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Not Every Promise is a Capital Commitment — Litigating Section 365(o) Claims by the FDIC

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The authors describe the Bankruptcy Code issues underlying the first-ever trial of a disputed capital commitment claim and explore how the case came to be tried not only in a federal district court, but to an advisory jury.

As part of the recent financial crisis, the banking sector faced unprecedented challenges. Between August 1, 2008 and November 14, 2012, 490 insured financial institutions failed in the U.S..[1] Although banks and thrifts themselves are not eligible to file bankruptcy, this wave of bank failures has resulted in a large number of bankruptcies of bank and thrift holding companies.

Banking failures have placed a significant burden on the Federal Deposit Insurance Corporation ("FDIC"), and the depository insurance fund it manages. In one response to this burden, the FDIC has frequently sought to recoup its losses by pursuing claims against bankrupt bank holding companies. These claims can be valued in the hundreds of millions of dollars, generally render impossible any sort of reorganization of the holding company debtor and greatly impact recoveries for other creditors.

Recently, the FDIC has pursued claims against several bank and thrift

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holding companies under sections 365(o) and 507(a)(9) of the Bankruptcy Code. As discussed below, section 365(o) generally provides that a depository institution holding company debtor must immediately cure a breach in any commitment to a federal regulator by the holding company to maintain the capital of its depository institution subsidiary. Any claim resulting from the failure to cure such a commitment has priority under section 507(a)(9) of the Bankruptcy Code. These code sections provide the FDIC and other regulatory entities with significant weapons for enforcement.[2]

In the first-ever trial of a disputed capital commitment claim under sections 365(o) and 507(a)(9), the U.S. District Court for the Northern District of Ohio on June 6, 2011, ruled against the FDIC in such a claim, finding that AmTrust Financial Corporation (now known as AmFin Financial Corporation) ("AFC") did not make a "commitment" under section 365(o) of the Bankruptcy Code to maintain the capital of its subsidiary — AmTrust Bank. The FDIC had valued the claim in excess of $500 million. The case represents one of the largest capital claims ever successfully defended by a depository institution holding company.[3]

On September 14, 2012, the U.S. Court of Appeals for the Sixth Circuit affirmed the district court's decision.[4] The Sixth Circuit agreed that AFC made no commitment for purposes of section 365(o) and found that the source of the commitment alleged by the FDIC — language in a stipulated Cease and Desist Order — was ambiguous as to AFC's supposed obligations.

The *AmFin* decision adds to a small but growing body of jurisprudence regarding section 365(o) of the Bankruptcy Code. The case is notable not only for its outcome. The *AmFin* case was the first (and, as of today, only) section 365(o) dispute litigated to decision after a trial on the merits. And, even though it was a bench trial and neither of the litigants had requested a jury, Judge Donald C. Nugent of the Northern District of Ohio empanelled an advisory jury to assist him in making his decision. Ultimately, both the advisory jury and the court independently determined that AFC did not make an enforceable commitment to maintain the capital of AmTrust Bank. Moreover, this case also represents the first 365(o) case decided at the appeals court level. As such, it is expected to have greater precedential impact than lower court decisions.

This article describes the Bankruptcy Code issues underlying the case,

and explores how the case came to be not only before Judge Nugent, but tried before an advisory jury.

SECTION 365(o), GENERALLY

One of the FDIC's most useful tools in trying to recover funds from the holding company of a failed depository institution is found in section 365(o), which provides in part that in a Chapter 11 case, the estate shall be deemed to have assumed, and must immediately cure any deficit under, any commitment by the debtor to maintain the capital of an insured depository institution.

Section 365(o) was enacted in 1990 as part of the Crime Control Act of 1990, which modified certain sections of the Bankruptcy Code, primarily in response to widespread misconduct at bank and thrift holding companies that resulted in the infamous savings and loan crisis. The Bankruptcy Code changes were intended to close off the "bankruptcy 'escape hatch' for persons whose fraud and mismanagement have jeopardized the financial health of a depository institution" by preventing them from using bankruptcy to evade capital commitments to a federally insured depository institution.[5]

Section 365(o) does not define several of the important terms used within the section, including "commitment," "maintain" or "capital." Thus, the courts have been left to determine the meaning of these terms on their own. It is reasonable to expect that future litigation under section 365(o) is likely to involve varying interpretations of these critical terms.

