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Expert Analysis

Bank Failures and the Rights of the FDIC Against Bank Holding Companies

A Performance Guaranty Is No Longer a Guaranty

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Two recent rulings directly and materially impact and reduce the Federal Deposit Insurance Corp.'s rights against bank holding companies.

The impact of the financial crisis on the banking system has been staggering. In the first four months of 2009, the FDIC has taken over 29 U.S. banks — a rate of closure nearing two banks for every week of 2009.

Generally, these banks are closed and their deposits assumed by other, presumably more healthy, banks. But what happens to a bank's holding company when its subsidiary bank fails? It is often the case that the holding company's only asset is the stock in the failed bank, and the holding company is forced into its own bankruptcy proceeding.

Until recently, a bank holding company had little recourse in the face of the FDIC's demands under a performance guaranty.

In many instances, prior to the FDIC's closure of the subsidiary bank, the FDIC will have required the bank's holding company to guaranty the bank's performance under a capital restoration plan. The FDIC will then seek to enforce the guaranty in the holding company's bankruptcy case and, in the Chapter 11 context, seek to have the bank holding company immediately pay its obligations under the guaranty as a condition to remaining in a Chapter 11 reorganization case.

Ironically, this guaranty of the bank's performance by the holding company — given at a time when the subsidiary bank is indisputably in crisis — will, in many cases, have resulted in little or no benefit to the likely insolvent parent holding company.

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Regardless of the circumstances surrounding the grant of the performance guaranty or the holding company's financial condition, the FDIC has uniformly taken the position in these cases that, pursuant to the provisions of the Federal Deposit Insurance Act, 12 U.S.C. § 1828(u) ("FDIA"), a parent holding company's obligations under a performance guaranty are absolute and not subject to avoidance under the fraudulent transfer laws.[1]

Notably, the fraudulent transfer laws apply to almost every other industry to prohibit the transfer of assets or incurrence of obligations for less than reasonably equivalent value if the transferor is insolvent or rendered insolvent by the transfer or new obligation.

The FDIC also has taken the position that its claims against the holding company under the performance guaranty are entitled to virtually the highest priority in a holding company's Chapter 11 bankruptcy case — even if such case subsequently converts from a Chapter 11 reorganization case to a Chapter 7 liquidation case.

The FDIC now faces the risk that a Chapter 11 debtor will be able to avoid its claim altogether as a fraudulent conveyance.

In many cases, the FDIC's sizable claims under a performance guaranty would engulf all of the available assets of the holding company's estate — to the detriment of all other creditors and interested parties.

Until recently, a bank holding company had little recourse in the face of the FDIC's demands under a performance guaranty, and these demands often dictated the outcome and conduct of the holding company's bankruptcy case from the outset — including whether the holding company could even seek to reorganize under Chapter 11 of the Bankruptcy Code.

Now, however, bank holding companies — especially those located in the 9th Circuit (which includes California, Nevada, Arizona, Oregon, Washington, Idaho, Montana, Hawaii and Alaska) —have compelling arguments to defend against the FDIC's claims, as well as to address the priority of those claims.

In a matter of first impression in any reported decision, the 9th U.S. Circuit Court of Appeals struck a significant blow to the FDIC and its rights vis-à-vis a bank holding company that provided a guaranty of its subsidiary bank's performance.

In *Wolkowitz v. Federal Deposit Insurance Corp. (In re Imperial Credit Industries Inc.),* 527 F.3d 959 (9th Cir. 2008), the 9th Circuit held that, contrary to the FDIC's assertions, the immunity provisions of the FDIA did not insulate the FDIC from being sued to avoid, as a constructive fraudulent transfer, a guaranty issued by a bank holding company in support of its bank subsidiary.

In so ruling, the 9th Circuit drew a distinction between the transfer of an asset, which would not be recoverable under the FDIA, and the incurrence of an obligation such as a performance guaranty, which could be avoided under circumstances where the provisions of the fraudulent transfer statutes otherwise were met.

