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Section 365(o) Coming into Focus

Reason: Bank Failures Rise to Record Highs

By Daniel A. Lowenthal

The Great Recession continues to take a toll on banks. In 2010, 149 banks had failed by mid-November. That's nine more than in 2009 and more than five times the number in 2008. Not since 1992 have so many banks failed in one year. *See* www.bloomberg.com/news/2010-11-22/adelphia-vitro-lehman-workflow-local-insight-bankruptcy.html.

The situation is not expected to improve soon. The Federal Deposit Insurance Corporation (FDIC) recently reported that 860 banks in the U.S. are "problem" institutions. *See* www.fdic.gov/news/news/press/2010/pr10256.html. That means that almost one in nine of the nation's 7,760 banks are the highest risk for failure. *See* www.ny times.com/2010/11/24/business/ 24fdic.html?scp=1&sq=Eric%20Dash%20and%20FDIC&st=cse.

What Happens to Troubled Banks?

Bankruptcy professionals know that banks in the U.S. cannot file for bankruptcy protection. The Bankruptcy Code bars banks with U.S. branches or agencies from being debtors. Bankruptcy Code § 109(b)(3)(B). Troubled banks under the FDIC's jurisdiction often end up in conservatorships or receiverships. But bank holding companies that own U.S. banks can file for bankruptcy. And special rules apply in such cases.

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Many key rules and regulations that govern failed bank holding companies and their subsidiary banks, particularly savings and loan associations, stem from the troubled real estate era of the late 1980s and early 1990s.

For instance, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) abolished the Federal Home Loan Bank Board. The Office of Thrift Supervision (OTS) became the regulator of federally insured savings associations. *See* 12 U.S.C. § 1462a(e). The Resolution Trust Corporation (RTC) was also formed to act as conservator or receiver for federally insured thrifts that failed between 1989 and 1995. 12 U.S.C. §1441a(b)(1),(3). Then, in 1995, the FDIC took over as conservator or receiver in RTC's cases. 12 U.S.C. § 1441a(m)(1).

Section 365(o)

In 1990, Congress enacted § 365(o) of the Bankruptcy Code 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 (Crime Control Act of 1990). A key legislative purpose of the law was to keep banks from "using bankruptcy to evade commitments to maintain capital reserve requirements of a Federally insured depository institution." H.R.Rep. No. 681(I), at 179 (1990), reprinted in 1990 U.S.C.C.A.N. 6472, 6585; *Resolution Trust Corp. v. Firstcorp, Inc.* (*In re Firstcorp, Inc.*), 973 F.2d 243, 246 (4th Cir. 1992). Section 365(o) 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, 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, 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 agency.

Section 365(o) refers to a "Federal

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depository institutions regulatory agency," which is defined in Bankruptcy Code § 101(21B), to mean:

(A) with respect to an insured depository institution (as defined in section 3(c)(2) of the Federal Deposit Insurance Act) for which no conservator or receiver has been appointed, the appropriate Federal banking agency (as defined in section 3(q) of such Act) … .

(D) with respect to any insured depository institution for which the Federal Deposit Insurance corporation has been appointed conservator or receiver, the Federal Deposit Insurance Corporation.

Section 365(o) applies in Chapter 11 cases where debtors (such as bank holding companies) have made a commitment prepetition to a federal depository institution's regulatory agency (such as the FDIC) to maintain the capital of an insured depository institution (such as a savings and loan association). The commitment is typically memorialized in a written agreement between the bank holding company and the FDIC — an agreement that is an executory contact in Chapter 11.

Section 365(o) sets forth special requirements with respect to this type of executory contract that differ from the treatment available for other executory contracts. Debtors are not afforded the typical options of assumption, assumption and assignment and rejection. Instead, capital maintenance agreements must be assumed and cure payments must be made immediately. Otherwise, courts have ruled, Chapter 11 cases must be converted to Chapter 7.

