Message from the Chair

I am pleased to be sending you the Fall 2009 issue of our Banking Law Committee Journal. Peter Heyward, our Editor, has done a great job putting this timely and informative issue together. This edition contains an insightful analysis from Tom Vartanian and Gordon Miller of recent transactions reflecting the FDIC's evolving methods for resolving failed banks; a timely and detailed primer on commercial real estate loan workouts from savvy practitioner Elizabeth Bohn; and Travis Nelson's valuable summary of some of the most significant recent developments affecting the financial services business. On a lighter note, this issue also introduces a new feature - Test Your Banking Knowledge! - which will enable Committee members to compete in their recollection of useless banking industry trivia. We hope you will enjoy it.

All Committee members are encouraged to contribute articles to the Journal. Analyses of recent developments are always welcome, but book reviews, opinion pieces or other submissions relevant to the banking business are also appropriate. You will be reaching a nationwide audience of more than 2000. Feel free to contact Peter Heyward at peheyward@venable.com or 202-344-4616 if you would like to propose an item for the next issue.

Sally Miller
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Featured Articles

The Commercial Real Estate Loan Workout: Strategies for Minimizing Losses in a Troubled Market
Elizabeth M. Bohn

The housing market has finally begun to show signs of recovery, signaling the beginning of the end of unprecedented levels of home mortgage foreclosures in most markets. The forecast for commercial real estate markets is not nearly as sanguine. Tight credit markets, continued high unemployment and the poor economy have left commercial property owners unable to meet or refinance mortgage debt obligations, contributing to soaring commercial real estate loan defaults. The situation is likely to worsen as loans come due, credit remains scarce, and property values continue to deteriorate.

In this market, and considering the time and costs involved in obtaining a foreclosure judgment and then holding and remarketing foreclosed property, simply foreclosing and taking back the property may result in losses to the lender. If the borrower files for bankruptcy, additional issues will also arise with the potential to detrimentally affect the lender's position.

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2009 Developments in FDIC Failed Bank Resolutions
Thomas P. Vartanian and Gordon L. Miller

During the first nine months of 2009, the condition of the U.S. banking industry continued to put severe strains on the capacity of the Federal Deposit Insurance Corporation (FDIC) to cope with failed and failing institutions. This has compelled the FDIC to continue to innovate in order to streamline its receivership operations and reduce costs.

Numbers tell the story. From December 31, 2008 to June 30, 2009, banks and thrifts on the agency’s watch list increased from 252 to 416, the largest number since 1994. Total assets of those 416 institutions were $299.8 billion, the largest amount on the watch list since 1993. The FDIC’s Deposit Insurance Fund (DIF), its principal unallocated source of funds to finance receiverships and conservatorships, declined to $10.4 billion, or 0.22% of insured deposits, the lowest percentage coverage in more than 16 years. Forty-five institutions failed in the first half of 2009, compared to four in the first half of 2008. Twenty-one institutions failed in the second half of 2008, but during the third quarter of 2009 alone an additional 45 institutions were closed, including the sixth and eleventh largest institutions ever to fail, at an estimated total cost to the DIF of $14.8 billion. On nine occasions during the first nine months of 2009, no bank or thrift could be found to assume the deposits of a failed institution on acceptable terms, requiring the FDIC to establish a Deposit Insurance National Bank to assume deposits, create a bridge bank or make a direct payout to depositors of the insured amount of their accounts.

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Current Issues in Financial Services
Travis P. Nelson

This article provides a brief overview of issues emerging on Capitol Hill, in the regulatory agencies, and in the financial services industry in general, that are of importance to financial institutions and their customers.

Financial Regulatory Reform

In June 2009, the Obama Administration proposed an ambitious and much debated regulatory reform proposal. The proposal, while intending to streamline the financial regulatory process, making it more efficient and targeted in its objectives, would create or modify four new regulatory regimes: (i) a Financial Services Oversight Council (the “Council”), chaired by Treasury and including the heads of the principal federal financial regulators; (ii) a National Bank Supervisor (“NBS”); (iii) an Office of National Insurance (“ONI”) within Treasury; and (iv) a Consumer Financial Protection Agency (“CFPA”).

More...
Test Your Banking Knowledge!

With this issue, we introduce a new, occasional feature of the Banking Law Committee Journal: Test Your Banking Knowledge! The rules are simple. TYBK will consist of a question about some aspect of banking law or history. The correct answer, and the names of the first five respondents to e-mail it to Peter Heyward (peheyward@venable.com), will be published in the next issue of the Journal. Peter's determinations regarding what constitutes a "correct" answer will be final.

This issue's question is:

What do Alan Greenspan and the late Ernesto "Che" Guevara have in common?

Good luck!
THE COMMERCIAL REAL ESTATE LOAN WORKOUT: STRATEGIES FOR MINIMIZING LOSSES IN A TROUBLED MARKET

By

Elizabeth M. Bohn

The housing market has finally begun to show signs of recovery,\(^2\) signaling the beginning of the end of unprecedented levels of home mortgage foreclosures in most markets.\(^3\) The forecast for commercial real estate markets is not nearly as sanguine. Tight credit markets, continued high unemployment and the poor economy have left commercial property owners unable to meet or refinance mortgage debt obligations, contributing to soaring commercial real estate loan defaults. The situation is likely to worsen as loans come due, credit remains scarce\(^4\), and property values continue to deteriorate.

In this market, and considering the time and costs involved in obtaining a foreclosure judgment and then holding and remarketing foreclosed property, simply foreclosing and taking back the property may result in losses to the lender. If the borrower files for bankruptcy, additional issues will also arise with the potential to detrimentally affect the lender’s position.

A successfully negotiated structured loan modification, or “workout,” often provides a better alternative to maximize the lender’s recovery on a commercial loan, especially in the current environment. A “workout” has been aptly described as “a dynamic process that in the first instance identifies problems in and then redefines the relationship between a lender and a borrower. It is an art, not a science. A successful workout requires a combination of business, legal, and psychological acumen.”\(^5\) Seeking to provide at least the business and legal acumen that a successful workout requires, this article will discuss the considerations involved in and process of negotiating a successful loan workout, primarily from the standpoint of a lender’s workout counsel.

I. Before the Restructuring: Early Warning Signs and Considerations for the Lender

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\(^1\) Ms. Bohn is a partner in the Miami office of Jorden Burt LLP and regularly represents lenders in loan workouts. Ms. Bohn was one of the panelists at “Anatomy of a Loan Workout,” CLE program presented by the ABA Commercial Finance Committee at the Annual meeting, August, 2009 and by teleconference, October, 2009. She originally wrote and presented portions of this article as part of that program.


\(^3\) Notable exceptions include certain markets in California, Nevada, Arizona and Florida, which reported 23% home mortgage loans in default as of September. The S&P/SCI excludes condominium prices, which are also under increased pressure in Florida.


Lenders should be proactive and diligent in watching for warning signs of loan deterioration, before a payment default appears. The lender who notices the signs early, evaluates their causes expeditiously, and takes prompt action in response, will invariably have the better outcome.

Early signs of potential problems may be external to the situation of a particular borrower, or they may be specific to a loan. External signs of potential losses include factors present in the current environment, i.e., a weak market, poor economy, scarcity of new credit, as well as weakness in the specific borrower’s industry.

Loan-specific warning signs may include rising balances in the borrower’s revolving credit facilities, use of revolving credit to pay down term loans, increasing requests for covenant relief, sudden changes in the borrower’s ownership or management (in particular, positions of financial responsibility), unexplained reductions in EBIDTA, or failure of the borrower to provide financial statements, collateral reports, or other required information. Any of these events should trigger prompt investigation and analysis by the lender to determine the cause, and to assess whether the situation may worsen and/or lead to payment default.

Unless the lender feels assured after its own investigation that the credit will continue to perform according to its terms, it should begin preparing for the possibility of a workout or enforcement proceedings. This is also the time for the lender to engage outside workout counsel who is knowledgeable about enforcement remedies in the jurisdiction to assist in the process. Although the best financial outcome may be achieved through a negotiated workout, rather than enforcement and foreclosure, knowledge of enforcement remedies (and using that knowledge effectively in the negotiations) as well as bankruptcy law, is essential to achieving the best result.

Outside counsel can also serve as a useful buffer between lender and borrower. As a loan deteriorates and the borrower’s desperation increases, the borrower may increasingly seek concessions, waivers, and modifications from the lender. The borrower may then try to use (and distort) the content of its direct communications regarding covenant relief, default, enforcement, and potential modification against the lender. For example, a borrower might claim that the lender agreed to a covenant waiver or some other type of forbearance. If the borrower’s communications are instead channeled through outside counsel, the borrower’s ability to use them to its advantage against the lender will be greatly reduced.

After engaging outside counsel to assist in the workout, the lender should also convey to counsel institutional objectives which may not be readily apparent, including potential regulatory and/or accounting concerns that may affect the lender’s decision-making (in addition to providing information specific to the loan), so that outside counsel can gain a complete understanding of the lender’s goals and interests.

II. Due Diligence: Critical Information about the Loan and the Borrower
To structure a successful modification, it is essential that the lender and workout counsel have information necessary to perform a thorough due diligence analysis. The following information and documents should be fully reviewed and understood:

- the nature of the borrower, its business and apparent causes of present financial distress;
- all loan documents including all notes, amendments, and security agreements;
- all written correspondence (including emails) with the borrower;
- UCC-1’s, rent assignments, and other documents describing collateral;
- account notes/loan or account history reflecting current balance and interest charges;
- the existence and the status of the borrower’s other major creditors and/or lienholders;
- all specific event(s) and date(s) of all uncured defaults;
- the status of communications with the borrower regarding the current default(s);
- the lender’s course of dealings with the borrower on past defaults, and whether there has been a history of waivers of defaults or course of dealing contrary to the loan terms;
- the nature, location, and value of all collateral and whether security interests are perfected;
- the identity of the borrower’s other primary secured creditors and the collateral securing that debt.

