CHAPTER 10

Treatment of Uninsured Depositors and Other Receivership Creditors

Introduction

A failed bank or thrift receivership has a statutory obligation to identify creditors and distribute proceeds of the liquidation of assets to these creditors commensurate with applicable statutes and regulations. Typical receivership creditors include uninsured depositors, general trade creditors, subordinated debtholders, and shareholders. This chapter discusses the evolution of the claims process from 1980 to 1994 into a uniform system now codified in federal law.

The chapter details the history of the order in which the creditors of the various types of receiverships are paid after the receivership's assets have been liquidated, and describes the actual process used to make distributions, known as liquidating dividends, to uninsured depositors and other creditors with allowable claims. The discussion then focuses on the history of the treatment of each of the different classes of creditors.

The Administrative Claims Process

The administrative claims process varied among the Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC), and the Resolution Trust Corporation (RTC) and even changed for the FDIC with the passage of the Federal Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA).

FDIC Receiverships (Before FIRREA)

Before FIRREA was enacted in 1989, the National Bank Act (NBA) of 1864 required all creditors with claims against national bank receiverships to file their claims against the receivership. Unlike FIRREA, the NBA addressed claims issues very generally. The NBA stated that the receiver should publish notice to claimants in a newspaper for three consecutive months after the receiver had been appointed. It also allowed an unlimited amount of time up until termination of the receivership for a claim to be filed and determined. The statute further mandated that the proceeds from the sale of assets should be distributed on a pro rata basis to the creditors. It is important to note that even though the NBA stated that creditors should file claims against the receivership estate, the courts allowed lawsuits to be filed without requiring that claimants first go through the claims process.

State chartered bank receiverships adhered to claims processes outlined in state liquidation statutes, for which a specific provision existed in most state codes. The actual steps in the process varied somewhat from state to state, but in general, most states provided for notifying creditors, filing claims, and allowing or disallowing the claims submitted.

Federal Savings and Loan Insurance Corporation Receiverships (Before FIRREA)

From 1984 to 1989, the Federal Savings and Loan Insurance Corporation contended that courts lacked subject matter jurisdiction over claims filed against FSLIC receiverships before claims had been presented to the FSLIC. That policy was based on a decision by the Fifth Circuit Court in *North Mississippi Savings and Loan v. Hudspeth*, 756 F.2d 1096 (1985), involving a compensation dispute between an association and its former president. As a result of the decision, the FSLIC developed internal procedures for processing claims.

In October 1988, the Federal Home Loan Bank Board (FHLBB) had attempted to correct the deficiencies in the claims procedures by promulgating regulations establishing detailed procedures for determining claims filed with the FSLIC as receiver. Several years earlier, the FSLIC had adopted detailed procedures for deposit insurance reconsiderations (*Code of Federal Regulations (C.F.R.),* volume 12, section 564.1[d]). The FDIC, however, had no regulation for reconsiderations and did not adopt the FSLIC regulation in 1989. Instead, the FDIC and the RTC heard requests for deposit insurance reconsiderations based on internal policies and practices.

In March 1989, the U.S. Supreme Court overruled *Hudspeth* in *Coit Independence Joint Venture v. FSLIC*, 489 U.S. 561 (1989). The court found the claims procedure deficient because no clear constraints existed for the time it took the FSLIC to make a determination on claims filed against a receivership. *Coit* also determined that the FSLIC procedures improperly gave the FSLIC and the FHLBB authority to make final decisions without allowing the claimant an opportunity for a de novo judicial review.

FDIC and RTC Receiverships (After FIRREA)

FIRREA established new procedures for presenting and resolving claims filed by creditors against failed financial institutions. These claims provisions more closely resembled the FDIC's pre-FIRREA procedures and were intended to cure the constitutional problems the Supreme Court had with the FSLIC procedures. FIRREA established a receivership claims process applicable to all federal and state chartered banks and thrifts, thus standardizing the treatment of all receivership claims filed against either an FDIC or RTC receivership. The process required that the—

- Receiver post notice in a newspaper of general circulation for three consecutive months and mail notices to creditors on the books and records;
- Creditors file a claim within the time frame provided in the notice (approximately 90 days from the date of the published notice);
- Receiver make a determination on the claim within 180 days of the date of the filing unless both parties agreed to an extension; and
- Creditors file suit in a U.S. District Court within 60 days of the date of a denial or within 60 days to 180 days after the claim had been filed if no determination had been made.

Both the FDIC and the RTC developed procedures to implement the statute. Over time, however, and because of the ambiguous nature of some of its provisions, questions such as 'Who must file a claim?' and 'Does the state court or federal court have jurisdiction over lawsuits filed as the result of disallowed claims?' arose concerning FIRREA's claims procedures.

