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FDIC Receivership and Bank Litigation: What Litigators and Their Clients Need to Know

JASON A. LIEN AND JULIAN C. ZEBOT

The authors examine some of the practical effects of FDIC receivership on bank litigation.

You and your client are in the midst of a lawsuit involving a bank. Suddenly, you receive a phone call: The bank has been placed into receivership, the FDIC is now in charge, and they are going to be substituted into the litigation as a named party. You call your client to relay the news. Your client, of course, wants to know what its options are and what effect the FDIC receivership will have on its position within the litigation. You hang up the phone and scramble to find answers to your client's questions.

Is this a far fetched scenario? Hardly. One hundred and three banks have already failed through the first seven months of 2010;¹ 139 failed in all of 2009.² This compares with 25 bank failures in 2008 and only 3 fail-

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ures in 2007.³ As the economic recovery continues to proceed in fits and spurts, more bank failures appear all but inevitable.

While much media attention has been generated by the growing number of bank failures, lost in this coverage is any consideration of the implications of bank failure on pending or threatened litigation involving the failed bank. But for individuals, businesses, and even other banks involved in, or anticipating, litigation with a distressed bank, the consequences of FDIC receivership are potentially significant. This article, which examines some of the practical effects of FDIC receivership on bank litigation, is intended to fill at least some of that void.

THE FDIC'S RECEIVERSHIP POWERS

The FDIC is endowed with sweeping powers when acting in its capacity as receiver for a failed bank. These powers typically come into play upon a determination by a bank's chartering authority that the bank is functionally insolvent or "critically undercapitalized." A bank is critically undercapitalized when its ratio of tangible equity to total assets has fallen below two percent.⁴ To ensure the orderly liquidation and distribution of the failed bank's assets, the chartering authority then appoints a receiver,⁵ which, in most instances, is the Federal Deposit Insurance Corporation ("FDIC").⁶

As receiver, the FDIC steps into the failed bank's shoes.⁷ It inherits the rights, powers, and privileges of the failed bank;⁸ it may collect on any debts or obligations owed to the bank; it may liquidate the bank's assets and property;⁹ and it may merge the bank with, or transfer its assets and liabilities to, another bank.

Less obvious, but no less important to anyone who may become involved in litigation against a failed bank, are the FDIC's powers to minimize the receivership's loss exposure. As receiver, the FDIC may:

- request a temporary stay from the court, within 90 days of its appointment, in order to evaluate the lawsuit;¹⁰
- remove a pending state court lawsuit to federal court;¹¹

- administratively review claims against the failed bank;¹² and
- avoid certain types of claims, defenses, and remedies.

The FDIC may also repudiate, at its sole discretion, any contract or lease to which the failed bank is a party on the grounds that the contract is “burdensome” and its repudiation “will promote the orderly administration of the bank’s affairs.”¹³ The FDIC’s repudiation power applies to virtually any type of contract to which the bank is a party, including not only financial instruments issued by the bank, but also leases, employment contracts, and employee benefits;¹⁴ however, the FDIC has a much more limited ability to repudiate loans that are secured by the failed bank’s assets, and it can only do so under specific circumstances, such as where the interest is taken with the intent to hinder, delay, or defraud the bank.¹⁵ Where the FDIC repudiates a third party’s contract with the failed bank, the third party is not without recourse; it may seek “actual direct compensatory damages” caused by the contract’s repudiation through the FDIC claims process as discussed below.¹⁶

STAY OF LITIGATION

With respect to pending lawsuits, the most immediate impact of FDIC receivership will likely be the imposition of a temporary stay of all litigation. The FDIC is statutorily entitled, upon request, to a stay of up to 90 days from the date of its appointment as receiver.¹⁷ While this stay has been typically described as mandatory in nature, at least one district court has held that the FDIC’s stay request may be denied where the FDIC has already had sufficient time to familiarize itself with the lawsuit and imposition of the stay would subject the other party to irreparable harm.¹⁸ Furthermore, since some courts have interpreted the 90-day period as beginning to run from the date of the FDIC’s appointment, the actual length of the statutory stay may be significantly shorter than 90 days, depending on when the FDIC actually makes its request of the court.¹⁹ As a practical matter, however, where the FDIC is named as a defendant to the lawsuit, it may seek — as it has in the past — a longer stay of up to 180 days in

order to administratively review the claim asserted against the failed bank as part of its mandatory claims process. Because exhaustion of this claims process, which is discussed in greater detail below, is considered a jurisdictional requirement, a court may be willing to entertain such a request, even though it is not statutorily required to do so.