Particular attention should be paid to loan document terms identifying defaults and remedies on default, default interest rates, cure periods, and the borrower’s covenants other than payment of the debt, including terms requiring the debtor to provide financial information and reports, permit inspection of collateral, and authorizing the lender to obtain appointment of a receiver. This information will be useful in the workout process or litigation, should litigation be required.

Internet searches should also be conducted on the borrower, using Google or other search engines, and its corporate status should be confirmed with the Secretary of State. Searches can also be conducted for other litigation against the borrower using Westlaw or Lexis service.

A. **Interviewing the Loan Officer.** After reviewing the documents and information gathered from public sources, workout counsel (and in-house counsel, if available) should interview the loan officer to gather information which might not be reflected in the documents, but will be important in evaluating the borrower and its potential defenses, including:

- What communications have occurred with the borrower as to current defaults (including telephone conversations) and how has the borrower responded?
- What has the borrower told the lender about the causes of its financial problems and how it expects to repay?
• Are other lenders or creditors are causing issues for the borrower?
• Has the loan officer visited the borrower’s business, and if so, what did he/she observe?
• What discussions and communications has the officer had with the borrower with respect to prior defaults?
• Has the borrower threatened lender liability claims?

B. **Analysis of Collateral.** By its nature, a workout contemplates a delay in enforcement of certain remedies. This delay could result in loss or dissipation of collateral.

Therefore, early in the workout process the lender and its counsel should work together to determine the nature and value of all collateral securing the loan, the risk of loss associated with the collateral. Together, they should develop a plan to preserve and prevent further losses of collateral during the workout process and protect or enhance the lender’s collateral position. Workout counsel will want to:

A. Identify all collateral described in the security agreements, mortgages, UCC-1’s, assignments of rent, receivables or other assets and confirm that all security interests granted in loan documents are properly perfected.

B. Determine whether there are other creditors who may have competing interests:

1. Has the debtor identified other creditors in its financial statements and/or business plan provided to the lender?
2. Conduct a UCC-1 search to determine other UCC-1’s filed against the collateral.
3. If the borrower does not own real property at which collateral may be located, determine the existence, extent and priority of any landlord’s liens on that collateral.
4. Determine whether the lender has received any purchase money security interest (PMSI) notices from finance companies supplying goods or equipment.
5. Run a property search to determine whether there are other mortgages on the same property.

C. Determine the value of all collateral:

1. Review existing appraisals.
2. Obtain updated appraisals from an appraiser qualified to testify as an expert in the event of bankruptcy.
3. Obtain and analyze rent rolls.
4. Conduct on-site audits of inventory and any other collateral at the borrower’s locations.
5. Demand the borrower to provide all financial reports called for in the documents.
6. Evaluate the risk of dissipation and loss of collateral and assist the lender in developing a plan for monitoring it closely.
7. Determine whether the borrower has funds on deposit available for set-off and evaluate the risk to the borrower’s business resulting from set-off.

D. Develop a plan to protect existing collateral.

To the extent permitted by the loan documents, a procedure should be put in place for continuous monitoring of the collateral to ensure it is not used outside the ordinary course of business.

**III. Evaluating Collateral Remedies**

Only when the facts relating to the loan, the borrower, and the nature, value, and status of the collateral are fully understood, can a determination be made as to whether and the extent to which a workout modification, as opposed to immediate enforcement, is in the lender’s best interest, and an effective workout strategy planned. For example, the lender and its workout counsel should consider:

A. The likelihood the borrower can survive and whether the borrower is taking concrete steps to survive, as opposed to merely biding time (and dissipating cash and other assets) until the inevitable occurs.

B. To what extent collateral can be retaken without legal action, for example, by surrender (in the case of personal property), or set-off in the case of deposit accounts.

C. The risk of loss of the collateral if enforcement action is not taken, including ongoing loss or diminution of collateral value resulting from:

- Use/dissipation of rents, profits, deposit accounts, proceeds, receivables and other cash collateral.
- Sale of inventory in the ordinary course of business.
- Sale or disposal of assets outside the ordinary course of business.
D. Whether the liquidation value of the collateral is sufficient to make the lender whole if enforcement remedies are exercised, and if not, the extent of other repayment sources. If enforcement will not make the lender whole, what collateral does the borrower need to stay in business to generate income for repayment? If so, how can dissipation of existing collateral needed for the debtor to stay in business be prevented?

E. The lender’s capacity to manage the real estate, and to repossess and liquidate the collateral in a commercially reasonable manner.

F. Location of the collateral and possible need for filing suits in multiple jurisdictions to recover it.

G. What other collateral or agreements might the borrower offer in exchange for forbearance?

H. If enforcement remedies are exercised, the risk the borrower will raise defenses or assert lender liability counterclaims. For example, is the borrower likely to argue that a past course of dealings or communications with the lender resulted in waivers of terms or agreements to modify? Or, that the lender did not comply with the terms of the loan, letters of assurance or other representations made in communications? Are there grounds for the borrower to assert that the lender exercised undue control which might result in lender liability counterclaims?

I. The risk of a bankruptcy filing, how it will affect the lender’s position, and what steps can be taken in a workout to improve the lender’s position if/when bankruptcy is filed.

IV. Litigation and Mechanics for Enforcing Lender’s Collateral Remedies

A workout should always be structured in contemplation of the possibility of future enforcement litigation and/or bankruptcy of the borrower, with the dual goal of (a) strengthening the lender’s position legally and in collateral in the event legal action is required, and (b) minimizing borrower defenses.

Even when a negotiated workout is the goal, enforcement litigation may be useful to halt collateral dissipation, or eliminate sub-liens. For example, even when the lender and borrower reach an agreement with respect to the borrower’s obligations, a “friendly foreclosure” may be used by the lender solely to eliminate sub-liens. Where elimination of sub-liens is not an issue, commencement of enforcement litigation may still provide, in addition to tools for collateral preservation, a framework for a workout agreement which may be blessed by the court and limit future litigation in the event of further default.

All liens on collateral covered by the Uniform Commercial Code (“UCC”) (for example, liens on intangibles, accounts, proceeds, and personal property) must be enforced in compliance with Article 9 of the UCC in order to protect the lender from possible claims associated with its
recovery and disposition.\textsuperscript{6} Methods for lien enforcement against collateral will vary logistically depending on the status and location of collateral.

A. **Enforcing Interests in Tangible Personal Property.** If a borrower refuses to assemble or voluntarily surrender collateral as may be called for in the loan agreement, the UCC permits a lender to use self-help to repossess personal property collateral such as goods, equipment and inventory (including raw materials) to the extent it can do so “without breach of the peace\textsuperscript{7}.”

However, the lender will often need court assistance to recover collateral. State laws vary as to their procedures for court sanctioned repossession of collateral prejudgment and requirements as to court hearings before issuance of a replevin or recovery order. In many cases, an order for recovery of personal property collateral may be obtained without notice or hearing, but only after the posting of a bond. Other procedures contemplate obtaining a hearing, with fairly short notice.\textsuperscript{8}

Recovering collateral will stop its loss, put the lender in control, and get the borrower’s attention, which may give the lender an advantage in workout negotiations. On the other hand, a lender in possession of collateral must treat the collateral in accordance with the requirements of the UCC or face loss of deficiency rights or possible damage claims. For example, if the lender elects to sell or dispose of the collateral, it must give proper notification before the sale to the borrower, guarantor, and other parties with an interest in it, sell or dispose of it in a commercially reasonable manner, and apply the proceeds as required by the UCC.\textsuperscript{9}

If the lender wishes to accept the collateral in full or partial satisfaction of the debt (also known as “strict foreclosure”), the lender must send notification of its proposal to do so to the

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\textsuperscript{6} A thorough analysis of Article 9 remedies and requirements is beyond the scope of this article, but can be found in “\textit{UCC Article 9 and the Exercise of Secured Party Remedies},” by Lynn Soukup, presented June 2, 2009, by the ABA Uniform Commercial Code Committee, Commercial Finance Committee and ABA Center for Continuing Legal Education and is available online at the ABA website.

\textsuperscript{7} See: UCC §9-609.

\textsuperscript{8} Florida, for example, provides alternative procedures for quick prejudgment recovery of personal property collateral in Chapter 78 Florida Statutes (“Replevin”). Under this statute, property may be seized forthwith under a replevin writ issued ex parte and without notice if the claimant establishes the right to its possession by affidavit (for example, alleging that the items are subject to a security interest and the borrower has failed to pay as agreed), and posts a bond for the lesser of twice the value of the property, or twice the amount of the debt as security if the writ is found to be wrongfully issued. Fla. Stat. §78.068. Alternatively, the claimant can request the Court to issue a show cause order and set a hearing at which the party in possession is required to show why the property should not be taken from it and delivered to the claimant. Fla. Stat. §78.065. The obvious risk of using the second procedure is notice to the borrower in advance resulting in loss of the collateral. Therefore, it is the opinion of the author that it not advisable to proceed with notice unless the right to possession does not stem from a security agreement, or the secured party’s right to repossession under the security agreement is in question.

\textsuperscript{9} UCC §§ 9-610, 9-615.
borrower and other parties claiming an interest in the collateral.\textsuperscript{10} Strict foreclosure requires the lender to act in good faith, but there is no requirement for it to act in a commercially reasonable manner.

Therefore, before recovering collateral, outside counsel should advise the lender to consider how it will store collateral after it is recovered, how it will dispose of it to comply with UCC requirements of commercial reasonableness and good faith, if a strict foreclosure, and whether and to what extent strict foreclosure may be appropriate.

B. Deposit accounts, proceeds, accounts. Enforcing interests in collateral such as deposit accounts, proceeds, and the accounts of the borrower may be simpler and faster than enforcing interests in personal property collateral.