History of the Claims Priorities and the Payment Process

Before the National Depositor Preference (NDP) Amendment (described later in this chapter) was enacted, the National Bank Act had established the priority of payment of unsecured claims for national bank receiverships. Although the NBA did not explicitly state the claims priorities, the FDIC interpreted the payment order to be as follows:

1. Administrative expenses of the receiver;
2. Deposit liabilities and general creditor claims;
3. Subordinated debt claims;
4. Federal income taxes; and
5. Stockholder claims.

Individual state laws specified the distribution priorities for receiverships of state chartered banks and may have incorporated the concept of depositor preference, depending on the laws of the given state.

The FSLIC claims priorities regulation (12 C.F.R. 569c.11), promulgated in 1988, was adopted by the FDIC in 1989. The FDIC and the RTC used the regulation for failed thrift receiverships until 1993. Under the regulation, unsecured claims against the receiver had the following order of priority:

1. Administrative expenses of the receiver;
2. Administrative expenses for the failed association, provided that such expenses were incurred within 30 days before the appointment of the receiver, and that such expenses were limited to reasonable expenses incurred for services actually provided by accountants, attorneys, appraisers, examiners, or management companies or to reasonable expenses incurred by employees;
3. Claims for wages and salaries earned before the appointment of the receiver by an employee of the savings association whom the receiver determined was in the best interest to retain for a reasonable period of time;
4. If authorized by the receiver, claims for wages and salaries earned before the appointment of the receiver, up to $3,000 by an employee not retained by the receiver;
5. Claims for governmental units for unpaid taxes other than federal income taxes;
6. Claims for withdrawable accounts, including those of the FDIC as subrogee, and all other claims that had accrued and become unconditionally fixed on or before the date of default, unless the association was chartered and operated in a state where state law provided priority to depositors over other creditors. In that case, the depositors had priority over other creditors in both a state chartered or federal chartered association;
7. Claims other than those that had accrued and become unconditionally fixed on or before the date of default, including claims for interest after the date of default on claims under paragraph (6);
8. Claims of the United States for unpaid federal income taxes;
9. Claims that had been subordinated in whole or in part to general creditor claims; and
10. Claims by holders of nonwithdrawable accounts, including stock.

National Depositor Preference

The National Depositor Preference Amendment (Public Law No. 103-66 Section 3001 [a]), enacted on August 10, 1993, standardized the asset distribution plan for all receiverships, regardless of the institution's charter, and gave priority payment to depositors, including the FDIC as "subrogee" for insured deposits. Because, so far, most liabilities of failed institutions have been deposit liabilities, the effect of depositor preference in practice has been to eliminate any recovery for unsecured general creditors. Under the NDP Amendment and related statutes, claims are paid in the following order of priority:

1. Administrative expenses of the receiver;
2. Deposits (the FDIC claim takes the position of the insured deposits);[1]
3. Other general or senior liabilities of the institution;
4. Subordinated obligations;[2] and
5. Shareholder claims.

The Dividend Process

Payments are made to creditors with valid claims through the dividend process. The payment of any claim depends on two factors: (1) a favorable final determination by the receiver on the merits of the claim, and (2) the availability of assets in the receivership estate with which to pay the claim. The receiver is authorized, at its discretion and to the extent that funds are available, to pay valid claims at any time. If no funds are available for immediate distribution, the claimant receives a receivership certificate showing entitlement to a share in the receivership estate.

To reduce the hardship on uninsured depositors, in 1984 the FDIC began making "advance dividend" payments soon after a bank's closing. The advance dividend percentage is based on the estimated recovery value of the failed bank's assets. The FDIC did not pay advance dividends when the value of the failed institution's assets could not be reasonably determined at the time of closing.

Advance dividends provided uninsured depositors with an opportunity to realize an earlier return on the uninsured portion of their deposits without eliminating the incentive for large depositors to exercise market discipline.

1. Because of the manner in which the Federal Deposit Insurance Act of 1950 defines a "deposit," foreign deposits are not accorded the benefit of this priority and are therefore paid with the other general or senior liabilities of the institution.

2. Any liability of the insured depository for a cross guarantee assessment would receive distributions after subordinated debtholders but before distributions were made to shareholders. See Chapter 3, Evolution of the FDIC's Resolution Practices.

If the FDIC's actual collections on the assets of the failed institutions exceeded the advance payments and administrative expenses of the receivership, the uninsured depositors and other creditors received additional payments on their claims. If the total of actual collections was less than the advance payments and administrative expenses of the receivership, the FDIC insurance fund absorbed the shortfall.

Between 1984 and 1987, the FDIC authorized advance dividends for 29 of the 118 cases involving insured deposit only resolutions. During the next four years, no advance dividends were approved. From 1992 through 1994, 176 banks were resolved, for which 103 involved insured deposit only transactions. In 69 of those cases, advance dividends totaling $274.9 million were paid at resolution, and 9 cases indicate a possible overpayment totaling $324,000, or one-tenth of 1 percent of total advance dividends paid. Of the nine cases, six were located in California, with five in the Los Angeles area, where real estate values continued to decline after the failures and assets were liquidated at a much slower pace than originally had been contemplated.