REMOVAL TO FEDERAL COURT

Litigants who have filed suit in state court against the failed bank prior to the FDIC's appointment also face the imminent prospect of their lawsuits being removed to federal court. The FDIC is entitled to remove a lawsuit against the failed bank to federal court within 90 days of being named a party to the action;²⁰ however, under a limited statutory exception, it may not do so where the lawsuit (1) is against a failed state-insured bank, (2) involves only the litigant's "preclosing" rights, or its rights as a depositor, creditor, or shareholder, against the bank, and (3) only requires the court to interpret state law.²¹ Of course, even where this statutory exception applies, the FDIC may still seek to remove the lawsuit on any grounds that would have otherwise been available to the failed bank, including the diversity of the litigants' citizenship.²²

FDIC CLAIMS PROCESS

The FDIC claims process also has special significance for litigants and their counsel. After appointment as receiver, the FDIC publishes — typically in a local newspaper, as well as on its web site — a notice to the bank's creditors. This notice must be published at least three times: the first notice at least 90 days before the deadline for filing claims; the second notice 60 days before the deadline; and the third, and final, notice, 30 days prior.²³ The FDIC is also required to mail the notice to any creditor whose name appears on the bank's books and to any other claimant whose name and address are otherwise discovered.²⁴

Anyone possessing a claim against the bank must file a proof of claim by a certain "bar" date specified in the notice. Once a proof of claim has been filed, the FDIC has 180 days to decide whether to allow or disallow

the claim.²⁵ If the claim is disallowed, the claimant may file a federal lawsuit or continue pending litigation.²⁶ The proper venue for judicial review of the claim's denial is the federal district court for the district within which the failed bank's principal place of business is — or was — located or, alternatively, the federal district court for the District of Columbia.²⁷ Accordingly, if venued elsewhere, pending litigation may need to be either transferred to, or dismissed without prejudice and re-filed in, the appropriate federal court. If, however, the claimant does not seek judicial review within 60 days of the claim's denial or the expiration of the 180-day review period, the claim is barred.²⁸

The FDIC claims process applies with equal force to litigants who have pending lawsuits against the failed bank. Federal law expressly predicates a court's subject matter jurisdiction over a litigant's lawsuit upon exhaustion of the administrative claims process.²⁹ Therefore, most of the circuit courts of appeal that have considered the issue have held that a court lacks subject matter jurisdiction when the litigant has failed to exhaust that process.³⁰ This failure can, under certain circumstances, prove to be an insurmountable hurdle for the litigant. For instance, if the claim's bar date has passed by the time of the court's dismissal of the claim, the litigant will be unable to seek any further judicial relief.³¹ This is true even when the FDIC, having substituted itself as the defendant in a pending lawsuit involving the failed bank, has actively engaged in the litigation without first encouraging or requiring the litigant to go through the claims process.³²

However, not all of the circuit courts of appeal are in agreement, and a split has developed as to whether a litigant must always exhaust the claims process before continuing to litigate its claim in federal court.³³ These contrary decisions appear to rest on a statutory interpretation that Congress did not intend to strip the courts of their subject matter jurisdiction to hear and decide lawsuits that were filed prior to FDIC receivership.³⁴ Nevertheless, individuals and businesses possessing claims against a failed bank, as well as their attorneys, would be well advised not to ignore the FDIC claims process, as their failure to take action may later preclude the assertion of otherwise meritorious claims against the bank or result in dismissal of their already pending lawsuits.

D'OENCH, DUHME DOCTRINE

Other hardships for litigants and their attorneys may result from the FDIC's intervention as receiver. Most notably, an otherwise properly submitted claim may be disallowed for failure to meet strict documentation requirements under what is often referred to as the *D'Oench, Duhme* doctrine. This doctrine was initially developed by the United States Supreme Court in its decision bearing the same name to protect the FDIC from secret side agreements between banks and third parties.³⁵ It has since been statutorily codified.³⁶ Under the doctrine, the FDIC can disallow claims, and seek dismissal of related litigation, if the basis for the claims are not contained within the bank's written records.³⁷ Specifically, no agreement against the interest of the FDIC will be enforceable against it unless the agreement: (1) is in writing; (2) was executed by the bank and the litigant contemporaneously with the acquisition of the asset; (3) was approved by the board of directors or loan committee of the bank, and the approval is reflected in the board or committee minutes; and (4) has continuously been an official record of the bank since the time of its execution.³⁸ At least one circuit court of appeals has called the restrictions on enforcement "startling in [their] severity."³⁹