For example, to the extent the lender has control over a deposit account which is pledged as collateral for the debt, the lender may take and apply the funds in the account to the obligation.\textsuperscript{11} Even if a deposit account is not specifically pledged, if the lender has a security interest in proceeds (of other collateral) in a deposit account, this also provides a ground for claiming funds in the account are collateral which the lender may take and apply to the debt.\textsuperscript{12} If the borrower’s “accounts” are pledged, the lender may also directly enforce the obligations of the borrower’s account debtors.

C. Foreclosure of the mortgage on real estate. If there are junior mortgages, liens or other encumbrances, and the junior lienholders are not part of the workout, a foreclosure action will be required to clear title. Filing a foreclosure action may also be an effective means to bring the borrower to the table to negotiate a workout within the action. Mortgages on real property must be foreclosed in accordance with the procedures available under the law of the state where the property is located. In Florida, a lawsuit must be filed seeking foreclosure of the mortgage, the claims are litigated, judgment must be obtained, and the property must be sold thereafter at foreclosure sale for certificate of title to issue to the lender. Claims may be brought in the same litigation on the note, for foreclosure of the security interest, and on guaranties. Florida also provides a streamlined foreclosure procedure whereby the lender may obtain an order to show cause why the foreclosure judgment should not be entered.\textsuperscript{13}

D. Assignments of Rent. If rents are assigned as additional collateral under the mortgage or by separate documents, the law of the state where the property is located may provide for specific additional relief for the lender. For example, in Florida law, a rent assignment is perfected upon recording of the mortgage, and is enforceable upon the borrower’s default and the lender’s demand for payment of the rent.\textsuperscript{14} Florida law also provides a procedure for the mortgagee to obtain immediate sequestration of rents, in order to prevent their dissipation.

\textsuperscript{10} UCC §§9-620; 9-621.
\textsuperscript{11} UCC §9-607(1)(d).
\textsuperscript{12} UCC §9-607(1)(b).
\textsuperscript{13} Fla. Stat. §702.10.
\textsuperscript{14} Fla. Stat. §697.07.
by the borrower. A motion for sequestration of rents should be filed together with the foreclosure complaint. Sequestration under the statute contemplates deposit of the rents in the court registry. But after the motion is filed, counsel can negotiate with the borrower for deposit and use of the rents in a more convenient manner.

E. Appointment of a Receiver. Commercial mortgages typically contain terms under which the lender may obtain a receiver to take control of and manage mortgaged property and rents. During the due diligence process, the lender and workout counsel should have considered the lender’s ability to manage the property, and found an entity suitable and acceptable to the lender to do so. In filing a motion for appointment of a receiver, the lender can request appointment of the entity it has preselected for this purpose, rather than ask the Court to appoint a third party.

V. Use of Enforcement Remedies in the Negotiated Workout

As loan performance deteriorates, the goals and interests of the lender and the borrower will increasingly diverge. The lender’s primary goal is to restore the loan to performing status, so as to avoid charge-off. But in the current market, the borrower may be unable to find sources for repayment to pay off or perform the loan’s terms.

If the borrower cannot perform or payoff the loan, the lender’s secondary goal is to maximize recovery and minimize losses. The borrower’s goal is to stay alive and in control of its assets and revenue stream, even though its continued use and consumption of assets will lead to greater losses for the lender if the loan cannot be restored to performing status or restructured satisfactorily. The borrower often will not be inclined to voluntarily permit the lender to take control of any collateral asset. The lender will also prefer not to enforce remedies against collateral, if this can be avoided.

Workout counsel must advise the lender on how best to structure a solution to protect the lender given its concerns, and the likely response of the borrower. Often, taking initial legal steps to enforce the lender’s interest in the collateral, even if the lender’s ultimate goal is not to own it, is the best way to force the unrealistic borrower to agree to a workout solution acceptable to the lender.

Thus, while completing a foreclosure action and taking back real property which the lender will then have to manage and sell is typically not a desired result, the threat to the borrower of imminent loss of access to the cash generated by the property and other assets attendant to the filing of a foreclosure action, a request for rent sequestration and/or a receiver, and/or recovery of personal property collateral, will usually force it to the table and motivate it to agree to workout terms acceptable to the lender which don’t include owning the property. By initiating enforcement litigation, the lender may also be able to obtain some immediate payment on the debt from collateral seized through legal action, and/or convince the borrower to provide additional collateral, in exchange for some form of forbearance and abeyance of foreclosure.

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15 Id.
Since the lender as plaintiff will be seeking relief in the litigation, a state court will not force the lender to move the case quickly. Rather, the lender can file the enforcement litigation, seek collateral orders, and then use the litigation to bring about a workout agreement. In sum, commencement of enforcement litigation to facilitate a workout may confer the following benefits:

- Rent sequestration orders or other restrictions on rent use;
- Orders to stop collateral losses while workout discussions occur;
- Orders for the appointment of a receiver;
- Time for negotiating how collateral will be handled, including procedures for sale of repossessed collateral;
- Minimizing risks of borrower defenses based on waiver, course of dealing, or modification of terms outside the documents;
- A framework to conduct workout negotiations as settlement communications, which are generally inadmissible under rules of procedure and cannot be used against the lender in the enforcement litigation, unlike discussions outside of litigation;
- A facility for joining junior lienors and negotiating their interests in collateral at the same time, including negotiating agreements as to treatment of claims and liens in the event of bankruptcy;
- Structure for obtaining admissions to the validity of the debt and the lender’s security interest, as well as waivers of defenses to future enforcement should the borrower default under the workout;
- Means to obtain faster judicial relief for the lender should the borrower default under the workout, for example, by entry of judgment;
- Court approval of the workout agreement.

VI. Bankruptcy Considerations

The impact of the borrower’s bankruptcy must always be carefully analyzed in a workout situation. While many issues may arise in bankruptcy, three primary bankruptcy planning considerations for the lender in a workout are: (1) the impact of the bankruptcy stay; (2) protecting, maintaining and/or improving the lender’s secured position in collateral, and (3) mitigating risks of preference and avoidance claims by the debtor or trustee.

A. Automatic Stay. The filing of a bankruptcy case operates a stay (or injunction), prohibiting, inter alia, the following:

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case, or to recover a claim against the debtor that arose before the commencement of the case;

16 An analysis of all bankruptcy issues is beyond the scope of this presentation.
(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor.\(^\text{17}\)

Thus, the automatic stay requires the complete cessation of all efforts to: (1) collect or enforce debts from the debtor, (2) repossess collateral, and (3) perfect or enforce liens against property of the estate, including the recording of a UCC-1 financing statement, lien, or mortgage. Thus, in initial planning states of a workout, the lender and its counsel should ensure its security interests are properly perfected, and that it enforces rights against collateral such as deposit accounts before filing occurs.

B. **Maintaining or strengthening the lender’s collateral position.** The bankruptcy code deals with “creditors” holding “claims.” A claim is defined as “a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured.\(^\text{18}\)”

Claims in bankruptcy are paid in accordance with priorities set forth in the bankruptcy code. Generally, all claims in the same class must be treated alike in descending order according to the priority of the class.\(^\text{19}\) Thus, creditors holding secured claims are entitled to be paid ahead of unsecured claims, based on the value of the collateral securing their claims. All unsecured claims must be treated alike, and unsecured claims are paid only after secured claims are paid.\(^\text{20}\)

Outside of bankruptcy, unperfected security interests are still enforceable against the borrower (subject to any other perfected liens in the same collateral). This is not the case in bankruptcy. Creditors with unperfected security interests are treated as having no security interest, i.e., unsecured claims in bankruptcy proceedings. Since the automatic stay prevents post-petition perfection of security interests, pre-petition perfection is essential, and should be an early step in the workout process.

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\(^{17}\) 11 U.S.C. §362(a).


\(^{19}\) 11 U.S.C. §507.

\(^{20}\) Id.
In bankruptcy, to the extent the value of collateral securing a lender’s claim is less than the amount of the claim, the lender’s claim is bifurcated as to “secured” and “unsecured” portions:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest, . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property….and is an unsecured claim to the extent that the value of such creditor's interest … is less than the amount of such allowed claim.  

A lender with a $20 million debt secured by real estate and other collateral worth $15 million thus has a secured claim of $15 million and an unsecured claim of $5 million. In bankruptcy, that portion of a lender’s claim which is secured will be repaid ahead of that portion which is unsecured, and payments a lender receives in a non-consensual Chapter 11 will largely determined by the value of the secured portion of its claim. A lender who is “over secured” is also entitled to post-petition interest and attorneys’ fees as provided in the agreement.

A lender’s ability to establish the highest value for its secured confers certain advantages, particularly if the lender is over secured, i.e., collateral value exceeds the amount of the debt. If the borrower (or a junior lender) disputes the value the lenders assigns to the collateral securing its claim, as is often the case, then the bankruptcy court will hold an evidentiary hearing to make that determination.

The value of collateral in bankruptcy must be determined “in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.” Thus, the value of collateral proposed to be liquidated may be determined differently from collateral which will continue to be utilized in operations.

The importance of collateral value in bankruptcy demonstrates the importance of the lender’s early due diligence in evaluating collateral and obtaining appraisals from experts qualified to testify at any valuation hearing.