Despite its roots in deterring illegal behavior, courts have not limited the use of section 365(o) to situations involving holding company misconduct. Likewise, despite the placement of section 365(o) within a broader statutory regime primarily dealing with leases and executory contracts, courts have not strictly required that capital maintenance commitments be enforceable contracts. This is because any true capital maintenance contract is not likely to be an executory contract.

Pre-2010 Section 365(o) Cases

Until fairly recently, section 365(o) appeared in only a handful of reported decisions. Prior to 2010, all of the cases involved either explicit holding

company guarantees or stipulations where the holding company consented to provide such a guarantee. In 1992, the Fourth Circuit in *Resolution Trust Corp. v. Firstcorp*[6] focused on the proper administrative priority treatment of cure payments where a thrift holding company had admittedly obligated itself under a subsidiary's capital maintenance agreement to maintain capital of its thrift subsidiary.

The court held that the holding company's bankruptcy did not absolve it of its pledge to provide capital support to its subsidiary. The debtor argued, to no avail, that requiring it to immediately turn over assets to the receiver on the petition date was inconsistent with the administrative priority structure under the Bankruptcy Code. The court disagreed, and noted that immediate cure under section 365(o) is mandatory, and functions automatically, without bankruptcy court review (unlike the normal assumption and cure of executory contracts).

In 2001, the Tenth Circuit in *OTS v. Overland Park Fin. Corp.*[7] confirmed that curing a deficiency under a capital maintenance commitment pursuant to section 365(o) is a prerequisite to continuing in Chapter 11. This case involved a more informal commitment than the explicit resolution in *Firstcorp* — one that arose out of a net worth stipulation. The *Overland* court held that nowhere in section 365(o) "does Congress mention [that] the commitment must be contractual, executory, [or] formal.…"[8]

Importantly, however, the language of *Overland's* stipulation far exceeded a "mere acknowledgement" of its regulatory responsibilities, stating that the holding company would cause the net worth of its thrift subsidiary to be maintained at the mandated level and where necessary, that it would infuse sufficient additional equity capital to effect compliance with such requirement.[9]

In *Wolkowitz v. FDIC ("Imperial")*,[10] the holding company board of directors delivered a performance guarantee in conjunction with the submission of the bank's capital restoration plan. The commitment in that case could not have been clearer, stating that the holding company would "*absolutely, unconditionally and irrevocably guarantee* the performance of" the subsidiary depository institution under the terms of its capital plan and would pay the demanded sum to the subsidiary or otherwise as directed by the FDIC in immediately available funds upon receipt of such demand by the holding company.[11]

A portion of the controversy in *Imperial* surrounded whether the guar-

antee continued to be enforceable notwithstanding subsequent capital plans that were submitted by the same entities. The court found that the guaranty represented an explicit recognition by the holding company of its role in the subsidiary's reorganization process and held that the "guaranty is valid and enforceable."[12]

Following these and similar decisions, it appeared that the bankruptcy "escape hatch" targeted by lawmakers had successfully been closed, at least in cases where the commitment was not in dispute.[13] However, none of these early cases involved a commitment based on anything less than an explicit, written agreement to maintain a subsidiary's capital. The *AmFin* case and other recent decisions have drawn national attention because they do not involve similarly clear and unequivocal commitments. Rather, the FDIC has sought to expand the concept of "commitment" well beyond what any other decision has previously permitted.

The *Colonial* Case

In late 2010, the U.S. Bankruptcy Court for the Middle District of Alabama granted summary judgment to a bank holding company debtor, in *In re Colonial Bancgroup, Inc.*[14] The court found that the debtor did *not* make a commitment to a regulatory agency for purposes of section 365(o) despite contrary allegations by the FDIC.[15] The court determined that both the unambiguous language of the three documents offered by the FDIC as the source of a commitment and the intent of the parties to the contract demonstrated that the parent holding company did not make a commitment to maintain the capital of its thrift subsidiary within the meaning of section 365(o).