Because the *D'Oench, Duhme* doctrine applies to all transactions and agreements entered into in the ordinary course of the bank's business,⁴⁰ the doctrine can easily lead to harsh consequences for those who regularly transact business with banks. This is especially true because some of the doctrine's requirements, such as board or committee approval and record maintenance, are completely outside of a third party's control. Even where the requirements are arguably within the litigant's control, the litigant is often insufficiently aware of the doctrine's potential application at the time of the initial transaction to ensure that all of the requirements are met by the bank. As a result, certain claims and defenses based on oral agreements or representations — including claims for breach of warranty, misrepresentations, and other tort claims — may not be available to a litigant in a lawsuit against the failed bank once the FDIC is appointed receiver.⁴¹

Perhaps in part because of the doctrine's wide-spread application, courts have made efforts to curb some of its harshness in recent years.

In some jurisdictions, the common-law doctrine — which arguably provides broader protections to the FDIC in certain situations — is no longer deemed to be separate and independent from its statutory codification at 12 U.S.C. § 1823(e).⁴² Courts in those jurisdictions have often stressed that state law, rather than federal common law, should be used to fill gaps within the statute.⁴³ In light of such judicial efforts to rein in the doctrine, some scholars and practitioners have delighted over its perceived demise.⁴⁴ Nevertheless, while attorneys should remain vigilant regarding case law developments affecting the doctrine's scope and application, the core tenets of *D'Oench, Duhme* remain codified and — absent legislative intervention — are here to stay.

LIMITATIONS ON AVAILABLE REMEDIES

Finally, FDIC receivership also affects the remedies available in litigation against a failed bank. Federal law prohibits courts from issuing injunctions or other equitable relief that would interfere with the FDIC's activities as receiver for the bank.⁴⁵ While these statutory provisions do not bar the recovery of monetary damages, they preclude the issuance of any order to seize assets in the possession of the receiver.

CONCLUSION

Many industry observers predict that bank failures will continue to increase before the current economic recovery strengthens. Consequently, individuals, businesses, and other banks involved in, or anticipating, litigation with a potentially distressed bank would be well advised to take a few simple precautions, including:

- reducing all agreements with the bank to a writing that satisfies 12 U.S.C. § 1823(e)'s requirements;
- monitoring the bank's status through the FDIC's web site (www.fdic.gov) and other news sources; and
- being prepared to file a proof of claim as soon as possible (and before

the specified bar date) to preserve their rights.

Additional precautions should be taken if one suspects that the *D'Oench, Duhme* doctrine might have some application to the claims or defenses to be asserted in litigation. First, litigants and their counsel should conduct an extensive pre-suit investigation and draft the relevant pleadings with an eye toward defeating an early dispositive motion by the FDIC. Second, if, as may well be the case, key documents or other evidence are outside the litigant's exclusive possession, the litigant's attorneys should serve discovery requests upon the FDIC and the successor bank as soon as practicably possible or, in the alternative, move for expedited discovery in order to uncover the necessary evidence bearing on the doctrine's application.

Finally, litigants and their counsel should appreciate that appointment of the FDIC as receiver may result in various litigation-related hardships, including delays, removal of the lawsuit to federal court, unavailability of certain claims and defenses, and limited remedies. With adequate awareness and preparation, however, the FDIC's sudden intervention as receiver need not be a game changer for litigants and their counsel.

NOTES

¹ Chris Serres, *A New Prague Bank Fails*, STAR TRIBUNE, July 23, 2010, available at <http://www.startribune.com/business/99149204.html> (last viewed August 16, 2010).

² Federal Deposit Insurance Corporation, Failed Bank List, at <http://www.fdic.gov/bank/individual/failed/banklist.html> (last viewed August 16, 2010).

³ *Id.*

⁴ Patricia McCoy, BANKING LAW MANUAL § 15.01 (2d ed. 2010) [hereinafter, "McCoy"].

⁵ *Id.*; see also 12 U.S.C. §§ 1821(c)(2)(A)(ii), (c)(13)(B), (d)(2)(E).

⁶ McCoy, *supra* note 4, at § 15.04. The FDIC generally acts as receiver — rather than a private entity or a state agency — in order to maximize the ability to recover losses to the federal deposit insurance fund. *Id.* at § 16.04[1] (citing Peter P. Swire, *Bank Insolvency Law Now That It Matters Again*, 42 DRAKE L.J. 469, 475, 478-82 (1992)).

⁷ *O'Melveny & Meyers v. FDIC*, 512 U.S. 79, 86-87 (1994).