Cash collateral. Bankruptcy law affords special protections to a lender with an interest in “cash collateral,” defined as rents or other “cash equivalents” pledged as security for a debt:

22 Under, 11 U.S.C. § 1129 (b)(2), to be confirmed, a Chapter 11 plan must provide for deferred payments to secured creditors totaling at least the value of their secured claims (i.e., the value of the collateral) as of the plan’s effective date.
24 On the other hand, being over secured is a two-edged sword, in that it may reduce the likelihood of entitlement to adequate protection payments, as discussed, infra.
25 Id.
After the filing of a bankruptcy case, a bankrupt borrower still operating its business is not permitted to continue to use the lender’s cash collateral without court approval. It:

“may not use, sell, or lease cash collateral … unless—
(A) each entity that has an interest in such cash collateral consents; or
(B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.27

Until the Court issues an order permitting use of cash collateral by the borrower in Chapter 11, it is required to “segregate and account for any cash collateral in [its] possession, custody, or control.”28

Since the borrower will most likely need cash collateral to operate, motions to use cash collateral are usually filed by the bankrupt borrower on the first day of its bankruptcy. The lender may and often should file a cross-motion requesting that conditions be imposed on the borrower’s use of cash collateral as necessary to provide it with adequate protection for its interest.29

Adequate protection. A primary purpose of Chapter 11 reorganization is to maximize the benefits to creditors generally by preserving the debtor’s value as a going concern. If the debtor establishes the need to use the cash collateral to fund operations and preserve its going concern value, a motion to use it will usually be granted, subject to adequate protection for the lender. The debtor will generally present (and the lender should require) a detailed budget as to its proposed use of cash collateral.

The concept of “adequate protection” means protecting the lender from a decrease in the value of the collateral which it would otherwise be entitled to recover, but for the bankruptcy resulting in the borrower’s continued utilization of same. In other words, the lender should not suffer a reduction in the value of its secured claim as a result of the debtor’s use of the collateral.

Adequate protection often involves regular payments to the lender, for example interest payments, and may include a requirement that the cash collateral be used only for insurance and/or other expenses associated with preserving and protecting the property and income-

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27 11 U.S.C. §363 (c)(2). Although the statute refers to use of cash collateral by “the Trustee,” in a Chapter 11 case, the debtor in possession has the rights and is required to perform the functions of a bankruptcy trustee. 11 U.S.C. §1107(a).
producing operations of the debtor related to it. Note that the over-secured creditor may be less likely to receive adequate protection payments as the court may deem that the “equity cushion,” i.e., the amount by which the collateral value exceeds its claim, sufficient to protect its interests.

During the workout planning process, the lender and counsel should evaluate the value of collateral (other than cash) securing its claim, and consider different methods of valuation based on its potential disposition or use in bankruptcy. Although the temptation to execute on cash collateral may be strong, unless the cash is in immediate danger of dissipation, the ability to obtain adequate protection to compensate it for its loss of same, may caution against such action, especially if the lender wants the borrower to survive to maximize value, and believes survival is possible.

Ideally, the workout should be structured so that, to the extent the borrower retains non-cash collateral, that collateral’s value will be maximized in bankruptcy. It may make sense for the lender to permit the borrower access to cash collateral needed to operate the property which the lender does not wish to acquire, subject to approval of a budget and appropriate reporting requirements, audit rights, and other steps as necessary to safeguard it from dissipation.

Financing the bankrupt borrower’s operations. If the borrower/Debtor-in Possession (“DIP”) needs additional financing (“DIP financing”) to continue operating in bankruptcy, a pre-petition lender might consider providing DIP financing on conditions requiring repayment of prepetition debt is made in the bankruptcy. This is controversial and may be subject to attack by other secured lenders as unfairly preferring the DIP lender. However, if the lender and borrower can show that no other financing is available and that the financing is in the best interests of all creditors, it may pass muster.

As with enforcement litigation, a bankruptcy filing may provide an ideal framework for negotiating and executing a workout agreement, providing all benefits of a state court setting, and in addition, the possibility of stay relief, limitations on debtor’s ability to use or sell assets without court approval, Chapter 11 plan requirements, and the ability to deal with all creditors, as well as equity interests at the same time.

C. Mitigating the risk of claims to avoid payments as preferences. During the workout process, the lender and counsel should also attempt to mitigate the risk that transfers of collateral, payments, and new obligations incurred by the borrower in the workout will be subject to claims in bankruptcy to avoid them (i.e., require the lender to repay them to the debtor’s estate) as preferential transfers.

The transfer of any interest in property of the debtor to a creditor for antecedent debt (debt owed before the transfer), made “while the debtor was insolvent,” and within 90 days of a bankruptcy filing, which “enable the creditor to receive more than it would receive” if the case was a Chapter 7 liquidation and the transfer or payment had not been made, may be “avoided” by

30 For purposes of preference claims, “insolvency” is presumed for the 90 day period preceding a bankruptcy filing 11 U.S.C. 547 (f).
31 (one year if the creditor was an insider) 11 U.S.C. §547 (b)(4)(B).
the trustee (or the debtor in possession), subject to certain defenses. In other words, the creditor who received the transfer or payment may be sued in bankruptcy by the borrower or trustee to recover the payment.

Therefore, payments or transfers of the borrower-in-default’s property to the lender may be subject to avoidance actions to recover them as preferential, subject to certain defenses. For example, a transfer or payment to a lender may not be avoided as preferential under Section 547 if, inter alia:

- the transfer was intended by the debtor and lender to be “a contemporaneous for new value given the debtor,” and the transfer was, in fact, “a substantially contemporaneous exchange,” or
- to the extent that after the transfer, the lender gave the debtor “new value” which was not secured by an otherwise unavoidable security interest, and on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

In structuring a workout, the lender and counsel should be aware that debt reduction or surrender of collateral to the lender on a loan in default may create claims for avoidance of the payments or transfers as preferential. Therefore, agreement should be sought from the borrower that it will not seek to set aside the transfers in bankruptcy as preferential. However, if a borrower’s Chapter 11 case is converted and a trustee is appointed, these agreements may not be enforceable against an appointed trustee.

Even with careful planning, it may not be possible to eliminate all risks of preference avoidance claims which could arise in bankruptcy after a workout. If the choice comes down to the opportunity for the lender to receive a payment or surrender of collateral which will otherwise be lost or not receiving it, accepting the risk of an avoidance action is usually better than not receiving the payment at all.

VI. The Pre-Workout Agreement and Final Workout Agreement

The “Pre-Workout” Agreement. To the extent workout negotiations take place before the filing of enforcement litigation or a bankruptcy case, a “pre-workout” agreement to enter into negotiations is advisable to prevent communications occurring during such negotiations from creating new borrower defenses.

If litigation or bankruptcy is in process, a pre-workout agreement is not necessary, as long as the parties agree that the negotiations shall be treated as confidential and inadmissible.

33 11 U.S.C.§547(c) lists all defenses to preference claims. Only those thought to be most relevant to prepetition payments by a borrower to a lender in a workout are listed here.
34 11 U.S.C. §547 (c)(1).
settlement negotiations. If the lender has not commenced litigation or bankruptcy has not been filed, then without such an agreement and the protection afforded in litigation for settlement communications, a desperate borrower may argue that the lender agreed to waive defaults, rights or otherwise modify the loan.

The pre-workout agreement may be entitled “Agreement to Enter into Workout Negotiations” or something similar. In it, the lender should attempt to obtain recitations, some of which will be incorporated in the final workout agreement, that:

A. the borrower and lender are parties to the loan and security agreement and other loan documents (and if the borrower will agree), that the documents are valid and enforceable according to their terms);

B. the loan is in default and the events of default (if the borrower will agree, the amount owed should be included);

C. the borrower and the lender wish to engage in settlement negotiations regarding the defaults under the loan;

D. the content of the settlement negotiations will be privileged and inadmissible against both parties, and that neither the lender’s engagement in settlement negotiations nor any communications made in the course of those negotiations may be deemed to constitute a waiver by the lender of any rights provided under or modification of any of terms in the loan agreement, which shall not be considered modified absent execution of a formal written modification agreement;

E. participation in settlement negotiations shall not prejudice the lender in any manner, or create any defenses in the event of subsequent litigation or bankruptcy;

F. if the settlement negotiations result in an agreement for resolution of the defaults acceptable to both parties, a formal, written loan modification agreement will be executed setting forth the terms;

G. if settlement negotiations do not result in an agreement for resolution of defaults acceptable to the lender within such defined time period as the lender may elect, the lender may exercise all rights provided under the loan documents as if the negotiations did not occur.

The Final Workout or (Forbearance) Agreement. Workout agreements typically involve some form of forbearance on the part of the lender in exchange for agreements of the borrower to offer collateral and/or make other concessions which will simplify the lender’s ability to foreclose after future defaults.

The terms of final agreement, which may have a title similar to “Forbearance Agreement and Amendment to Loan and Security Agreement” are limited only by the imagination of
lender’s counsel applied to the facts at hand. Generally, the final workout agreement will include (A) and (B) above, and should or may also include:

C. Acknowledgement by the borrower and guarantors of the amount of the debt and details of any modifications in payment obligations;

D. Reaffirmations by the borrower of the validity of and provisions contained in the loan documents except to the extent modified by the agreement;

E. Identification of any additional collateral offered as security to the lender in the workout;

F. Clarifications or modifications needed to strengthen the lender’s interest and the borrower’s duties which respect to existing collateral, for example, increased audit rights for the lender and reporting duties for the borrower;

G. The borrower’s waiver of all defenses and counterclaims purported existing to date;

H. Consent of any guarantors, and, if applicable additional guaranties;

I. Default and enforcement provisions;

J. Terms for disposition of collateral on default, including an agreement to a specific method for collateral disposition as commercially reasonable;

K. Specification of the forbearance the lender is granting in exchange for the borrower’s new covenants;

L. Terms for streamlined or fast-track enforcement of remedies on subsequent default by the borrower and enforcement litigation;

M. Terms which will apply in the event of bankruptcy, for example:

- agreements to consent to stay relief and/or surrender with respect to certain collateral;
- agreements as to what will constitute adequate protection;
- stipulations as to the value of collateral for claims valuation purposes;
- agreements that payments or transfers of other property in the workout shall not be subject to avoidance as preferential by the borrower as debtor-in-possession.

While a bankruptcy court may not enforce all of these terms, they are nevertheless worth including as evidence of the borrower’s intent, and as potential admissions against interest.
If the workout occurs in the context of enforcement litigation, the terms may also be incorporated into a settlement stipulation approved by the Court, and may provide the lender with additional remedies such as entitlement to immediate foreclosure judgment after default.