Advance dividends typically were funded by a loan from the FDIC corporate account to the receiver, which used the cash to pay the advance dividends to the third-party claimants. As the receiver liquidated assets, cash proceeds were used to reduce the loan balance.

Treatment of Like Classes of Creditors

As the deposit insurer, the FDIC is obligated to satisfy deposit liabilities of a failed institution up to the deposit insurance limit. The FDIC in its corporate capacity then "steps into the shoes" of the depositor as a claimant and files its subrogated claim against the receivership estate. The FDIC, like other creditors in the same class, then is paid a pro rata share of its claim based on the liquidation value of the receivership assets.

In 1978, in *First Empire Bank v. Federal Deposit Insurance Corporation*, 572 F.2d 1361 (9th Cir. 1978), the Ninth Circuit Court of Appeals (Ninth Circuit Court) ruled that the FDIC could not arrange a transaction that passed all of a national bank's assets and satisfied some of its liabilities in full while failing to satisfy other liabilities, regardless of class, without violating the NBA's ratable distribution requirement. The decision had a significant effect on the FDIC for several years thereafter.

Transaction Types: 1980 to 1988

In the early 1980s, the FDIC used two transaction methodologies to resolve failed banks: the purchase and assumption (P&A) transaction and the deposit payoff. In P&A transactions, all deposits (insured and uninsured) and most other liabilities transferred to an acquiring institution. If all liabilities that were at the same priority level as the deposit liabilities transferred, the FDIC was, in effect, in compliance with the *First Empire* decision because all creditors had been treated equally. When some liabilities were left behind in the receivership that were on par with the deposit liabilities, the

First Empire Decision

In 1973, the United States National Bank of San Diego (USNB), San Diego, California, closed, and its assets and liabilities were assumed by Crocker National Bank (Crocker). As of the closing date, USNB had 335,000 depositors with $932 million in deposits. That was the largest financial institution failure since the inception of the FDIC and the first occasion on which the FDIC modified its standard purchase and assumption (P&A) agreement. In the standard P&A, the liability for outstanding standby letters of credit (LOCs) transferred to the acquiring institution and continued to be honored.

The FDIC determined that certain standby LOCs might have been fraudulently issued to guarantee the debts of companies controlled by the former president of USNB and his associates. Potential participants in the P&A, including Crocker, believed that assumption of liability on the LOCs presented an unacceptable risk; therefore, the LOCs remained with the receiver. The holders of the suspected fraudulent LOCs were not paid, but were provided with a receiver's certificate that would allow them to share in any eventual distribution of funds as USNB's assets were liquidated. In contrast, the LOCs that were not suspected of fraud were transferred to Crocker and paid in full when presented.

Two holders of the allegedly fraudulent LOCs, First Empire Bank and Societé Generale, sued the FDIC, maintaining that USNB's obligations to them should have been treated in the same manner as the LOCs assumed by Crocker. A California federal district court held that the FDIC, in determining not to pay the suspect letters of credit, had properly exercised the discretion granted to it under federal banking law. That decision was appealed to the Ninth Circuit Court and was reversed in favor of the holders of the LOCs. In October 1978, the Supreme Court declined the FDIC's request to review the Ninth Circuit Court's opinion. Accordingly, the FDIC had to pay the holders of the LOCs that were not assumed by Crocker. The *First Empire* case affected subsequent P&As and placed more significance on the classes of liabilities transferred.

FDIC made the creditors whole out of the receivership estate (that is, creditors were paid from the receivership or were given receivership certificates, rather than being paid from the assuming institution). Once again, all like creditors were treated the same. For payoff transactions, the FDIC paid the insured portion of the depositor's account, and all other creditors (such as uninsured depositors and trade creditors) received a receivership certificate and a distribution that was pro rata with other creditors in their class. Again, in this type of transaction, all creditors of like classes were treated the same.

Between 1980 and 1982, 39 institutions were closed and resolved using a P&A transaction, 12 institutions were closed and resolved using a deposit payoff, and 12 institutions received open bank assistance.

The *First Empire* decision had significant implications for the resolution of Penn Square Bank, N.A. (Penn Square), Oklahoma City, Oklahoma. Until 1982, all failed banks with deposits totaling more than $100 million were handled with P&A transactions, which protected uninsured depositors. In July 1982, Penn Square, with assets of $517 million, was closed and uninsured depositors were not paid in full.[3] The FDIC decided not to give full protection to uninsured depositors primarily because of the potential contingent liabilities associated with more than $2 billion in participation loans. Because of suspected inaccuracies in the loan documentation, the FDIC anticipated multiple lawsuits, which made it difficult to value the bank's assets and to determine accurately the volume of creditors' claims. The FDIC also would have to make whole all creditors if uninsured depositors were given complete protection through a P&A transaction. With $2 billion of possible claims, a P&A transaction could not be viewed as less costly than a deposit payoff.