The language of § 365(o) states that debtors "shall be deemed to have assumed" capital maintenance agreements. Debtors have no choice. The Bankruptcy Code mandates assumption. The statute adds that debtors "shall immediately cure" any prepetition deficits. Debtors are afforded no grace period in Chapter 11 to pay the cure. Absent payment, debtors cannot stay in Chapter 11.

In addition, § 365(o) provides that any claim (by the FDIC) for a debtor's subsequent breach of the obligations set forth in § 365(o) is entitled to a ninth priority under Bankruptcy Code § 507(a). Initially, the Crime Control Act of 1990 gave such a claim an eighth priority. It was moved to a ninth priority by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394.

In re Firstcorp

A handful of court decisions since the early 1990s show how § 365 works and the policies underlying the statute. The leading case is a 1992 decision by the U.S. Court of Appeals for the Fourth Circuit. *Resolution Trust Corp. v. Firstcorp, Inc.* (*In re Firstcorp, Inc.*), 973 F.2d 243 (4th Cir. 1992). Firstcorp was a holding company for savings and loans. In 1985, Firstcorp signed an agreement with the Federal Home Loan Bank Board (FHLBB) to maintain the capital of the subsidiary thrifts. By 1990, one of thrifts, First Federal Savings and Loan Association of Raleigh (FF-Raleigh), was financially strapped due to bad real estate loans.

The OTS filed an administrative proceeding against Firstcorp for allegedly failing to maintain the capital of FF-Raleigh. Firstcorp filed for Chapter 11. The OTS appointed the RTC as receiver for FF-Raleigh. In Firstcorp's bankruptcy case, the OTS and the RTC filed motions pursuant to § 365 seeking to require Firstcorp to assume its capital maintenance agreement in favor of FF-Raleigh and to pay the cure of the deficit outstanding under that agreement. Judicial review of the motions eventually reached the Fourth Circuit.

The court concluded that "the assumption of a capital maintenance obligation and cure of a deficit under such an obligation are pre-requisites to reorganization under Chapter 11." 973 F.2d at 248. The Fourth Circuit explained the policy behind the statute. "[A] depository institution holding company that has committed to maintain the capital of a depository institution subsidiary that has become unprofitable cannot use a Chapter 11 reorganization to jettison the subsidiary in an effort to enhance its own financial position and that of its creditors, while leaving the federal deposit insurance system (and ultimately the taxpayers) to bail out the capital-deficient subsidiary. If the holding company is not financially able to satisfy its capital maintenance obligations, then § 365(o) denies it the opportunity to reorganize under Chapter 11, leaving liquidation under Chapter 7 as its only option. Through this mechanism, § 365(o) places the financial interest of the federal deposit insurance system ahead of that of the holding company and its creditors." *Id*.

The court held that Firstcorp had signed a capital maintenance agreement and thus had to assume the contract and cure the deficit. *Id*. at 251. It also concluded that the cure had to be "immediate" — meaning "'without lapse of time; without delay; instantly; at once.'" *Id*. at 247 (internal citation omitted). "[W]e cannot imagine that the phrase [in § 365(o)] 'shall immediately cure' means other than that the cure is, in effect, a prerequisite to reorganization under Chapter 11." *Id*. The Fourth Circuit made clear that the cure required related to the pre-petition breach of the capital maintenance agreement. At issue was not the priority for a "subsequent breach" that is also mentioned in § 365 (o). *Id*. at 248.

In re Overland Park Financial

The U.S. Court of Appeals for the Tenth Circuit followed the Fourth Circuit's analysis when it ruled that a net worth maintenance stipulation signed by a bank holding company in favor of a subsidiary savings and loan triggered § 365(o)'s assumption and cure requirements. *Office of Thrift Supervision v. Overland Park Financial Corp.* (*In re Overland Park Financial Corp.*), 236 F.3d 1246 (10th Cir. 2001). Citing *Firstcorp*, the Tenth Circuit held that the debtor, Overland Park Financial Corporation, could proceed in Chapter 11 only if its "commitment to assume and cure its capital deficit [was] satisfied." *Id*. at 1253.