**VI. Conclusion**

The goals of a successful workout should be maximum recovery, strengthening the lender’s collateral position and rights, reduction of loss and other risks, and avoidance of the expense of protracted litigation (even if litigation is initiated to bring the borrower to the table). In exchange for this additional certainty and strength, time and/or other concessions may be granted to the borrower which make practical sense for the lender after careful analysis of the factors discussed above in each particular situation. Additionally, the successful workout should better position the lender to enforce its rights and remedies in court without a long battle should the borrower default after the restructure.
2009 DEVELOPMENTS IN FDIC FAILED BANK RESOLUTIONS

By
Thomas P. Vartanian
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During the first nine months of 2009, the condition of the U.S. banking industry continued to put severe strains on the capacity of the Federal Deposit Insurance Corporation (FDIC) to cope with failed and failing institutions. This has compelled the FDIC to continue to innovate in order to streamline its receivership operations and reduce costs.

Numbers tell the story. From December 31, 2008 to June 30, 2009, banks and thrifts on the agency’s watch list increased from 252 to 416, the largest number since 1994. Total assets of those 416 institutions were $299.8 billion, the largest amount on the watch list since 1993. The FDIC’s Deposit Insurance Fund (DIF), its principal unallocated source of funds to finance receiverships and conservatorships, declined to $10.4 billion, or 0.22% of insured deposits, the lowest percentage coverage in more than 16 years.\footnote{FDIC Quarterly Banking Profile, Second Quarter 2009 (“QBP”), available at \url{www.fdic.gov/qbp/2009jun/qbp.pdf}.} Forty-five institutions failed in the first half of 2009, compared to four in the first half of 2008. Twenty-one institutions failed in the second half of 2008, but during the third quarter of 2009 alone an additional 45 institutions were closed, including the sixth and eleventh largest institutions ever to fail, at an estimated total cost to the DIF of $14.8 billion.\footnote{FDIC Failed Bank List, available at \url{www.fdic.gov/bank/individual/failed/banklist.html}; FDIC Press Release PR-143-2009 (Colonial Bank, Montgomery, Alabama) (Aug. 14, 2009); FDIC Press Release PR-150-2009 (Guaranty Bank, Austin, Texas) (Aug. 21, 2009); CNN Money, “Third Largest Bank Failure of 2009 Announced,” available at \url{www.money.cnn.com} (last updated Aug. 21, 2009).} On nine occasions during the first nine months of 2009, no bank or thrift could be found to assume the deposits of a failed institution on acceptable terms, requiring the FDIC to establish a Deposit Insurance National Bank to assume deposits, create a bridge bank or make a direct pay-out to depositors of the insured amount of their accounts.\footnote{FDIC Failed Bank List.}

The ability of the banking industry to absorb losses also has been taxed, which foretells continuing pressure on the DIF. In the second quarter of 2009, the industry posted a net loss of $3.7 billion, only the second quarterly loss since 1991. Factors contributing to the loss included net charge-offs of $48.9 billion, the largest quarterly charge-offs in dollars and as a percentage of total loans on record. Noncurrent loans and leases increased for the 13th consecutive quarter and also set a record in dollar amount and as a percentage of total loans and leases. The ratio of loan loss reserves to total loans and leases rose to a new high of 2.77%, but

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the ratio of such reserves to noncurrent loans fell to 63.5%, the lowest level since September 30, 1991.4

In the face of these conditions, the traditional methods of the FDIC to resolve a failed bank—sell the deposits, retain and manage a majority of the assets and dispose of those assets over time—have evolved. The FDIC is now pursuing four principal resolution strategies: loss sharing transactions with strategic buyers; loss sharing transactions with joint ventures between strategic buyers and private equity investors (PE Investors); transactions with PE Investors that acquire a shelf charter and can tolerate the restrictions established by the FDIC’s new Statement of Policy on Qualifications for Failed Bank Acquisitions (SOP);5 and most recently, split or “good bank/bad bank” transactions in which a strategic buyer acquires the deposit franchise and an eligible investor acquires the assets through a private placement of an interest in a structured investment, such as the announced Corus transaction.6

Loss Sharing Transactions

During 2008, only three of the 25 institutions that failed were resolved in transactions in which the FDIC agreed to share a portion of the losses on the assets purchased by the acquiring institution.7 During the first nine months of 2009, the FDIC entered into loss sharing transactions for 56 of the 95 institutions that failed.8 Loss sharing transactions accounted for $74.6 billion out of $138.7 billion, or 54%, of the assets of all the institutions that failed during that period. In the loss sharing transactions for which the FDIC reported the information, the loss sharing covered $55.7 billion, or 75%, of the total assets purchased by the acquirers of those institutions.9

Loss sharing has clearly become a standard part of the FDIC’s resolution arsenal. In some cases, loss sharing may be the only means to interest bidders in the toxic assets of a failed bank or thrift.10 However, even when the FDIC is disposing of healthier assets, loss sharing has several advantages for the agency. The FDIC can reduce substantially and in some cases eliminate entirely the front-end cost of a receivership, which it incurs when it must pay cash to an acquiring institution in lieu of transferring the assets of the failed institution. Similarly, the agency can reduce the manpower, overhead and outsourcing required to manage retained assets.11 Finally, it can keep the majority of the assets of failed institutions in the private sector,

4 QBP, at 1-2.
8 Since May 22, 2009, loss sharing occurred in 45 of the 62 bank closings; only nine of the 62 bank closings represented traditional purchase and assumption transactions. See FDIC Failed Bank List.
9 Id.
10 But see Matthew Monks, Midsize Players Passing on Further Failure Deals, AMERICAN BANKER, Sept. 23, 2009, at 1, discussing reluctance of large regional banks to engage in FDIC-assisted transactions.
11 For the second quarter of 2009, the chief financial officer of the FDIC reported that expenses for receivership operations were substantially under budget, primarily because of the prevalence of structured
where those assets will presumably retain a higher value and minimize the impairment in value of comparable assets on the books of open institutions.

A typical loss sharing arrangement covers an identified portfolio of home mortgage loans, other loans and, in certain instances, asset-backed securities of the failed bank. The losses (and recoveries) on those assets are handled in three tranches. Losses in the first tranche are absorbed entirely by the acquirer. However, the size of the first tranche is determined by a formula that takes into account any premium or discount in the price of the assets, any premium or discount in the price of the assumed deposits and any deficiency between the value of the non-cash assets and the assumed deposits.12 Under this formula, in certain cases in which the assets are acquired at a significant discount or the value of the non-cash assets is less than the amount of the assumed deposits, the first tranche may be entirely eliminated.13 Losses in the second tranche, which covers all losses up to a stated threshold amount, are shared 80% by the FDIC and 20% by the acquirer.14 Losses in the third tranche, which covers all losses above the threshold, are typically shared 95% by the FDIC and 5% by the acquirer.15

In the view of the FDIC, this type of loss sharing arrangement sufficiently aligns the financial incentives of the FDIC and the acquirer to ensure that the covered assets will be managed effectively and in a manner that will contribute to a least-cost resolution by the FDIC.16

Joint Ventures

A loss sharing arrangement as described above is equally attractive to PE Investors and strategic buyers (established banking organizations), but the FDIC appears to have grown wary of dealing with PE Investors in loss sharing transactions. In two of the largest such transactions, the sales of IndyMac Federal Bank, FSB and BankUnited, FSB, the acquiring holding company was a newly formed organization owned almost entirely by a consortium of non-affiliated PE Investors, none of which, alone or in the aggregate, was deemed to control the holding company or the thrift that was organized to acquire the assets and liabilities.17 However, in its SOP, the FDIC subsequently suggested that it found such ownership structures to present special supervisory issues, and it has imposed special obligations on such acquirers and on any depository institution they may acquire.18 Many public commenters on the SOP expressed


See, e.g., Purchase and Assumption Agreement, dated Aug. 21, 2009, for the resolution of Guaranty Bank, Austin, Texas, available from the FDIC Failed Bank List.


See, e.g., Purchase and Assumption Agreement for Colonial Bank, supra.

Id.

Under section 13(c)(4)(A) of the Federal Deposit Insurance Act (FDIA), when the FDIC, in order to facilitate the purchase of any of the assets or assumption of any of the liabilities of one insured depository institution by another insured depository institution, guarantees the acquiring institution against loss by reason of such purchase or assumption, it must determine that such resolution is the least costly alternative to the DIF for meeting the FDIC’s obligations under section 13. 12 U.S.C. § 1823(c)(4)(A).


74 Fed. Reg. at 45446, 45448.
concern that such conditions will discourage PE Investors from bidding for failed institutions or will cause their bids to be non-competitive.\textsuperscript{19} Indeed, in the SOP, the FDIC expressly encouraged PE Investors to pursue an alternative acquisition strategy. If a PE Investor invests in, or enters into a joint venture or other arrangement with, a strategic buyer, provided that the strategic buyer has majority control of any depository institution used to assume the deposits of a failed institution, then the PE Investor and the depository institution will not be subject to the SOP.\textsuperscript{20}

A joint venture between a PE Investor and a strategic buyer may take several forms. In one model, one or more PE Investors may recapitalize a strategic buyer without acquiring control of the bank or thrift and being themselves required to register as a bank or thrift holding company, yet the strategic buyer may use the capital infusion to acquire a failed institution.\textsuperscript{21} However, the amount that a single PE Investor can invest in this manner is limited by the rules of the Federal Reserve Board (FRB) and the Office of Thrift Supervision (OTS) regarding control of banks and thrifts, respectively.\textsuperscript{22} Two or more unaffiliated PE Investors can make a larger investment without acquiring control, but such a structure may attract closer scrutiny by the FDIC under the SOP to ensure that such PE Investors are not affiliated and are passive.

Alternatively, one or more PE Investors may co-invest with a strategic buyer in a depository institution organized or acquired to hold the assets and liabilities of a failed institution, provided the strategic buyer is the controlling investor.\textsuperscript{23} This arrangement, however, is also subject to limitations on the size of the PE Investors’ investment in such a depository institution, on account of the rules of the FRB and the OTS governing control.