In December 1983, the FDIC introduced new procedures for bank closings intended to minimize the disruption of bank services generated by deposit payoffs yet expose uninsured depositors to some degree of risk in the event of a failure. The new "modified payoff" procedures provided for advance dividends (partial payments to uninsured depositors and other creditors) on the basis of an estimate of the proceeds from the liquidation of the assets. In many of the closings handled under the new procedures, an acquirer would be found who was willing to accept the insured deposit liabilities. That type of transaction became known as an insured deposit transfer. The uninsured depositors and unsecured creditors remained with the receivership and received pro rata payments based on the liquidation value of the receivership's assets, an arrangement in which all creditors were treated the same. The insured deposit transfer limited the disruption normally caused by a deposit payoff, while promoting some market discipline for larger depositors.

From 1983 to 1985, the FDIC resolved 248 institutions, the majority of which (185) were P&A transactions. Deposit payoffs were used in 33 cases, and the newly created insured deposit transfer accounted for another 21 closings. Open bank assistance was provided in nine transactions.

Efforts to have uninsured depositors share in the losses of failed banks came to a halt with the resolution of the Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois. Continental had purchased participation loans from Penn Square that contributed significantly to the more than $5 billion in nonperforming loans held by Continental. In May 1984, a massive deposit run and the inability to find an acquirer led the FDIC to arrange for open bank assistance (OBA). Concerns about the effect this action would have on other financial institutions and the magnitude of the potential losses to uninsured depositors prompted the FDIC to issue a press release assuring full deposit protection. The FDIC's departure from policy and the

3. See Part II, Case Studies of Significant Bank Resolutions, Chapter 3, Penn Square Bank, N.A.

extraordinary amount of assistance it extended to Continental implied that the FDIC might have set a limit on the size of banks for which uninsured depositors were not protected in full, and questions were raised over whether certain banks were “too big to fail.”[4]

From 1986 to 1988, the FDIC resolved 395 failed institutions using P&A transactions. OBAs reached a high at 105 transactions, with 89 institutions resolved using insured deposit transfers. An additional 38 failed banks were resolved using deposit payoff transactions in which depositors received the insured portion of their accounts and uninsured depositors and other creditors received a portion of their outstanding claims.

Post-FIRREA: 1989 to 1994

FIRREA clarified existing law so that the FDIC’s maximum liability to any receivership claimant was limited to the amount the claimant would have received if the institution’s assets had been liquidated. In other words, the unassumed creditors were entitled to receive only what they would have received in a hypothetical liquidation, even though assumed creditors received payment in full. The statute also made it clear that the FDIC, at its sole discretion and in the interest of minimizing its losses, could use its own resources to make additional payments to any creditor or class of creditors without being obligated to make the same payment to any other creditor or class of creditors.

After the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 was signed, the FDIC was required to select the least costly resolution method available. The requirement had a significant effect on the FDIC’s and RTC’s resolution practices. Previously, the FDIC had structured most of its transactions to transfer both insured and uninsured deposits along with a significant amount of failed bank assets. Under FDICIA, however, when transferring the uninsured deposits was not the least cost solution, the FDIC began entering into P&A transactions that included only the insured deposits.

Of the 1,423 closings from 1989 to 1994, 1,063 were resolved with P&A transactions. The insured deposit transfer method was used in another 224 closings, payoffs accounted for an additional 129 closings, and OBA was provided in 7 transactions.

Unclaimed Deposit Accounts

Before the Unclaimed Deposits Amendment Act (UDAA), which amended the Federal Deposit Insurance Act (FDI Act), was enacted on June 28, 1993, depositors had been required to make a claim within 18 months of the appointment of the receiver or lose their deposit insurance coverage and have their claim be treated as a receivership claim.

4. See Part II, Case Studies of Significant Bank Resolutions, Chapter 4, Continental Illinois National Bank and Trust Company.

The UDAA, which applies to all receiverships established after its enactment, allows the FDIC to make insurance payments available to depositors for 18 months, after which time all remaining unclaimed funds are offered to the appropriate state. The state can attempt to locate the depositors for 10 years before the funds revert to the FDIC in its corporate capacity.

Classes of Creditors (Post-National Depositor Preference Amendment)

The National Depositor Preference Amendment set forth the priority that claims against the receivership would be paid. This section describes those priorities.