In 2008, the U.S. Court of Appeals for the Ninth Circuit issued a decision that analyzed the § 507(a)(9) reference in § 365(o). *Wolkowitz v. FDIC* (*In re Imperial Credit Indus., Inc.*), 527 F.3d 959 (9th Cir. 2008). Imperial Credit Industries (Imperial) had guaranteed capital payments owed by a subsidiary, Southern Pacific Bank (Southern), to the FDIC. Southern failed to perform; Imperial filed Chapter 11; and the FDIC sought to enforce the Imperial guaranty under § 365(o).

The District Court issued two decisions. First, it ruled that Imperial had to assume and pay the FDIC the full cure amount. The District Court also noted that if Imperial converted the case to Chapter 7, then the cure would not have to be paid immediately. Imperial converted the case to Chapter 7, and the FDIC sought a ruling that the cure was entitled to an administrative priority under Bankruptcy Code § 507(a)(2), which permits "administrative expenses" for the "actual, necessary costs and expenses of preserving the estate." In its second decision, the District Court ruled in favor of the FDIC. 527 F.3d at 965.

On appeal, the Ninth Circuit disagreed and ruled that the FDIC's claim was not entitled to administrative priority. The court held that "a failure to cure a § 365(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.

Colonial BancGroup

Several months ago, a bankruptcy court in Alabama analyzed § 365(o). *In re The Colonial BancGroup, Inc.*, 436 B.R. 713 (M.D. Ala. 2010). The debtor, The Colonial BancGroup, Inc., was a bank holding company that owned a subsidiary bank, Colonial Bank (Colonial). In 2008, bank regulators downgraded Colonial's composite rating. In 2009, the debtor signed a memorandum of understanding with the Alabama Banking Department and the Federal Reserve Bank of Atlanta that required the debtor to make a "good-faith" effort to implement a program of "corrective action." Bank regulators later entered into a cease and desist order with debtor, requiring it to submit a written capital plan for Colonial by Aug. 14, 2009. On that date, however, the Alabama Banking Department closed Colonial and sold its assets, and the FDIC was appointed the receiver. On Aug. 25, 2009, the debtor filed for Chapter 11.

The FDIC filed a motion pursuant to § 365(o), asserting that the memorandum of understanding was a commitment by the debtor to maintain Colonial's capital and seeking payment of a deficit of about $1 billion. The bankruptcy court held an evidentiary hearing and took testimony from numerous witnesses concerning the language of the memorandum of understanding.

The bankruptcy court held that, in contrast to the documents at issue in the cases cited above, the language of the memorandum of understanding did not create a commitment or a guaranty by the debtor to maintain the capital of Colonial. Rather, the court held, the language just required the debtor "to 'assist' the bank in reaching target capital ratios." 436 B.R. at 733.

The bankruptcy court also noted that neither the memorandum of understanding nor any other document was signed by the debtor and the Federal depository institution's regulatory agency — the FDIC. Finally, the court held that § 365(o) was inapplicable because the FDIC had closed Colonial. Any commitment by the debtor could not be assumed and cured since the depository bank was no longer operating. *Id*. at 738. The FDIC has appealed the bankruptcy court's decision.

Conclusion

The high number of "problem" banks in the U.S. today presages more bank failures in 2011. Banks will be placed into conservatorships, receiverships, or sold. Bank holding companies will continue to file for Chapter 11. And contracts that those holding companies signed prepetition with certain federal regulatory agencies will be tested under § 365(o). In addition, such executory contacts will qualify as commitments by the holding companies to maintain subsidiary banks' capital and, if so, the holding companies can cure deficits will be crucial issues at the outset of the Chapter 11 cases. Practitioners who expect to be involved in those cases are well-advised to master § 365(o) and the cases that have analyzed it to date.