One or more PE Investors and a strategic buyer also may agree to a pass-through arrangement in which the strategic buyer acquires the assets and liabilities of a failed institution from the FDIC and sells certain assets to the PE Investors or enters into a structured financial transaction with the PE Investors for the management and liquidation of those assets. A pass-through arrangement is not subject to size constraints based on rules governing control, but it must overcome other significant obstacles. Foremost is that, under a typical loss sharing arrangement, when a loan is transferred to a non-affiliate, it is no longer covered by the loss sharing provision.\textsuperscript{24} Therefore, a pass-through arrangement must be negotiated with the FDIC as part of the purchase and assumption of the failed institution. Among other factors, the FDIC must be convinced that the PE Investor has the experience and commitment to administer

\textsuperscript{19} 74 Fed. Reg. at 45443.
\textsuperscript{20} 74 Fed. Reg. at 45446, 45448.
\textsuperscript{21} While not involving a failed institution, an example of such a transaction was reported in April 2008, regarding a proposal for Kohlberg Kravis Roberts & Co. to make a capital infusion in KeyCorp in order to finance its acquisition of National City Corporation, both of Cleveland, Ohio. Robin Sidel and Valerie Bauerlein, National City Talks to Key; Credit Crunch Drives Ohio Banks to Consider Idea Dismissed in Past, WALL ST. J., Apr. 2, 2008, at C1.
\textsuperscript{22} For banks and bank holding companies, see 12 U.S.C. § 1841(a)(2)(A); see also 12 C.F.R. § 225.41(c)(2). For savings associations and savings and loan holding companies, see 12 U.S.C. § 1467a(a)(2)(A); 12 C.F.R. § 574.4(b)(1)(i).
\textsuperscript{23} 74 Fed. Reg. at 45448.
\textsuperscript{24} See, e.g., Sec. 2.7 of the Single Family Shared-Loss Agreement, Ex. 4.15A of the Purchase and Assumption Agreement, dated Sept. 18, 2009, for the resolution of Irwin Union Bank and Trust Company, Columbus, Indiana, available from the FDIC Failed Bank List.
effectively a loan modification or loan refinancing program for the transferred loans, if applicable, without the FDIC or any other federal banking agency having the supervisory authority to hold such PE Investor strictly to account for its actions.\textsuperscript{25} In addition, many PE Investors are not authorized to manage and liquidate an asset portfolio, or they are not interested in doing so. Their business model is to provide capital and expertise to operating businesses in order to grow those businesses and increase their value as going concerns before selling them;\textsuperscript{26} a pass-through arrangement has no appeal to such PE Investors. Pass-through investors also may have only a limited opportunity to conduct due diligence during the bidding process for an institution about to fail.

While encouraging joint ventures between PE Investors and strategic buyers, the FDIC has not yet approved a joint venture to acquire the assets and liabilities of a failed institution in a loss sharing or other whole bank transaction. It has approved a similar transaction in which a group of investors, none of which were PE Investors, acquired and recapitalized a small strategic buyer in order to engage in a whole bank transaction, but it remains to be seen whether this model can be adapted for PE Investors in a significant number of transactions or for transactions of a significant size.\textsuperscript{27}

\textbf{Shelf Charters}

Shelf charters or inflatable charters have been discussed since late 2008 as a method by which PE Investors and other non-strategic buyers may bid for failed institutions.\textsuperscript{28} A shelf charter consists of obtaining preliminary approval from the Office of the Comptroller of the Currency (OCC) to receive a charter and preliminary approval from the FDIC to receive deposit insurance for that charter. On that basis, the investor is eligible to be notified of and to bid on failing institutions as if it owned an operating depository institution.\textsuperscript{29} The OTS has a similar, but less formalized, procedure to grant preliminary approval to applicants for a federal thrift charter.\textsuperscript{30} However, the preliminary approval process may be arduous. Among other factors, the organizers may have to “lock up” well-qualified senior executive officers far in advance of an acquisition opportunity possibly materializing, and the OCC has imposed stiff enforcement-like operating requirements on such de novo organizations.\textsuperscript{31}

\textsuperscript{25} The FDIC in this context has expressed the view that banks and thrifts have a special responsibility. \textit{See} 74 Fed. Reg. at 45441 (“The FDIC is particularly concerned that owners of banks and thrifts, whether they are individuals, partnerships, limited liability companies, or corporations, accept the responsibility to serve as responsible custodians of the public interest that is inherent in insured depository institutions. . . .”). The FDIC could seek to have a purchaser under a pass-through arrangement share this responsibility.

\textsuperscript{26} \textit{See} Letter from Douglas Lowenstein, President, Private Equity Council, to Robert E. Feldman, Executive Secretary, FDIC, at 2 (Aug. 6, 2009), commenting on the proposed SOP.

\textsuperscript{27} FDIC Press Release PR-130-2009 (regarding subsidiaries of Security Bank Corporation, Macon, Georgia) (July 24, 2009).


\textsuperscript{30} \textit{See} www.ots.gov/index.cfm?p=PreclearanceProgram.

\textsuperscript{31} \textit{See, e.g.}, Conditional Approval Letter No. 917, to Robert L. Tortoriello, Esq. (July 31, 2009). Before granting final approval, the OCC has required the bank and, in some cases, its investors to enter into an Operating Agreement with the agency. An Operating Agreement may constitute a written agreement and
An inflatable charter is similar to a shelf charter. In that case, a relatively small depository institution is acquired with the expectation that it will be recapitalized when an opportunity arises to acquire a significantly larger open or failed institution.32

With either a shelf charter or an inflatable charter, the individual or organization that acquires the institution is deemed to control it. This structure, therefore, is not suitable for a diversified PE Investor that is unable or unwilling to register as a bank or thrift holding company. In addition, the FDIC declared in the SOP that a PE Investor is prohibited from acquiring a depository institution through a “silo” structure, in which one branch of an organization registers as a holding company while the rest of its organization remains unregistered.33 To date, no bidder has acquired a failed bank or thrift using a shelf charter.

**Split or “Good Bank/Bad Bank” Transactions**

Another influence on the development of the FDIC’s efforts to dispose of the assets of failed banks has been the agency’s participation with the Department of the Treasury (Treasury) in the Troubled Asset Relief Program. In March 2009, the Treasury and the FDIC announced the Legacy Loans Program as a partnership intended to help restore liquidity to open banks and thrifts burdened by troubled loans.34 Under the Legacy Loans Program, the FDIC proposed to acquire loans from participating institutions and place them into several limited liability companies (LLCs) that it would organize. Qualified investors would bid to provide 50% of the equity for those LLCs, and the Treasury would provide the remaining 50%. The FDIC would oversee the selection of loans and other assets to be placed in the LLCs, prescribe how the LLCs would operate and provide a non-recourse guarantee of the obligations issued by the LLCs to pay for the acquired assets.35 In June 2009, the FDIC announced that a planned pilot sale of loans under the Legacy Loan Program had been postponed.36 The development of the program was hindered by questions about the role of the government in the management and operation of the LLCs and by an improvement in the financial condition of many of the banks and thrifts that were expected to participate in the program as sellers.37

In its June announcement, the FDIC stated that it would continue to develop the funding mechanism of the Legacy Loans Program, drawing in part on the experience of the Resolution

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32 See Conditional Approval Letter No. 872, to J. Christopher Flowers (Aug. 27, 2008), not objecting to a notice filed under the Change in Bank Control Act to acquire control of First National Bank of Cainsville, Cainsville, Missouri.

33 74 Fed. Reg. at 45447, 45449.


35 “Public-Private Investment Program,” available at www.financialstability.gov/roadtostability/publicprivatefund.html. The non-recourse guarantee would be secured by the loans and other assets acquired by the LLCs.


Trust Corporation (RTC) in the 1990s in financing asset sales through the use of leverage.\textsuperscript{38} The FDIC also can draw on its experience in a small number of more recent transactions in which it has sold loan portfolios by accepting a lower purchase price but sharing profits with the purchasers.\textsuperscript{39}

In July, the FDIC began to put its new funding mechanism to the test in a series of closed-bid auctions.\textsuperscript{40} Using the techniques of the Legacy Loans Program, the FDIC indicated that it would organize a series of LLCs, place whole loans in each LLC, auction off a 50% equity interest in each LLC to a qualified bidder and provide a non-recourse guarantee of the obligations issued by each LLC to pay for the loans. Like the RTC program and the FDIC’s profit-sharing arrangements, but unlike the Legacy Loans Program, the FDIC would provide the loans. Borrowing another technique from its profit-sharing arrangements, the FDIC also would accept bids to acquire a smaller equity interest, based on the FDIC entering into a profit-sharing arrangement with the LLC. Distinct from any of the previous programs, the FDIC would provide the matching equity investment in the LLCs in addition to providing the leverage.\textsuperscript{41} It also may seek to sell the notes it receives from the LLCs and thereby help to replenish the DIF.