Administrative Expenses of the Receiver

Administrative expenses, the category given first priority of payment, include post-appointment obligations incurred by a receiver as part of the liquidation of an institution. It may also include certain expenses incurred before the appointment of the receiver but determined necessary to facilitate the smooth and orderly transfer of banking operations to a purchasing institution or to obtain an orderly accounting and disposition of the assets of the institution. The expenses may include, but are not limited to, payments for the institution's last payroll, guard services, data processing services, utilities, and expenses for leased facilities. Administrative expenses usually do not include expenses such as severance claims, "golden parachute" claims, and claims arising from contract repudiations. An interim final regulation (12 *C.F.R.* 360.4), promulgated in August 1993, limits the inclusion of expenses within the scope of "administrative expenses" to those that the receiver determines are "necessary and appropriate" for the orderly liquidation or other resolution of the institution.

Deposit Liability Claims

The category given second priority applies to any deposit liability of the institution, including both the insured depositors and the uninsured depositors. Insured deposit claims are claims by depositors for insured amounts of their accounts at the time of the appointment of the receiver. Because the FDIC in its corporate capacity satisfies its deposit insurance obligations and in doing so assumes the rights of the depositors to make a claim against the institution, the FDIC is almost always the largest creditor of the receivership.

Uninsured deposit claims are claims filed by depositors whose accounts exceeded the federally insured limit. These claims are paid on par with the FDIC corporate claim for the insured depositors.

Depositors with uninsured funds can be classified into one of two broad categories: (1) depositors unfamiliar with the deposit insurance rules and the financial condition of the institutions in which they deposit money, and (2) depositors who are fully aware of the deposit insurance rules and the financial condition of the institutions with whom they do business, but are willing to assume a certain level of risk to obtain higher interest rates on deposits.

Because certain aspects of the deposit insurance regulations were more complicated than others, there was confusion among certain types of depositors, namely joint and testamentary account holders. Deposit accounts associated with charity organizations also caused confusion but usually did not account for a large percentage of the uninsured.

The receiverships established in the early 1980s were unique because they had a higher proportion of uninsured funds in relation to the total number and dollar amount

Bank of Credit and Commerce International and Independence Bank

In 1992, the FDIC was affected by the highly publicized Bank of Credit and Commerce International (BCCI) scandal and the eventual closing of the bank by the Bank of England. The closing affected the treatment of Independence Bank, Encino, California, for which a receiver had been appointed on January 30, 1992. Allegations that the former managers and operators of BCCI fraudulently acquired direct or indirect ownership of Independence Bank, along with First American Bankshares, Inc. (First American), Washington, D.C., led to that closing.

Because of those alleged ties, the FDIC was concerned that a direct payoff of Independence Bank could cause a deposit panic and a run on the multi-billion-dollar First American. However, the FDIC was unable to locate an acquirer willing to assume Independence Bank's 14 branches.

Depository institutions were contacted to see if they would simply help the FDIC pay off the depositors. Finally, the FDIC secured the assistance of First Interstate Bank, Los Angeles, California. Because First Interstate was only paying the deposits on behalf of the FDIC and not assuming them, the arrangement required new legal documents that were finalized at 2:00 a.m. on January 31, 1992. The payoff of more than 33,000 accounts was to begin in 14 hours, at 4:00 p.m., that same day.

As part of an overall settlement of the BCCI matters in the United States, the Justice Department assured all U.S. government entities that were owed money by BCCI that they would be reimbursed for losses incurred as the result of the failure of BCCI. That assurance was crucial to the FDIC's decision to make all depositors whole through the payment of deposit insurance.

Depositors were paid from First Interstate branches located close to Independence Bank branches to avoid media attention that might incite panic at First American. As of year-end 1997, the depositors at Independence Bank had been paid $522 million, of which $21 million were uninsured deposits. First American remained stable and was subsequently sold to First Union Corporation, Charlotte, North Carolina, in 1993.

of accounts. Most of those deposits were either “jumbo” ($100,000) certificates of deposit or brokered deposits including brokers “chasing” the higher interest rates. In the mid-1980s, institutions began offering $98,000 certificates of deposit to prevent the accumulation of uninsured interest. After 1986, that type of uninsured interest was rarely seen.

Measuring the runoff of deposits before the appointment of a receiver may reveal the level of consumer awareness over time. The FDIC used two methods to determine uninsured deposit runoff. First, assuming that uninsured deposit runoff was to some extent correlated with total deposit runoff, total deposit balances as of the quarter before intervention were compared to total deposits as of the closing date for receiverships not yet terminated as of August 1997. From 1986 to 1994, 214 Bank Insurance Fund (BIF) institutions that had depositors with uninsured funds were closed. Deposit runoff ranged from 6.25 percent in 1989 to 17.83 percent in 1994. Higher percentages of runoff were experienced from 1986 to 1987 and again from 1993 to 1994 than between 1987 and 1993. It appears that while the number of failures was rising, depositors became more confident in the insurance system.