In that same decision, in another issue of first impression in the 9th Circuit, the court ruled that the post-conversion (from Chapter 11 to Chapter 7) status of a claim of the FDIC under a performance guaranty is of a much lower priority in the Chapter 7 case (11 U.S.C. § 507(a)(9)) than in Chapter 11 (11 U.S.C. § 507(a)(2)), placing the FDIC's claim in a Chapter 7 case (whether such case was initiated as a Chapter 7 case at the outset, or subsequently converted from Chapter 11 to Chapter 7) below the claims of many other creditors entitled to priority in a bankruptcy case, including, for example, claims for wages (11 U.S.C. § 507(a)(4)), contributions to employee benefit plans (11 U.S.C. § 507(a)(5)), and claims of the Internal Revenue Service and state taxing authorities (11 U. S.C. § 507(a)(8)).

The FDIC, therefore, now faces the dual risk that a Chapter 11 debtor will be able to avoid its claim altogether as a fraudulent conveyance, while at the same time facing the risk that the Chapter 11 case converts to one under Chapter 7, dramatically reducing the priority of its claim.

Factual Background

The *Wolkowitz v. FDIC* decision arises out of a case involving a federally insured bank, Southern Pacific Bank ("SPB"), and its holding company, Imperial Credit Industries Inc. ("Imperial").

In 2002, the FDIC notified SPB that it was undercapitalized and required SPB to submit a capital restoration plan. SPB submitted a capital restoration plan, as well as a guaranty from Imperial that SPB would perform under the plan.[2] SPB failed to implement its capital plan and the California Department of Financial Institutions closed SPB and named the FDIC as the receiver.

Thereafter, Imperial filed a Chapter 11 bankruptcy case. In Imperial's Chapter 11 case, the FDIC demanded that Imperial immediately pay its obligation on the guaranty in the amount of $18,375,800.

Imperial commenced an adversary proceeding against the FDIC, asserting various causes of action against the FDIC seeking to avoid any obligation under the performance guaranty under, *inter alia*, 11 U.S.C. §§ 544 and 548(a)(1) and Cal. Civ. Code § 3439.04(a). The adversary proceeding subsequently was withdrawn from the bankruptcy court to the United States District Court for the Central District of California ("District Court").

The District Court rejected Imperial's causes of action against the FDIC, and ruled that section 365(o) of the Bankruptcy Code required Imperial to cure its deficit to the FDIC as a condition to remaining in Chapter 11.[3]

Imperial subsequently converted its case to Chapter 7, thereby avoiding the requirement that such amounts be paid immediately under section 365(o), but not addressing the ultimate priority of the FDIC's claim absent further proceedings.

Edward M. Wolkowitz was appointed as the trustee in Imperial's chapter 7 case ("trustee"). The FDIC moved for declaratory relief in the District Court, seeking a determination of the priority of Imperial's obligations under the performance guaranty.

The District Court granted summary judgment in favor of the FDIC, holding that the FDIC's claim was entitled to administrative priority expense under 11 U.S.C. § 507(a)(2)[4] notwithstanding the conversion of Imperial's bankruptcy case to Chapter 7.

On appeal to the 9th Circuit, the trustee challenged the District Court's decision as to whether, *inter alia*, Imperial was bound by the capital plan and whether the performance guaranty could be avoided as a fraudulent conveyance. The trustee also challenged the District Court's holding that the FDIC's claim was entitled to priority under 11 U.S.C. § 507(a)(2), arguing that the FDIC's claim was entitled only to ninth priority under 11 U.S.C. § 507(a)(9).[5]

While affirming the District Court's conclusion that Imperial was bound by the performance guaranty, the 9th Circuit reversed the District Court's determination that the Trustee's fraudulent conveyance claim against the FDIC was statutorily barred, and remanded the issue for further proceedings on the merits.

A bank holding company is no longer completely defenseless against the FDIC's claims under a performance guaranty.

In addition, the 9th Circuit reversed the District Court's determination that the FDIC's claim in the Chapter 7 case was entitled to priority under 11 U.S.C. § 507(a)(2), agreeing with the trustee that the FDIC's claim in the Chapter 7 case was entitled only to ninth priority under 11 U.S.C. § 507(a)(9).