The FDIC reached an agreement for the first such transaction in September 2009 in connection with the sale of $1.3 billion of residential mortgage loans acquired by the FDIC as receiver in November 2008.\textsuperscript{42} Shortly thereafter, in connection with the closing of Corus Bank, N.A., the FDIC conducted a similar bidding process for the sale of substantially all the assets that it acquired as receiver for that institution.\textsuperscript{43} The FDIC placed approximately $4.5 billion of construction loans and foreclosed properties in a LLC and sold a 40% equity interest in the LLC to a single bidder. Significantly, the FDIC was able to schedule the closing to take place within 35 days of the closing of Corus Bank.\textsuperscript{44}

This adaptation of the Legacy Loans Program should benefit non-strategic bidders, including PE Investors, by giving them an opportunity to conduct more thorough due diligence regarding the assets of a failed bank or thrift than they could perform on a failing institution in the process of being closed. If the FDIC is able to use this program to sell assets within the timeframe that the FDIC has described for disposing of the assets of Corus Bank, then the FDIC will in effect have established a “good bank/bad bank” model for dealing with failed institutions. In other words, the FDIC will be able to market the “good bank” (consisting of the retail deposit franchise, functional subsidiaries and unimpaired assets) solely to strategic buyers (and avoid

\textsuperscript{38} FDIC Press Release PR-84-2009.
\textsuperscript{40} FDIC Press Release PR-131-2009, “Legacy Loans Program – Test of Funding Mechanism” (July 31, 2009).
\textsuperscript{41} FDIC Press Release PR-131-2009.
\textsuperscript{44} FDIC Press Release PR-183-2009, “Corus Bank Assets – Winning Bidder Announced” (Oct. 6, 2009). The FDIC agreed to finance the transaction by providing a non-recourse loan in the amount of $1.39 billion (equal to the value of the total equity of the LLC) and a $1 billion facility to fund the completion of construction. The FDIC also received an “equity kicker” of 10% based on the LLC’s performance.
offering it to those strangers to banking whose commitment to retail banking is suspect in the eyes of the FDIC) and simultaneously market the “bad bank” (consisting primarily of impaired assets) to a broader group of qualified investors (which must be able to manage a variety of loan modification or loan refinancing programs applicable to residential loans). Offering the good bank and the bad bank separately should appeal to more bidders and result in a higher total return than if they were sold as a single unit and should cause relatively little increase in the FDIC’s administrative expenses as compared to a loss sharing or other whole bank transaction.

Whether this model will fulfill these expectations may depend on two factors. First, as noted above, many PE Investors may be unable or unwilling to bid for loan portfolios. Prospective investors also must overcome whatever concerns they may have about government restrictions, such as limits on executive compensation, that may be imposed on the LLCs and about the participation of the FDIC in the management of the LLCs, in light of the agency’s large financial stake.45 Therefore, it remains to be seen how much new capital the FDIC will be able to attract. Second, the obligation of the FDIC to provide 50% of the equity for the LLCs and a non-recourse guarantee for up to approximately 85% of the purchase price of the loans acquired or to provide up to 80% of the equity and loss protection may not achieve the hoped-for savings to the DIF and may not constitute the least-cost resolution of the institutions that fail.

**Conclusion**

The FDIC has shown significant ingenuity in developing several methods of selling assets and in combining those methods in order to attract new investors. It may have found a way to implement a “good bank/bad bank” resolution model. However, it has also placed a bet that it can convince PE Investors to participate in the resolution process either under an uniquely restrictive set of rules or solely as buyers of assets, rather than as buyers of operating companies. The success of the FDIC’s bet should become apparent in the coming months.

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CURRENT ISSUES IN FINANCIAL SERVICES

By

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This article provides a brief overview of issues emerging on Capitol Hill, in the regulatory agencies, and in the financial services industry in general, that are of importance to financial institutions and their customers.

Financial Regulatory Reform

In June 2009, the Obama Administration proposed an ambitious and much debated regulatory reform proposal. The proposal, while intending to streamline the financial regulatory process, making it more efficient and targeted in its objectives, would create or modify four new regulatory regimes: (i) a Financial Services Oversight Council (the “Council”), chaired by Treasury and including the heads of the principal federal financial regulators; (ii) a National Bank Supervisor (“NBS”); (iii) an Office of National Insurance (“ONI”) within Treasury; and (iv) a Consumer Financial Protection Agency (“CFPA”).

The Administration’s proposal is designed to meet five major goals:

- Promoting robust supervision and regulation of financial firms;
- Establishing comprehensive supervision and regulation of all financial markets;
- Protecting consumers and investors from financial abuse;
- Improving tools for managing financial crises; and
- Raising international regulatory standards and improve international cooperation.

Financial Services Oversight Council

The new Council would be created as an independent agency to facilitate and coordinate information sharing, fill gaps in supervision, identify emerging prudential risks and inform the Federal Reserve where such risks could pose a systemic threat, and provide a forum for jurisdictional disputes among regulators.

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Heightened Consolidated Supervision and Regulation for Tier 1 FHCs

The Administration’s proposal would subject to enhanced supervision those financial institutions whose combination of size, leverage, and interconnectedness (“Tier 1 FHCs”) suggest increased systemic risk. Such systemic risk coverage would apply to institutions regardless of whether they controlled a depository institution. A Tier 1 FHC would be subject to higher capital, liquidity and risk management standards than other firms.

Secretary Geithner has recently reiterated the Administration’s commitment to addressing institutions that pose systemic risk. In a September 23, 2009 address to the House Financial Services Committee, the Secretary stressed that financial regulatory reforms should include requirements that institutions posing systemic risk concerns meet more stringent capital and liquidity requirements, and incur capital charges on exposures between financial firms.

Creation of the National Bank Supervisor

The proposal would merge the Office of the Comptroller of the Currency (“OCC”) and the Office of Thrift Supervision (“OTS”), into one National Bank Supervisor, which would succeed to the responsibilities of both agencies. The proposal would eliminate the federal thrift charter, particularly in view of fact that the specialized lending concentration of thrifts in real estate has proven a vulnerable practice in the current crisis, as it was in the savings and loan crisis of the early 1990’s. The Obama Administration’s proposal to eliminate the thrift charter has already met with opposition from House Financial Services Committee Chairman Barney Frank (D-Mass.), who has said that he supports eliminating the OTS, but believes that a new regulator can oversee both the bank and thrift charters.2

Office of National Insurance

The Administration’s proposal, unlike the Bush Administration’s Blueprint for Regulatory Reform, would not create a federal insurance charter. Rather, the Administration’s proposal would establish the Office of National Insurance as an arm of Treasury to monitor the insurance industry, with the goal, in part, of gathering information and identifying problems so as to avoid the next big insurance failure in a future financial crisis.

Consumer Financial Protection Agency

The Administration has proposed the creation of a Consumer Financial Protection Agency, which would be in charge of supervising and enforcing consumer protection laws as to insured depository institutions. The CFPA would have the authority to supervise and examine institutions, issue regulations, bring enforcement actions, and to supervise intermediaries and servicers of institutions. The CFPA would also have the authority to prohibit unfair or deceptive acts or practices by financial institutions. Further, Section 164 of the current bill would transfer employees from the current federal bank regulatory agencies to the new CFPA.

**Resolution Authority**

The Administration’s proposal would create a new resolution regime, modeled upon current Federal Deposit Insurance Corporation (“FDIC”) authority, which would allow the government to resolve failing bank holding companies, including Tier 1 FHCs, discussed above. The proposed reforms would not replace existing bankruptcy procedures for “normal” institutional failures, but would provide a special system for the failure of an institution posing systemic risk. Under the Administration’s proposal, such authority would only be invoked by the Treasury in consultation with the President and the other regulators.

Secretary Geithner recently affirmed the Administration’s commitment to the efficient resolution of institutions in the event of a financial crisis. Specifically, the Secretary said that the Administration “will require our major financial firms to prepare and regularly update a credible plan for their rapid resolution in the event of severe financial distress.” “This requirement,” according to the Secretary, “will create incentives for a firm to better monitor and simplify its organizational structure and would better prepare the government – as well as the firm’s investors, creditors, and counterparties – in the event the firm collapsed.” With respect specifically to Tier 1 FHCs, Secretary Geithner suggested that the “intensity of government oversight” will serve as “a strong disincentive for firms to become too big, complex, leveraged, and interconnected.”

**Prepayment of FDIC Assessments**

On Tuesday, September 29, 2009, FDIC adopted a Notice of Proposed Rulemaking, that would require insured institutions to prepay their estimated premium assessments for the fourth quarter of 2009 and for all of 2010, 2011, and 2012. The FDIC estimates that the total prepaid assessments collected would be approximately $45 billion. The FDIC Board also voted to adopt a uniform three-basis point increase in assessment rates effective on January 1, 2011, and extend the restoration period from seven to eight years.

The FDIC believes that the prepayment of assessments will enable the industry to strengthen the cash position of the Deposit Insurance Fund immediately, while allowing the capital impact of the deposit insurance assessments to be felt gradually over time as the industry improves its own financial position. The banking industry has substantial liquidity to prepay

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4. Under generally accepted accounting principles (“GAAP”), the prepaid assessments would not immediately affect bank earnings. Each institution would record the entire amount of its prepaid assessments as a prepaid expense (an asset) as of December 30, 2009, the date the payment would be made. As of December 31, 2009, and each quarter thereafter, each institution would record an expense (charge to earnings) for its regular quarterly assessment and an offsetting credit to the prepaid assessment until the asset is exhausted. This would, in effect, allow the institution to spread the impact of the assessment over time rather than incur the accounting consequences at one time. See, FDIC Frequently Asked Questions on Prepaid Assessments (available at: http://www.fdic.gov/deposit/insurance/prepay/index.html) (last visited October 19, 2009).
assessments. According to FDIC reports, as of June 30, 2009, FDIC-insured institutions held more than $1.3 trillion in liquid balances, or 22 percent more than they did a year ago.

The FDIC’s move comes on the heels of 95 banks having failed so far this year, mostly as a result of losses in the real estate area and related bad loans. In June, the Deposit Insurance Fund fell 20 percent to $10.4 billion, its lowest since 1992, at the height of the savings-and-loan crisis. Additionally, the fund has slipped to 0.22 percent of insured deposits, well below the Congressionally mandated minimum of 1.15 percent.

The prepayment of premium assessments is not the only tool that the FDIC has in its fund-raising arsenal. Other options remain on deck in the event that additional working cash is required, such as:

- **Borrowing Directly from the Industry:** The FDIC Improvement Act of 1991\(^5\) gave the FDIC the authority to borrow directly from the banking industry, at an interest rate to be set by the Treasury Secretary. This option raises several concerns. First, the contractual terms of such borrowing would need to be set, which makes the level of funding less certain. Second, banks’ lending to the FDIC under this program would be on a voluntary basis, which would also increase uncertainty as to market interest. Third, there would remain a certain level of public skepticism at the FDIC about borrowing crucial funds from the entities that it regulates.