The RTC’s insured deposit transactions indicated a much more significant level of runoff of total deposits than did the FDIC’s, primarily because of the conservatorship program, which encouraged downsizing. During the height of RTC activity, total deposits decreased dramatically from the quarter before intervention (when a conservator was appointed) to the date of the final resolution, which could take place several months later. In 1990, the decline was 36 percent and by 1993, it had grown to 52 percent. Before the RTC was created, deposit runoff had ranged from 2 percent to 8.5 percent, a level that was much more in line with the industry average.

Among the many issues resulting from the RTC conservatorship program were those related to dealing effectively with potentially uninsured depositors who were likely to be affected by the subsequent final resolution. Although the RTC was under no legal obligation to provide notice to those depositors, the common presumption of government care prompted the RTC’s initial policy (in July 1990) to encourage the active reduction of uninsured funds during conservatorship. However, that policy was reversed in December 1990 when the reduction efforts were criticized as increasing the cost of resolution by facilitating a runoff of uninsured deposits.

A more difficult analysis was made of the reduction in actual uninsured deposits over a period of time. A study conducted by the FDIC in February 1996 compared uninsured deposit estimates prepared before a closing to the actual uninsured deposit balances as of the closing date. The estimates were completed for cost test purposes and were cursory in nature. The study suggests that preclosing estimates of uninsured deposits were approximately two to four times higher than the actual uninsured deposits from 1992 to 1994. Table I.10-1 compares the estimated uninsured deposits and the actual uninsured deposits.

The results of that study may indicate substantial depositor discipline. It is difficult to draw any firm conclusions, however, because the preliminary determination is based

Table I.10-1

Estimates of Uninsured Deposits Compared to Actual Uninsured Deposits

Year	Estimated Uninsured Deposits/ Total Deposits (%)	Actual Uninsured Deposits/ Total Deposits (%)	Actual Uninsured Deposits/Estimated Uninsured (%)
1992	3.00	1.41	47.0
1993	6.82	2.71	39.8
1994	6.75	1.74	25.8

Source: FDIC, Division of Resolutions and Receiverships.

on an estimate of the uninsured deposit amount rather than on a thorough insurance determination process that is conducted at the time of closing.

Other General or Senior Liabilities of the Institution

The category given third priority typically comprises all other claims against the receiver, including claims from vendors, suppliers, and contractors of the failed institution; claims arising from repudiated contracts; claims arising from employee obligations; tax claims; and claims asserting damages as a result of business decisions of the failed institution.

The NDP Amendment of 1993 lowered claimants in this category to a priority level below that of the deposit liabilities, thereby significantly reducing any potential recovery on these claims. However, before the NDP legislation, many banks and thrift receiverships paid general creditor claims on par with deposits.

Vendors and Suppliers. A trade creditor is any person, company, or corporation that provides goods or services to an institution before its failure. Examples of vendor claims include claims concerning advertising, appraisals, check printing, courier services, employment agencies, insurance, janitorial services, property management fees, office supplies, and utilities. Because the FDIC bridge banks and the RTC conservatorships were ongoing entities, discretion was used in determining claims against an initial receivership. In some instances, and in accordance with applicable P&A agreements, certain bills for goods and services (such as utilities, lease payments, data processing, and final payroll) were deemed essential to the ongoing operations of the receivership and therefore were paid as administrative expenses of the receiver or by the FDIC, at its discretion. Claims for less than $500 also were paid in full because of administrative ease and because the cost to process such claims would exceed that amount.

Repudiated Contracts. The FDI Act, as amended by FIRREA, gives the conservator or the receiver the power, at the conservator's or the receiver's discretion, to repudiate most contracts determined to be "burdensome," providing that the contract is not essential and the repudiation promotes the "orderly administration of the institution's affairs." The conservator or receiver must decide whether to exercise its power to repudiate within a "reasonable period" after appointment. A reasonable period for the conservator or the receiver to exercise its authority under the statute has been subject to interpretation by the courts. The liability of the conservator or receiver for a repudiated contract is limited to actual direct compensatory damages that are determined as of the date of appointment. The damages do not include punitive or exemplary damages, damages for lost profits, opportunity costs, or damages for pain and suffering.

Service Contracts. If a party entered into a contract with a failed institution and the FDIC repudiated the contract after the receiver was appointed, claims for services rendered before the appointment would be considered as allowable claims. If the party performed services after the FDIC's appointment and the FDIC accepted those services before the repudiation, the party would be paid under the administrative expense category for the services performed.

Leases. A receiver or conservator also has the authority to repudiate any burdensome lease, whether the receiver or conservator is the lessor or the lessee. If the institution were the lessee, the lessor would be entitled to a general creditor claim against the receivership for the payment of contractual rents accruing before the notice of repudiation.

Letters of Credit. In a bank closing, the FDIC typically encounters two types of letters of credit. The first is a commercial LOC that is used by a buyer of goods to ensure payment to the seller upon delivery. Those LOCs are backed by funds placed in an account by the buyer. At the time a receiver is appointed, the account, along with the LOC, usually transfers to an acquiring institution. In the case of a payoff transaction, the seller may delay delivery of the goods until the buyer obtains a substitute LOC. Money on deposit would be insured up to the deposit insurance limit.