The Fraudulent Conveyance Claim Against The FDIC Is Not Barred

In the adversary proceeding against the FDIC, the trustee sought, among other things, to avoid any obligation created by the alleged performance guaranty as a constructive fraudulent conveyance under 11 U.S.C. §§ 544 and 548. The FDIC argued that the trustee's fraudulent conveyance claim was barred by the FDIA (12 U.S.C. § 1828(u)), asserting that section 1828(u) prohibits avoidance of all constructively fraudulent conveyances against the FDIC and insured institutions.[6]

The trustee, on the other hand, argued that the FDIA prohibits only fraudulent conveyance claims regarding a transfer of *assets* and thus did not bar Imperial's claim requesting the avoidance of an *obligation* such as a guaranty.

The District Court rejected the trustee's argument, holding that it was based on an "unsupported distinction between assets and obligations" under section 1828(u). The District Court therefore dismissed the trustee's claim for constructive fraudulent transfer against the FDIC. The trustee appealed this decision to the 9th Circuit.

The 9th Circuit reversed the District Court's dismissal of the trustee's cause of action for constructive fraudulent transfer, finding that there is a distinction under the FDIA between seeking to avoid a transfer of an asset (which would be barred under the FDIA) and seeking to avoid an obligation pursuant to which no asset has been transferred (which, the 9th Circuit found, was not barred under the FDIA).

In adopting the trustee's position, the 9th Circuit held that, contrary to the District Court's decision, "we find that the distinction between assets and obligations is supported by the plain language of the statute and the legislative history." *Id.* at 971.

The 9th Circuit looked to the plain meaning of the statute and held that "[o]n its face, § 1828(u) prohibits persons from bringing fraudulent conveyance claims against federal banking agencies only for 'the return of assets … transferred to' a federally insured bank or 'for monetary damages or other legal or equitable relief in connection with such transfer,' if the transfer was made when the insured bank was undercapitalized. The statute makes no mention of obligations, which is what Imperial is attempting to avoid as a fraudulent conveyance." *Id.* at 971-72.

In addition, the 9th Circuit agreed with the trustee that the legislative history of § 1828(u), as set forth in the House Conference Report, "reveals that the purpose of section 1828(u) is to protect the federal deposit insurance funds from claims brought by the bankruptcy trustee of a depository institution holding company 'for the return of capital infusions,' not for the avoidance of obligations." *Citing* H.R.Rep. No. 106-434, at 183 (1999) (Conf. Rep.), *reprinted in* 1999 U.S.C.C.A.N. 245, 276.

The 9th Circuit further pointed to a number of statutes cited by the trustee addressing fraudulent conveyances that recognize that there is a distinction between avoiding an obligation and recovering a transfer, suggesting that Congress intentionally omitted "incurred obligations" from the scope of § 1828(u). *Compare* 12 U.S.C. § 1821(d)(17)(A) addressing the FDIC's powers to seek avoidance of fraudulent transfers ("The Corporation … may avoid a transfer of any interest of an institution-affiliated party … or any obligation incurred by such party or person.") *with* 12 U.S.C. § 1821(u) addressing the FDIC's limited immunity from such suits and, consequently only barring claims based on transfers of assets.

The 9th Circuit further agreed with the trustee that the transfer of an asset is not the equivalent of an incurrence of an obligation pursuant to which no actual transfer has been made. The 9th Circuit held that "[t]he FDIC is unable to effectively rebut our reading of § 1828(u) as barring only claims based on transfers of assets." *Id.* at 972.

The 9th Circuit dismissed the FDIC's attempt to argue that the term "asset" in § 1828(u) should be defined broadly as "something of value," finding that the FDIC "fail[ed] to support its interpretation with any statutory text, legislative history or case law." *Id.*

The 9th Circuit, therefore, found that the trustee could properly seek to avoid its obligations to the FDIC under the performance guaranty as a fraudulent conveyance, and remanded the proceedings to the District Court for a determination on the merits of the trustee's fraudulent conveyance action.

The FDIC's Claim in Imperial's Converted Chapter 7 Case Is Entitled Only to Ninth Priority

In *Wolkowitz v. FDIC*, the 9th Circuit also addressed the priority of the FDIC's claim upon the conversion of Imperial's bankruptcy case from Chapter 11 to Chapter 7.