The court reviewed the existing body of section 365(o) jurisprudence, noting that those cases had involved commitments made as a condition of approval of an acquisition or in response to a demand for prompt corrective action. The court found it determinative that Colonial "did not make this alleged commitment as a condition of approval of the acquisition of the Bank nor in response to a prompt corrective action notification."[16]

Additionally, the court in *Colonial* found that the language at issue in each of the earlier section 365(o) cases was far more explicit than the language used by Colonial's regulators, which was broad and general, required only that the debtor "assist" the bank and did not specifically require the debtor to

make a capital infusion, in any amount, in the bank.

The court also cited testimony by a former FDIC and Federal Reserve attorney who developed much of the language used by federal regulators in cease and desist orders and similar documents, to the effect that when the Federal Reserve wanted to trigger section 365(o), it knew how to do it, and it used exact language.

THE FDIC'S SECTION 365(O) CLAIM AGAINST AFC

The *AmFin* Case

AmTrust Bank was a savings association founded in Cleveland in 1889. Its primary business consisted of residential mortgage lending. In 1977, AFC was formed as the holding company of AmTrust Bank. The *AmFin* case arose out of the Chapter 11 cases of AFC and several of its non-bank subsidiaries, which commenced on November 30, 2009. AFC and its affiliates, primarily AmTrust Bank, had experienced financial distress stemming from AmTrust Bank's exposure to residential mortgages, which was exacerbated by rapidly deteriorating worldwide financial markets in the second half of 2008. The situation culminated on December 4, 2009, when the Office of Thrift Supervision ("OTS") placed AmTrust Bank into a receivership with the FDIC acting as receiver. Contemporaneously with the inception of the receivership, the FDIC sold substantially all of the assets of AmTrust Bank to New York Community Bank.

On April 1, 2010, the FDIC filed a motion in the AFC Chapter 11 cases seeking, pursuant to section 365(o), to require AFC to immediately pay an alleged deficit under certain purported capital maintenance commitments to the OTS. The FDIC alleged a priority cure obligation under section 507(a)(9) of the Bankruptcy Code of "at least $518,564,000."

The alleged capital commitments arose from several documents developed during the period of AmTrust Bank's decline. In 2008, AFC hired Merrill Lynch to help it raise up to $500 million in new capital from external sources, which could then be contributed to AmTrust Bank to improve its capital ratios. However, AFC's efforts were ultimately unsuccessful and in July 2008, AmTrust Bank and AFC entered into a non-public, non-binding

Memorandum of Understanding ("MOU") with the OTS that required submission of a new "business plan." In July 2008, and in response to the MOU, the boards of AmTrust Bank and AFC adopted a Management Action Plan and a related Capital Management Policy.

The FDIC alleged that the first of three commitments to maintain the capital of AmTrust Bank was contained in the Capital Management Policy. The policy provided that AmTrust Bank would "manage its capital position" within the specified limits and targets, but it contained no language indicating that AFC would contribute funds to AmTrust Bank if it fell below those required capital levels. The policy also provided the respective AFC and AmTrust Bank boards of directors with flexibility in modifying the required AmTrust Bank capital levels as appropriate under the circumstances.

The second commitment alleged by the FDIC was contained in a Cease and Desist Order agreed to by AFC on November 19, 2008, which required, in part, that AFC "submit a detailed capital plan" to attain and maintain specified capital levels at AmTrust Bank.

The third and final alleged commitment was also contained in another part of the AFC Cease and Desist Order, which required the AFC board to ensure that AmTrust Bank "complies with all of the terms" of the bank's companion Cease and Desist Order.

The District Court Litigation

Although the FDIC filed its 365(o) motion in the bankruptcy court conducting AFC's Chapter 11 case, the litigation was soon moved, at the FDIC's request, to the district court pursuant to a device known as "withdrawal of the reference."

After the completion of discovery, in October 2010, AFC and the FDIC both moved for summary judgment as to liability. In January 2011, the court denied both parties' motions for summary judgment, concluding that the language in the documents that allegedly created AFC's commitment to maintain the capital of AmTrust Bank was ambiguous, and there were genuine and material questions of fact that needed to be resolved in order to determine whether any such commitment was actually made.