The second type is the standby LOC, which is backed by a contingent promissory note from the bank customer to the bank, rather than being backed by actual funds on deposit, and serves as a guarantee mechanism. The issuing bank agrees to pay a third party ("the beneficiary") if the bank's customer does not honor its contract with or make payment to a third party, and the bank's advances are charged against the customer's promissory note. The FDIC historically has taken the position that a claim based on a standby letter of credit is provable against the receiver only if the contingency triggering payment under the LOC (generally, default by the bank customer) occurred before the appointment of the receiver. In such a case, the claim would be treated as a general creditor claim against the receivership or, in the case of a collateralized letter of credit, as a secured claim.

Employee Benefits. Employee benefit plans may be divided into two categories: qualified plans (under title 26 of the Internal Revenue Code) and nonqualified plans (these usually are unfunded contractual promises to provide certain retirement benefits). Examples of qualified plans include 401(k) plans, defined benefit plans, and profit-sharing plans. If a failed institution has sponsored a qualified plan, the receiver, upon appointment, becomes responsible for the plan.[5] Plan assets do not become part of the receivership estate except in rare instances for defined benefit plans for which a reversion of funds is created at the plan termination. In this instance, all plan obligations would have been satisfied before the reversion. The receiver's objective is to distribute vested benefits to plan participants and to terminate the plan in accordance with the Internal Revenue Service (IRS) and the Pension Benefit Guaranty Corporation (PBGC) requirements, if applicable.

Occasionally, a receivership has a defined benefit plan that is underfunded (the plan's assets are insufficient to pay the full benefits owed to the participants). In this situation, two options are considered. One option is a funding contribution from receivership assets that is sufficient to eliminate the deficiency in the plan. The second option is to transfer the underfunded plan to the PBGC. The decision to choose between the two options is based on the Employee Retirement Income Security Act (ERISA) of 1974 (as amended) rules concerning contributions from members of the control group to underfunded plans.

Under ERISA rules, solvent subsidiaries could be required to contribute to the plan to eliminate the underfunding. If such a situation existed, the receivership would fund the plan if sufficient assets existed. If no subsidiaries existed, the subsidiaries had minimal assets, or the subsidiaries were insolvent, the plan would be submitted to the PBGC for future administration and payment of benefits. The PBGC would then file a claim against the receivership for the liability assumed and would be entitled to dividends.

Individuals who have participated in employee stock ownership plans (ESOPs) and thus hold shares of stock in the institution probably will not recover anything from the financial institution's estate because of the low priority of shareholders' claims. When the ESOP assets consist of holding company stock, the ESOP may have some value beyond the holdings of the failed financial institution.

If a plan is nonqualified (and generally unfunded), a provable claim is satisfied on a pro rata basis in accordance with applicable claims priorities. Certain types of employee-related claims arise out of employment contracts, which may also be governed by additional regulations.

Claims for unpaid wages and salaries are usually paid as an administrative expense of the receiver. All other claims arising out of unfunded plans (such as severance and deferred compensation plans) are determined to be either allowable or disallowable, depending on whether the claim was fixed as of the date of appointment of the receiver or was contingent at that time. Fixed claims are allowable and are classified as a general creditor claim, but claims that are not fixed are disallowed.[6] As a general rule, if any rights to benefits are fixed before appointment of the receiver, the rights "survive" and the claim is

5. See *U.S. Code,* volume 29, section 1001(16).

6. Under the *Code of Federal Regulations,* volume 12, section 360.3, the governing priorities regulation for most savings associations that failed before August 10, 1993, contingent claims may be paid under priority (a)(7).

Great American Bank, FSA, and Home Federal Bank, FA

Both the RTC and FDIC occasionally had to administer an underfunded defined benefit plan. For example, the Great American Bank, FSA, San Diego, California, and the Home Federal Bank, FA, San Diego, California, receiverships were both underfunded by more than $10 million each. The employees of those institutions were very concerned about the underfunding. After an analysis of the applicable ERISA and PBGC regulations and the determination that the value of solvent subsidiaries exceeded the underfunding, the RTC determined that the receiver was obligated to infuse sufficient money to allow the plan to become fully funded so that participants would receive their full benefit.

allowable. If they have not been fixed, the rights are terminated. For severance plans, a claim is allowable upon the occurrence of a triggering event (such as termination without cause or retirement). Exceptions to this general rule have been made when the government participated in the hiring or retention of the employee. Finally, before allowing a claim for employee benefits under an employment contract, the receiver should consider whether the contract represented an "unsafe or unsound practice."