- **Borrowing on the $100 billion Treasury Line of Credit:** Congress recently gave the FDIC the authority to borrow $100 billion, with the added flexibility to borrow up to $500 billion under certain circumstances. The banking industry would be required to repay any borrowing, with interest, from the Treasury. Though Chairman Bair has affirmed her preference to avoid such borrowing, it would not be the first time that the FDIC has tapped this reserve. In 1991, the FDIC borrowed on this line, with full repayment occurring by 1993.

The FDIC’s announcement met with measured praise by James Chessen, Chief Economist at the American Bankers Association, who notes that by requiring the premium payment in advance, the FDIC will have “cash on hand sooner rather than later” in order to “provide[] more flexibility for dealing with any contingencies over the foreseeable future.”\(^6\) Mr. Chessen cautioned the FDIC against imposing a special assessment, warning: “Another special

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assessment would likely do more harm than good as it would directly reduce bank income, hinder capital growth, and make lending much more difficult.”

**Temporary Liquidity Guarantee Program**

The Federal Deposit Insurance Corporation (“FDIC”) adopted the Temporary Liquidity Guarantee Program (“TLGP”) in October 2008 following a determination of systemic risk by the Treasury Secretary. This program involves two components. First, the TLGP created the Debt Guarantee Program (“DGP”) which initially permitted participating entities to issue FDIC-guaranteed senior unsecured debt until June 30, 2009, with the FDIC’s guarantee for such debt to expire on the earlier of the maturity of the debt (or the conversion date, for mandatory convertible debt) or June 30, 2010. Subsequent rulemakings were also applied. Second, the TLGP also created the Transaction Account Guarantee Program (“TAGP”), which offers insured depository institutions the ability to receive unlimited deposit insurance coverage for funds held in qualifying non-interest bearing transaction accounts. Institutions that chose to participate in the TAGP paid an annualized ten basis point assessment quarterly on any non-interest bearing transaction account amounts that exceed the existing federal deposit insurance limit of $250,000.

**Extension for Debt Guarantee Program**

On September 16, 2009, the FDIC issued a Notice of Proposed Rulemaking, proposing two alternatives for winding down the DGP. In general, under Alternative A, insured depository institutions would be permitted to issue FDIC-guaranteed debt under the DGP no later than October 31, 2009, with the FDIC’s guarantee for such debt under the DGP no later than December 31, 2009, as provided for under the current regulation. Under Alternative B, although the DGP effectively would end as provided for under the current regulation, the FDIC would establish and make available on a limited, case-by-case basis, an emergency guarantee facility. The proposed emergency guarantee facility would be made available only following FDIC approval of an application submitted by an insured depository institution or other entity that issued FDIC-guaranteed senior unsecured debt on or before September 9, 2009. If approved by the FDIC, an applicant would be permitted to issue FDIC-guaranteed senior unsecured debt during the period between November 1, 2009, and April 30, 2010, subject to any other restrictions and conditions deemed appropriate by the FDIC, including limiting executive compensation, bonuses, or the payment of dividends.

**Transaction Account Guarantee Program**

The TAGP was scheduled to expire on December 31, 2009, however with the extension to June 30, 2010, the FDIC believes that it will be able to achieve an orderly phasing out of the program. In achieving this phased-out approach, the FDIC has proposed two alternatives for implementation. Under Alternative A, the FDIC would preserve the original termination date for the TAGP program. For those insured depository institutions that had not

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7 Id.
opted out of the TAGP program, the FDIC’s guarantee of non-interest bearing transaction accounts would expire on December 31, 2009.

Under Alternative B, the proposed expiration deadline would be extended through June 30, 2010. Under this option, insured depository institutions are provided with the opportunity to opt out of the extended TAGP; if the institution that is currently participating in the program opts out, the FDIC’s guarantee would expire as scheduled on December 31, 2009. This extension will come at an increased fee. In order to increase income so as to off-set potential losses during the extension period, participating institutions that have not opted out of the extension will pay an annualized fee based on its “Risk Category.” An institution’s Risk Category for TAGP purposes is the same category that the FDIC has assigned to the institution for purposes of its regular risk-based deposit insurance assessment. During the extension, the increased TAGP fee will be 15 basis points for Risk Category I, 20 basis points for Risk Category II, and 25 basis points for risk categories III or IV. The TAGP assessments will continue to apply only to those amounts in non-interest bearing transaction accounts that exceed the $250,000 federal deposit insurance limit.

Institutions that seek to continue participating in the TAGP program need do nothing. However, institutions that do not want to continue participation during the TAGP extension, must opt-out no later than November 2, 2009. Such opt-out is irrevocable.

**Preemption**

One of the hottest and most contentious bank regulatory issues currently being debated among lawmakers, regulators, and the industry is the application of federal preemption for federally chartered financial institutions. For nearly 200 years, since the debate over Maryland’s attempted taxation of the Second Bank of United States, lawmakers and the courts have attempted to define – and refine – the degree to which federally-chartered financial institutions will be subject to potentially hostile state regulatory regimes.

One of the recent flashpoints in the preemption debate has centered around the ability of federally-chartered banks to operate through intermediaries, namely operating subsidiaries and non-employee agents. In 2007, the Supreme Court held in *Watters v. Wachovia*, that operating subsidiaries of national banks are entitled to the same preemption as their national banks parents. In *Watters*, the Court said that the focus is properly on the power being exercised rather than on the means through which the institution chooses to exercise that power. Subsequently, in *State Farm v. Reardon*, *SPGCC v. Ayotte*, and *SPGCC v. Blumenthal*, three different federal courts of appeal upheld, to varying degrees, arrangements in

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10  539 F.3d 336 (6th Cir. 2008).

11  488 F.3d 525 (1st Cir. 2007).

12  505 F.3d 183 (2nd Cir. 2007).
which a federally-chartered financial institution partnered with a non-bank agent to sell the bank’s products. The synthesis of these decisions reflects classical agency principles, namely that the less discretion that the agent exercises in implementing the goals of the bank principals, the more likely the courts will find that the agent’s actions are entitled to the benefits of federal preemption.

The preemption debate has gained additional clarity in 2009 in the Supreme Court’s holding in *Cuomo v. Clearing House*, where the Court addressed the scope of “visitorial powers” as distinguished from “law enforcement” activities. At issue was the New York Attorney General’s claim that as a state law enforcement official, he retained the authority to enforce a national bank’s compliance with non-preempted laws. Clearing House and the OCC argued that such state activities would interfere with the OCC’s exclusive visitorial authority. In its decision, the Court distinguished between visitorial powers, which relate to the supervising and examining of the institution from a regulatory perspective, with “law enforcement” activities which relate to ensuring compliance with applicable law. According to the Court, in providing for visitorial powers over national banks, Congress did not intend to displace existing law enforcement activities, nor did it intend to transfer all law enforcement authority to the OCC. This decision affirms that visitorial powers is still foreclosed as to the states, however states may enforce non-preempted laws through a law suit (but not through state administrative enforcement processes).

In response to these and other developments in federal banking preemption law, Chairman Barney Frank (D-MA) of the House Financial Services Committee has proposed the Consumer Financial Protection Agency Act of 2009 (“CFPA”). Among other things, this bill would provide that state consumer laws of general applicability, that are not inconsistent with federal law, and do not discriminated against national banks, shall apply to national banks. This would include state laws prohibiting unfair or deceptive acts or practices, consumer fraud law, and collections law. The scope of such non-preempted laws would also include any state law enacted in accordance with federal law, where federal law allows for states to enact supplemental legislation. Additionally, while the CFPA does not alter prior court precedent with respect to the applicability of state law to operating subsidiaries or agents, because under the CFPA many state consumer protection laws would become applicable as to the national bank parents, the practical effect is that operating subsidiaries of federally-chartered banks, such as mortgage companies, will become subject to potentially burdensome state consumer laws.

**Madoff Ponzi Scheme Scandal and the Need for SEC Reform**

In 2009, Americans witnessed the unraveling of the Madoff Ponzi scheme, which shook the financial community, leaving a trail of victims from Wall Street to Main Street. As background, a “Ponzi” scheme is essentially an investment fraud wherein the scheme operator promises high financial returns or dividends that are not available through traditional investments. Instead of investing victims’ funds, the scheme operator pays “dividends” to initial

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13. 557 U.S. ___ (June 29, 2009).

investors using the principle amounts “invested” by subsequent investors. The scheme generally falls apart when the operator flees with all of the proceeds, or when a sufficient number of new investors cannot be found to allow the continued payment of “dividends” to prior investors. This type of scheme is named after Charles Ponzi of Boston, Massachusetts, who operated an extremely attractive investment scheme in which he guaranteed investors a 50 percent return on their investment in postal coupons. Although he was able to pay his initial investors, the scheme dissolved when he was unable to pay investors who entered the scheme later.

In the aftermath of the Madoff scandal, the Securities and Exchange Commission (“SEC”) Inspector General H. David Kotz launched an investigation into how even a fraudster as intelligent as Bernard Madoff could have evaded the SEC’s Enforcement Division. On September 29, 2009, the SEC Inspector General offered a few reasons. Over the course of his investigation Kotz revealed the SEC’s failure to detect the Madoff fraud despite 30 “red flags” and a flood of complaints from highly credible sources.

The Kotz report on the Enforcement Division contained several specific criticisms of the Division’s staff. For example, Kotz found that the “Enforcement staff lacked adequate guidance on how to appropriately analyze complaints.” Additionally, Kotz “found that Enforcement staff assigned to investigate Madoff were inexperienced and the investigation suffered from a lack of supervision which had consequences for the investigation,” and that “Enforcement staff did not always exercise due diligence in their handling of critical information regarding Madoff.”