The court set a trial date of April 18, 2011. Upon motion of AFC, the court bifurcated the trial so that the only issue to be determined was whether

a commitment had been made. The amount of the commitment would be calculated, if necessary, in a subsequent proceeding.

Approximately one month before trial, the court advised the parties that, pursuant to Rule 39(c) of the Federal Rules of Civil Procedure, it would empanel an advisory jury with respect to whether a section 365(o) commitment had been made.[17] The fact that a jury would hear the case necessarily and dramatically changed the dynamics of how the parties prepared for trial, and how they presented their respective positions. For example, AFC and the FDIC had to develop and draft proposed *voir dire* questions, as well as research and draft proposed jury instructions. Additionally, the parties had to develop what they thought was the best way to explain their arguments to lay persons who likely would have no familiarity with the litigation (or, even more generally, the relatively complicated regulatory process for federally regulated depository institutions and their holding companies). However, the fact that the trial had been bifurcated meant that the parties could focus solely on whether a commitment had been made. The jury was not informed of their advisory role at any point during the trial.

After the parties' opening statements, the FDIC presented its case through the testimony of five witnesses. These included (i) an expert witness on capital ratios, (ii) a former AFC and AmTrust Bank board member familiar with the historical events leading up to the AFC bankruptcy, (iii) an OTS employee who had been active in regulatory activities involving AFC and AmTrust Bank and (iv) two FDIC employees.

Thereafter, the FDIC rested its case. AFC then rested its case without calling any witnesses because AFC believed that the FDIC did not meet its burden of proof. The parties proceeded through closing arguments and the case was submitted to the jury. After a day of deliberations, the jury unanimously determined that the FDIC had not proven by a preponderance of the evidence that AFC made an enforceable commitment to maintain the capital of AmTrust Bank. Both AFC and the FDIC submitted proposed findings and fact and conclusions of law for consideration by the district judge. On June 6, 2011, the court entered its Memorandum Opinion finding in favor of AFC. The court held that the FDIC had "failed to present sufficient evidence to establish that either the OTS or… AFC understood or intended for the documents at issue to impose or create a commitment by AFC to maintain

the capital of the Bank."[18]

On June 20, 2011 the FDIC filed its notice of appeal to the Sixth Circuit Court of Appeals. Following oral argument on May 31, 2012, a three judge panel from the Sixth Circuit issued a unanimous decision on September 14, 2012 affirming the district court's findings. After noting that only the FDIC presented witnesses in the district court trial, the court concluded that "the FDIC's witnesses did not help its case." Rather, these witnesses undermined its fundamental litigation position that the Cease and Desist Order was unambiguous. The court explicitly found that testimony from two of the witnesses, "actually tended to support AFC's case," including AFC's reading of the Cease and Desist Order. According to the Sixth Circuit, the witness testimony and various documents and other evidence examined at trial suggested that neither the OTS nor AFC understood the Cease and Desist Order to create a capital maintenance obligation for AFC. As a result, the district court's decision in favor of AFC was affirmed.

CONCLUSION

Perhaps the most unique aspect of the AFC litigation was that while no party asked for a jury trial, twelve lay persons nevertheless ended up deciding whether AFC had made a commitment of over $500 million to the OTS. Judge Nugent then independently reached the same conclusion as the advisory jury.

Some of the lessons learned from this case are unique to the procedural posture and specific facts, while others can be applied almost universally to other litigation:

- *Depositions*: This case hinged on whether AFC and OTS understood that a commitment under section 365(o) had been made. All of the individuals who purportedly had knowledge about that issue were deposed during the discovery process. Thus, there were no surprises at trial with regard to the substance of any testimony. In addition, the deposition testimony exposed a significant dilemma for the FDIC. The FDIC, who was not a party to the alleged commitment, was faced with the fact that both parties to the alleged commitment — AFC and the OTS — denied the

existence of a commitment. In the end, the FDIC could not overcome this fact.