In the District Court proceeding, the District Court had determined that Imperial owed the FDIC the amount of $18,373,800 based on its obligations under the performance guaranty. As a result, the District Court ordered Imperial, pursuant to 11 U.S.C. § 365(o) (which mandates immediate payment of deficits to federal depository institutions), to immediately cure its deficit as a condition to remaining in Chapter 11.

Alternatively, the District Court noted that Imperial could convert its case to one under Chapter 7, in which case its unsatisfied cure obligations would have the status and priority in the Chapter 7 case which it is accorded under applicable bankruptcy law. Notably, the District Court did not make explicit the nature of such priority.

Imperial converted its case to Chapter 7, and litigation over the priority of the FDIC's claim ensued. On summary judgment, the District Court determined that the FDIC's claim was entitled to administrative priority in the Chapter 7 case under section 507(a)(2) of the Bankruptcy Code, which allows second prior-

ity to administrative expenses, including the actual, necessary costs and expenses of preserving the estate.[7]

The District Court found that Imperial's failure to cure its deficit to the FDIC was equivalent to an obligation arising from an executory contract, reasoning that obligations arising from executory contracts are generally accorded administrative priority in the bankruptcy context, and retain that status in Chapter 7 cases.

The trustee appealed this decision to the 9th Circuit, asserting that, under §§ 365(o) and 507 of the Bankruptcy Code, the FDIC's claims were only entitled to ninth priority once the Chapter 11 case was converted to one under Chapter 7.

The FDIC, on the other hand, asserted that the District Court had correctly accorded its claim priority under section 507(a)(2), notwithstanding the conversion of the case to one under Chapter 7.

The 9th Circuit, noting that that the priority of a claim arising from an uncured deficit under section 365(o) was an issue of first impression in the 9th Circuit, overruled the District Court, holding that the FDIC's claim was entitled only to ninth priority in Imperial's Chapter 7 proceeding.

In so holding, the 9th Circuit discussed the purpose of section 365(o), which was enacted as part of the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990, which constitutes Title XXV of the Crime Control Act of 1990 (Pub. L. No. 101-647, § 2522, 104 Stat. 4859, 4866) in response to the savings and loan crisis to prevent parties affiliated with federal depository institutions from "using bankruptcy to evade commitments to maintain capital reserve requirements of a Federally insured depository institution." *Id.* at 973 (citations omitted).

Section 365(o) provides that "[i]n a case under chapter 11 of this title, the trustee shall be deemed to have assumed (consistent with the debtor's other obligations under section 507), and shall immediately cure any deficit under, any commitment by the debtor to a Federal depository institutions regulatory agency." *Id.*

The 9th Circuit noted that the "assumption and cure" mechanism under Section 365(o) requires a trustee to immediately pay any deficit to a federal depository institution as a condition to remaining in Chapter 11. If a debtor cannot immediately cure such a deficit, then the debtor cannot proceed under Chapter 11, but may only proceed under Chapter 7 — to which section 365(o) does not apply. *Id.* at 974-75 (*citing Resolution Trust Corp. v. Firstcorp, Inc. (In re Firstcorp, Inc.*), 973 F.2d 243 (4th Cir. 1992).

In addition, said the 9th Circuit, Section 365(o) specifically addresses the priority of a claim arising from an obligation under a capital maintenance commitment, providing that any claim for a "subsequent breach of … obligations [under a commitment to maintain the capital of a federally insured depository institution] shall be entitled to priority under section 507." *Id.* at 974. The reference to section 507 in section 365(o) specifically points to section 507(a)(9), which places "unsecured claims based on any commitment by the debtor to a Federal depository institutions regulatory agency … to maintain the capital of an insured depository institution" in ninth priority in the bankruptcy case. *Id.*

The 9th Circuit held that this specific language in section 365(o) and 507(a)(9) trumped the more generic language of section 507(a)(2) and, in any event, the 9th Circuit did not view Imperial's obligation to the FDIC as an "actual, necessary" cost of preserving Imperial's Chapter 7 estate that would provide the FDIC's claim priority under section 507(a)(2). *Id.* at 975.

The 9th Circuit found that a holding to the contrary would lead to "nonsensical results." *Id.* The FDIC agreed with the trustee that, had Imperial initially filed under Chapter 7, section 365(o) would never have come into play, and the FDIC's claim would be in ninth priority pursuant to 11 U.S.C. § 507(a)(9).

