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WEATHERING THE STORM The FDIC's Authority to Repudiate Contracts

The current economic climate has led to a dramatic increase in bank failures over the past few years. In 2009 alone, 140 banks failed, compared to 26 bank failures in 2008 and only 3 bank failures in 2007. The Federal Deposit Insurance Corporation (the "**FDIC**") recently announced that it has 702 banks on its "Problem List" as of December 31, 2009, up 27 percent from 552 banks on September 30, 2009. This acute trend has heightened the awareness and interest in the role of the FDIC as receiver of a failed bank.

The determination that a bank is insolvent is typically made by its chartering authority (i.e., the state bank supervisor for state chartered banks, the Office of the Comptroller of the Currency or the Office of Thrift Supervision respectively for federally chartered banks or thrifts). Once the bank is considered insolvent, the regulator will then appoint the FDIC as receiver. The Federal Deposit Insurance Act (as amended, the "**Act**") grants to the FDIC as receiver substantial powers and the flexibility to facilitate the bank's orderly liquidation, dissolution, asset sale and/or merger. The receiver, by operation of law, succeeds to all rights, titles, powers and privileges of the failed bank, and of any stockholder, member, accountholder, depositor, officer, or director of such bank with respect to the bank and its assets.

In addition to any other rights the receiver may have, the receiver for any insured depository institution may disaffirm or repudiate any contract or lease (i) to which the institution is a party, (ii) the performance of which the receiver, in its discretion, determines to be burdensome, and (iii) the disaffirmance or repudiation of which the receiver determines, in its discretion, will promote the orderly administration of the failed institution's affairs.

The receiver has broad discretion in determining which contracts to repudiate. Virtually any contract to which the bank is party can be repudiated, including loan agreements, employment contracts, employee benefits, and leases, just to name a few. There are, however, special provisions under the Act related to the repudiation of certain contracts, such as service contracts, real estate contracts, and qualified financial contracts.

If the receiver repudiates a contract, the repudiation is treated as if the contract were breached on the date the receiver was appointed. The receiver, as the breaching party, is free from further compliance with identified portions of the repudiated contract. The counterparty (or parties) may be able to recover certain damages resulting from the repudiation.

When a bank is declared insolvent, it is prudent for all counterparties to review the specific provisions of their contracts with the failed bank to evaluate the likelihood of, and prepare a response to, the receiver's exercise of its broad powers. Most importantly, if the receiver repudiates a contract, it is imperative that the counterparties file timely claims for damages. Under federal law, with certain limited exceptions, failure to file a timely claim for damages will result in the disallowance of the claim by the receiver, which disallowance will be final, and further rights or remedies with respect to the claim will be barred. An exception may apply if (i) the claimant can prove that he did not receive notice of the appointment of the receiver in time to file such claim before the deadline, and (ii) the claim is filed in time to permit payment of such claim.

When a receiver is appointed to act on behalf of a failed bank, it is natural for counterparties to experience some level of uncertainty. Questions are likely to arise, such as:

1. *How will I know if my contract has been repudiated?* Typically, the FDIC will notify the counterparties to a repudiated contract in writing, via certified mail, return receipt requested, that their contract has been repudiated. The letter will state that the bank in question has been closed, and that the FDIC has been appointed as receiver of the bank. The letter will identify the contract to which the recipient of the letter may be a party and state that the FDIC has elected to repudiate or disaffirm the contract.
2. *How long does the receiver have to notify me that my contract was repudiated?* The receiver must determine whether or not to exercise its repudiation rights within a reasonable period of time following its appointment as receiver. What constitutes a “reasonable period” is a fact-specific determination that varies case by case.
3. *Am I entitled to damages? If so, how much?* The liability of the receiver for the repudiation of any contract is limited to actual direct compensatory damages, determined as of the date of the appointment of the receiver. Courts have avoided offering a clear definition of the term “actual direct compensatory damages,” other than to stress that the measure of damages to which a counterparty may be entitled is unique to the individual facts of each case. The Act is clear that the receiver is not liable for punitive or exemplary damages, damages for lost profits or opportunity, or damages for pain and suffering.
4. *How do I claim my damages?* If a counterparty believes he may be entitled to damages resulting from the repudiation, he must file a claim with the FDIC (a “**Proof of Claim**”) in writing, together with proof thereof, for an administrative determination by the FDIC regarding the claim’s validity. The letter from the FDIC notifying the counterparty of the contract repudiation will specify the deadline for filing a Proof of Claim (the “**Claims Bar Date**”), and provide a method (usually a phone number) by which a Proof of Claim form may be obtained. Failure to comply with this claims process precludes the counterparty from seeking relief in federal district court.
5. *How do I know if my claim for damages was allowed or disallowed?* The FDIC must determine whether to allow or disallow a claim within 180 days after the Proof of Claim is filed. If a counterparty’s Proof of Claim is disallowed, the counterparty will receive a Notice of Disallowance of Claim from the FDIC, typically in the form of a certified letter, return receipt requested. The letter will state that the FDIC has reviewed the claim and has determined to disallow it.

If the FDIC allows a Proof of Claim concerning a repudiated secured contract, the counterparty’s claim will have priority over unsecured claims. The FDIC cannot avoid any legally enforceable or perfected security interest in any assets of the institution except where such interest is taken in contemplation of the institution’s insolvency or with the intent to hinder, delay, or defraud the institution or the institution’s creditors. Legally enforceable or perfected security agreements must be honored to the extent of such damages, but no further. In other words, if there is a repudiation, the collateral securing the contract may be liquidated and the proceeds paid to or retained by the creditor up to the damages allowed by the statute, i.e., damages for actual direct compensatory losses measured as of the date of the appointment of the receiver. The remaining collateral or proceeds must then be remitted or returned to the receiver as property of the institution or its estate, or to a bona fide junior lienholder to the extent applicable.

If a counterparty's Proof of Claim concerning an unsecured contract is allowed, the counterparty becomes an unsecured general creditor of the failed institution. The FDIC may pay the counterparty's claim through the issuance of a Receivership Certificate, also known as a receiver's Certificate of Award. A Receivership Certificate entitles the holder to a pro rata share of the remaining proceeds of the liquidation of the failed institution, following the payment of administrative expenses, secured creditors, and deposit liability claims.

6. *Do I have any further remedies if my claim is disallowed?* If a counterparty's claim for damages is disallowed, he may file a lawsuit against the FDIC as receiver in the U.S. District Court for the District within which the failed bank's principal place of business was located or in the U.S. District Court for the District of Columbia. The lawsuit must be filed within 60 days from the date of the Notice of Disallowance of Claim. Failure to file suit within the 60 day period will result in the claim being permanently barred, and the counterparty will have no further rights or remedies with respect to the claim.

Haynes and Boone has represented a variety of clients, including borrowers, lenders, lessors and vendors faced with issues similar to those described above. Please contact us to assist in determining the proper course of action for your company.

If you have any questions, please contact:

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