- *Not Assuming the OTS and the FDIC Agreed on the Commitment Issue*: Before filing a proof of claim, the FDIC never asked anyone at the OTS whether a capital maintenance commitment had actually been made. AFC went to the OTS seeking information, which ultimately led to the deposition of Daniel McKee — regional director of the OTS central region (the region that encompassed AmTrust Bank). Mr. McKee's deposition was a critical part of the trial, and because he was the only OTS witness to testify, the fact that he did not identify a capital commitment was significant.
- *Bifurcate if Appropriate*: The trial revolved around one issue — the existence of a commitment. The complexity of the proceedings would have increased exponentially if the parties had to present testimony and evidence on the amount of the purported capital deficit. Additionally, the length of the trial would have easily doubled had that issue been presented to the jury. Parties should keep in mind the ability to ask for bifurcation. The argument becomes even more compelling if a jury is involved because courts are cognizant of not keeping jurors longer than necessary. Bifurcation also minimizes the risk of confusion among the issues, and it helps prevent the tendency of a fact finder to "split the baby" and give each party partial relief.
- *Realize that Presenting to a Jury is Different than Presenting to a Judge*: Jury trials are a rarity in bankruptcy cases. Changing from a bench trial to a jury trial made AFC realize that rather than focusing on legal doctrines and complicated statutory interpretations, practical and common sense arguments were more important. The point here is that a jury will do its best to get to the right decision. They are not, however, attorneys or judges. While cases like this will almost always involve some complicated facts or law, the focus should be on streamlining and simplifying the issues.
- *Know Who Has the Burden*: In what was not an easy call, AFC rested its case without putting on a single witness. That was because the FDIC — as the movant — had the burden of proving each of the elements of its 356(o) claim by a preponderance of the evidence. AFC argued that the

FDIC failed to meet its burden, and the jury and Judge Nugent agreed. The lesson here is that lawyers should not feel compelled to put on witnesses just because there is a story to be told. If the party with the burden has failed, then perhaps the presentation of a defense should be limited or, as in this case, even eliminated.

NOTES

[1] Source: Failed Bank List (Since October 1, 2000), available at http://www.fdic.gov/bank/individual/failed/banklist.html (last visited November 14, 2012).

[2] Notably, a regulator could seek to convert a Chapter 11 case to a case under Chapter 7 in which the debtor has failed to immediately cure a 507(a)(9) claim, if funds to cure the commitment are not immediately available.

[3] *In re AmFin Corp.*, No. 1:10-MC-25 (N.D. Ohio June 10, 2011).

[4] *FDIC v. AmTrust Fin. Corp. (In re AmTrust Fin. Corp.)*, 2012 U.S. App. LEXIS 19316 (6th Cir. Ohio 2012).

[5] *See* H.R. Rep. No. 681(I), 101st Cong., 2d Sess. 179 (1990), *reprinted in* 1990 U.S.C.C.A.N. 6472, 6585.

[6] *In re Firstcorp*, 973 F.2d 243, 248 (4th Cir. 1992).

[7] *In re Overland Park Fin. Corp.,* 236 F.3d 1246 (10th Cir. 2001).

[8] *Id.* at 1252.

[9] *Id.* at 1249.

[10] *Wolkowitz v. FDIC* (*In re Imperial Credit Indus.)*, 527 F.3d 959, 963 (9th Cir. 2008).

[11] *Id.* at 964 (emphasis added).

[12] *Id.* at 966.

[13] See *OTS v. Overland Park Fin. Corp. (In re Overland Park Fin. Corp.)*, 300 BR 534 (D. Kan. 2003) and *Franklin Sav. Corp. v. OTS*, 303 BR 488 (D. Kan. 2004).

[14] 436 B.R. 713 (Bankr. M.D. Ala. 2010).

[15] The FDIC filed two related motions: one to require the debtor, under section 365(o), to immediately cure the deficit under an alleged capital commitment to maintain the capital of its subsidiary bank and a second for leave of the automatic stay to partially collect the alleged deficit by exercising setoff rights against the debtor's balances in certain deposit accounts.

[16] *Id.* at 733.

[17] Rule 39(c) provides, in relevant part, that "[i]n all actions not triable of right by a jury the court upon motion or of its own initiative may try any issue with an advisory jury…." FED. R. CIV. P. 39(c). The decision to utilize an advisory jury is within the discretion of the trial judge.

[18] *FDIC v. Amfin Fin. Corp.*, 2011 U.S. Dist. LEXIS 60297 at *35 (N.D. Ohio June 6, 2011)