The 9th Circuit saw no "principled reason why a Chapter 7 debtor should be treated differently based on whether it initially filed in Chapter 11 or Chapter 7, when in either case the debtor ends up in Chapter 7 without benefiting from Chapter 11 reorganization possibilities." *Id.*

Accordingly, the 9th Circuit held that "a failure to cure a section 356(o) deficit in a Chapter 11 case does not give rise to an administrative priority in a Chapter 7 case. Rather, the FDIC's claim attributable to Imperial's failure to cure its debt is entitled only to ninth priority under §§ 365(o) and 507(a)(9)." *Id.* at 976.

The 9th Circuit's holdings have radically changed the playing field with respect to the claims of the FDIC based on a bank holding company's performance guaranty. During this time of record failures in the banking industry, a bank holding company is no longer

completely defenseless against the FDIC's claims under a performance guaranty. Armed with the 9th Circuit's decisions in *Wolkowitz v. FDIC*, a bank holding company — especially a company located within the 9th Circuit's jurisdiction — has significant additional leverage relative to the allowance and priority of the FDIC's claims under a performance guaranty.

Notes

[1] Federal bankruptcy law and similar state statutes provide for avoidance of "constructive" fraudulent conveyances by debtors, trustees and certain creditors. *See e.g.*, 11 U.S.C. § 548(a)(1); Uniform Fraudulent Transfer Act § 4(a); Cal. Civ. Code § 3439.04(a).

[2] Imperial and the FDIC disputed whether the performance guaranty by Imperial applied to the capital plan that was ultimately approved by the FDIC.

[3] Section 365(o) of the Bankruptcy Code provides:
In a case under chapter 11 of this title, the trustee shall be deemed to have assumed (consistent with the debtor's other obligations under section 507), and shall immediately cure any deficit under, and commitment by the debtor to a Federal depository institutions regulatory agency (or predecessor to such agency) to maintain the capital of an insured depository institution, and any claim for a subsequent breach of the obligations thereunder shall be entitled to priority under section 507. This subsection shall not extend any commitment that would otherwise be terminated by any act of such an agency.
11 U.S.C. § 365(o).
Section 356(o) is only applicable in a Chapter 11 case and does not come into play in a case under Chapter 7 of the Bankruptcy Code.

[4] Section 507(a)(2) of the Bankruptcy Code provides:
(a) The following expenses and claims have priority in the following order: ….(2) Second, administrative expenses allowed under section 503(b) of this title, and any fees and charges assessed against the estate under chapter 123 of title 28.
11 U.S.C. § 507(a)(2).
Section 503(b) of the Bankruptcy Code provides for an administrative expense claim for the "actual, necessary costs and expenses of preserving the estate." 11 U.S.C. § 503(b)(1)(A).

[5] Section 507(a)(9) of the Bankruptcy Code provides:
(a) The following expenses and claims have priority in the following order: … (9) Ninth, allowed unsecured claims based upon any commitment by the debtor to a Federal depository institutions regulatory agency (or predecessor to such agency) to maintain the capital of an insured depository institution.
11 U.S.C. § 507(a)(9).
The FDIC and the trustee agreed that, had Imperial's bankruptcy case been initiated under Chapter 7 of the Bankruptcy Code, the FDIC's claim would only be entitled to ninth priority under Section 507(a)(9).

[6] Section 1828(u) provides, in pertinent part, that: "No person may bring a claim against any Federal banking agency … for the return of assets of … a] controlling shareholder of the insured depository institution transferred to, or for the benefit of, an insured depository institution by such … controlling shareholder of the insured depository institution, or a claim against such Federal banking agency for monetary damages or other legal or equitable relief in connection with such transfer, if at the time of the transfer [the insured institution was undercapitalized]." 12 U.S.C. § 1828(u)(1). *See also* 12 U.S.C. § 1828(u)(2)(A) (for purposes of § 1828(u)(1), the term "claim" includes a cause of action providing for avoidance of fraudulent conveyances).

[7] Only domestic support obligations and certain administrative expenses of the trustee are paid before section 507(a)(2) expenses. *See* 11 U.S.C. § 507(a)(1).

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