- ⁸ 12 U.S.C. §§ 1821(d)(2)(A), (d)(2)(C); 12 C.F.R. § 580.2(b)(7)(i).
- ⁹ 12 U.S.C. § 1823(d)(1).
- ¹⁰ *Id.* § 1821(d)(12)(A)(ii).
- ¹¹ *Id.* § 1821(d)(13)(B).
- ¹² *Id.* § 1821(d)(4)(A).
- ¹³ 12 U.S.C. § 1821(e)(1).
- ¹⁴ Erin Burrows & F. John Podvin, Jr., *Revisiting the FDIC's "Superpowers": Contract Repudiation and D'Oench Duhme*, 127 *BANKING L.J.* 395, 397 (May 2010).
- ¹⁵ 12 U.S.C. § 1821(e)(12).
- ¹⁶ *Id.* § 1821(e)(3).
- ¹⁷ *Id.* § 1821(d)(12)(A)(ii).
- ¹⁸ *Hunter's Run I, Ltd. v. Arapahoe County Pub. Tr.*, 741 F. Supp. 207, 208 (D. Colo. 1990). *But see Praxis Props., Inc. v. Colonial Sav. Bank*, 947 F.2d 49, 51, 65-67 (3d Cir. 1991).
- ¹⁹ *See, e.g., Praxis*, 947 F.2d at 71; *Napa Valley I, LLC v. FDIC*, 651 F. Supp. 2d 1210, 1214-16 (D. Nev. 2009). *But see Wachovia Bank, N.A. v. Vorce*, No. 1:07-cv-847, 2007 WL 3471229 (W.D. Mich. Nov. 13, 2007); *Boylan v. George E. Bumpus, Jr. Constr. Co.*, 144 B.R. 1, 3 (Bankr. D. Mass. 1992).
- ²⁰ 12 U.S.C. § 1819(b)(2)(B).
- ²¹ *Id.* § 1819(b)(2)(D).
- ²² *Id.* § 1819(b)(2)(E).
- ²³ *Id.* § 1821(d)(3)(B).
- ²⁴ *Id.* § 1821(d)(3)(C).
- ²⁵ *Id.* § 1821(d)(5)(A).
- ²⁶ *Id.* § 1821(d)(6)(A).
- ²⁷ *Id.*
- ²⁸ *Id.* § 1821(d)(6)(B).
- ²⁹ *Id.* § 1821(d)(13)(D).
- ³⁰ *See, e.g., Intercont'l Travel Mktg., Inc., v. FDIC*, 45 F.3d 1278 (9th Cir. 1994); *Brady Dev. Co. v. RTC*, 14 F.3d 998, 1005 (4th Cir. 1994); *Bueford v. RTC*, 991 F.2d 481, 483 (8th Cir. 1993); *RTC v. Mustang Partners*, 946 F.2d 103 (10th Cir. 1991) (per curiam); *FDIC v. Shain, Schaffer & Rafanello*, 944 F.2d 129 (3d Cir. 1991).
- ³¹ 12 U.S.C. § 1821(d)(6)(B).
- ³² *See, e.g., Bueford*, 991 F.2d at 485.
- ³³ *See, e.g., In re Lewis*, 398 F.3d 735, 744 (6th Cir. 2005); *FDIC v. Lacentra*

Trucking, Inc., 157 F.3d 1292, 1304 (11th Cir. 1998).

³⁴ See, e.g., *In re Lewis*, 398 F.3d at 743-45.

³⁵ *D'Oench, Duhme & Co., Inc. v. FDIC*, 315 U.S. 447 (1942).

³⁶ 12 U.S.C. § 1823(e).

³⁷ *Id.*

³⁸ *Id.* § 1823(e)(1).

³⁹ *Bowen v. FDIC*, 915 F.2d 1013, 1015 (5th Cir. 1990).

⁴⁰ *In re New Valley Corp.*, 168 B.R. 82, 87-88 (Bankr. D.N.J. 1994).

⁴¹ *Langley v. FDIC*, 484 U.S. 86, 94-96 (1987); *Timberland Design, Inc. v. First Serv. Bank for Sav.*, 932 F.2d 46, 49-50 (1st Cir. 1991).

⁴² McCoy, *supra* note 5, at § 16.04[1].

⁴³ See, e.g., *Divall Insured Income Fund v. Boatman's First Nat'l Bank*, 69 F.3d 1398, 1402 (8th Cir. 1995).

⁴⁴ See, e.g., Joshua Glazov, *Ding, Dong the D'Oench, Duhme Doctrine Is Dead, Maybe* (Nov. 30, 2009), at <http://www.constructionlawtoday.com/2009/11/ding-dong-the-doench-duhme-doctrine-is-dead-maybe/>.

⁴⁵ 12 U.S.C. § 1821(j).