claim before a court.

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

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

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

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

2. Regulatory tools to prevent failure

2.1 Supervision, examination and enforcement

The FDIC and the other federal (and, where appropriate, state) banking regulators are granted extensive supervisory powers over depositary institutions and their holding

companies. This supervision is designed to address the safety and soundness of the institution and monitor compliance with laws and regulations. The supervisory powers include both on-site and off-site examination and evaluation of the institution.

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

2.2 Prompt corrective action

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

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

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

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

These prompt corrective action tools are designed to force the insured institution

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

2.3 Source of strength obligations

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

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

2.4 Discount window and other emergency lending facilities

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

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

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

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