Federal, State, and Local Taxes. Claims of governmental units for unpaid taxes at the federal, state, and local level may be allowable claims against a receivership. According to section 15(b) of the FDI Act, *U.S. Code,* volume 12, section 1825(b), if there are no specific state or federal exemptions, receivers usually are not immune from the following:

- Ad valorem real property taxes;
- Federal employment taxes, including the payment and remittance of the employee's portion as well as that of the employer (receiver);
- Federal excise taxes; and
- Federal income taxes. A December 1992 interagency agreement between the IRS and the RTC, affirmed by the FDIC for RTC receiverships for which the FDIC is acting as successor receiver, provides that for RTC receiverships, upon certification that "Treasury funds" would be needed to satisfy depositor claims, the IRS will assess, but not collect, income tax, interest, and penalties from those receiverships. The FDIC, however, asserts that section 7507 of the Internal Revenue Code prohibits the IRS from assessing or collecting federal income or excise taxes from most receiverships.

Furthermore, under the IRS regulations issued pursuant to section 597 of the Internal Revenue Code, all federal financial assistance (FFA) usually is allowed to be included as ordinary income to the receiver at the time the FFA was received or accrued. The collection of the tax is deferred, however, until those receivership assets, the losses of which will offset the income, are sold. The IRS therefore attempts to recapture any tax benefits obtained by the failed bank or affiliate for pre-receivership years. In any event, the regulation under section 597 states that the IRS will not collect taxes on FFA if the burden is to be borne by the FDIC.

All valid claims for pre-resolution state taxes, and for taxes from which the receivership is not immune, are paid under the appropriate priority system or as secured claims. A conservatorship usually has no tax immunities.

Receivers typically are immune from the following:

- Personal property taxes.
- Transfer, recording, and documentary stamp taxes, which are taxes imposed on the privilege of transferring real property, recording deeds, and the like.
- Intangible property taxes, which are taxes on copyrights, patents, stock, money, and so forth.
- State income, franchise, and privilege taxes. Several states have asserted that FFA should be treated as income to the failed bank. The FDIC, however, has been successful in arguing that because the assistance is provided to the receivership, it therefore is not taxable.
- Sales, use, gross receipts, occupation, and license taxes, if those taxes are imposed by state law on the receiver. Unless state or local law provides a special exemption, contractors are not exempt from sales or use taxes for property they purchase on behalf of receivers.
- State employment taxes on employers; however, the FDIC has never asserted any immunity on behalf of receivers from withholding and remitting state income taxes.
- Other state taxes, including utility and excise taxes.
- Penalties.

Subordinated Obligations

Subordinated obligations represent the fourth priority of claims. Subordinated debtholders are allowed claims on receivership assets only after all claims with a higher priority have been satisfied. As of October 1997, of the 1,107 open receiverships, 27 had subordinated debt claims filed against them for a total of $906.3 million. Four of the 27 receiverships had paid dividends on those claims for a total of $180.7 million.

Of special interest is a practice that occurred from the mid- to the late 1980s in both commercial banks and thrifts in which junk bonds were sold in retail branches, sometimes to the elderly who thought they were buying insured certificates of deposit. Approximately 23,000 of Lincoln Savings and Loan, Irvine, California, investors bought more than $200 million in uninsured bonds issued in 1987 and 1988 by American Continental Corporation (ACC), Lincoln's parent company. The depositors charged that they intended to buy insured certificates of deposit, but were steered instead to a special desk at Lincoln's 26 retail offices where the ACC bonds were sold. After the appointment of a receiver, the RTC settled with the ACC bondholders for a lump sum payment of $21 million.

Shareholder Claims

The fifth priority of claims is shareholder claims. From 1986 to 1994, the FDIC made distributions to stockholders of 16 receiverships for a total of approximately $40 million, with the largest payment ($22.8 million) occurring in 1989 to shareholders of Franklin National Bank, New York, New York. Approximately $13 million were distributed to shareholders of Birmingham-Bloomfield Bank, Birmingham, Michigan, which was terminated in 1993. Frequently the failure of a bank can lead to the inevitable bankruptcy of the holding company. It is important to note that as the institution's shareholder, only the holding company, not the creditor of a holding company, has a claim against the assets of the failed institution.

Conclusion

The FDIC's administrative claims process is an important part of its responsibility to mitigate the economic effects of financial institution failures. From 1980 to 1994, when the number of failed institutions rose, the FDIC increasingly emphasized the equitable treatment of all creditors. The FDIC's concern about market discipline, response to legislative initiatives requiring the least costly transaction possible, and changes in payment priority methodology affected how claims were determined and ultimately paid.

Thus, the FDIC's mechanism for providing payment to uninsured depositors and other receivership creditors evolved into one that is predictable while meeting statutory requirements. This process ensures that creditors are treated in an equitable and timely manner.

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The professional liability program contributed more than $5 billion in cash recoveries to the receivership efforts.