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Dealing with Lender Liability Claims on Loans Purchased from the FDIC

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Banks working through a loan portfolio purchased from the FDIC encounter a range of borrower and guarantor claims and defenses that range from the annoying to the large and frightening. This article discusses some of the ways such a bank can defeat those claims and ensure that the FDIC honors its loss share agreement.

Using D'Oench, Duhme and Section 1823(e) to kill lender liability claims
Statutory and case law has developed to provide a line of defenses for banks that acquire loans out of FDIC receivership. The defense apply to borrower or guarantor claims or defenses such as an alleged promise of a favorable loan modification or an allegation that the original bank tricked the borrowers or guarantors into signing the loan or guaranty documents. A 1942 Supreme Court decision, D'Oench, Duhme & Co. Inc. v. FDIC, recognized a Congressional policy of protecting the FDIC from secret agreements that could undermine the value of an acquired bank's assets. That decision was essentially codified in Section 13(e) of the Federal Deposit Insurance Act (12 U.S.C. §1823(e)), although courts do not agree on the extent to which the D'Oench, Duhme line of cases are preempted (replaced) by Section 1823(e) or remain at least part of the law.

Over time, many courts have relied on D'Oench, Duhme and/or section 1823(e) to invalidate a wide range of borrower and guarantor defenses and counterclaims as "secret agreements" or simply agreements that are unenforceable under the statute. The Supreme Court held in Langley v. FDIC that oral misrepresentations by bank personnel constituted a "secret agreement," regardless of whether they were fraudulent or whether the FDIC had knowledge of the defense through a lawsuit filed prior to the FDIC's acquisition of the loan. Other courts have disallowed counterclaims and defenses based on duties or obligations not specifically articulated in the underlying loan records, such as purported breaches of fiduciary duties, implied covenants of good faith, negligence, fraud and third-party agreements. In short, most lender liability claims cannot survive D'Oench, Duhme / Section 1823(e).

The acquiring bank and its counsel must cooperate closely with the FDIC in asserting the doctrine. The FDIC carefully reviews each request to use D'Oench / Section 1823(e) to ensure that the use of the doctrine is consistent with existing case law from the U.S. Supreme Court and the various U.S. Circuit Courts of Appeal as well as FDIC's internal policies. The FDIC is extremely sensitive to requests where the fact pattern suggests that available state law would provide the desired remedy without subjecting the doctrine to the rulings of a state court judiciary that. The FDIC believes that many state courts are simply not equipped to evaluate and properly rule on the doctrine and is very careful to protect against an adverse ruling that could negatively impact the evolution of FDIC's case law.

Federal holder in due course doctrine
In some cases, an acquiring bank may be able to characterize itself as a holder in due course (a

"Holder") and thereby avoid liability from attacks based on underlying events such as being induced to sign a guaranty through false assurances by the bank.

Usually, an acquiring bank cannot prove Holder status under state law because the bank usually cannot prove that it and the FDIC did not have actual or constructive notice of the borrower's claim. However, sometimes the theory works in federal court, although the doctrine has been adopted and applied inconsistently across the federal circuit courts. For example, the Supreme Court held in O'Melveny & Meyers v. FDIC that it would not create new federal common law to supplement the detailed FDIC statute. Other federal courts have concluded that federal holder in due course doctrine is not new common law and thus may be enforced as pre-existing federal common law. Accordingly, an acquiring bank should consider making this argument to eliminate any claims surviving Section 1823 if the doctrine is available in the bank's federal judicial circuit.

Shifting responsibility to the FDIC

Another solution to a lender liability issue is to shift primary responsibility to the FDIC, i.e., to show that the acquiring bank did not assume liability for the problem because it was retained by the FDIC. The relevant language in the FDIC's purchase and assumption agreements has changed over time. Thus, the approach and arguments to use must be tailored to the exact language in an acquiring bank's agreement.

Keeping the FDIC happy

The acquiring bank must be careful not to give the FDIC an excuse to avoid its loss share obligations. The leading excuse is the bank's failure to honor its agreement to treat loss share loans the same as its other loans. The FDIC's examination team will examine samples of loans covered by the loss share and compare them to samples of loans not covered by the loss share to determine whether the bank is applies its loan administration processes, credit risk management policies (including its loan review and credit grading policies) and loss recognition and charge-off standards consistently to both categories of loans.

The FDIC knows that it is frequently hard to tell if a bank's practices are being applied consistently because the two types of loans are often quite different. The loss share loans are frequently lower quality and involve unique issues and challenges. However, the acquiring bank should steer clear of doing things like applying a higher discount rate to appraisals on loss share assets, both because there is little logical basis for doing so and because it invites criticism from the examiners.

What should a bank do about the host of other decisions that must be made in the course of a workout or enforcement? While banks would like to get FDIC approval for every expense advance and other tactical decision, this is not practical or even desirable to the FDIC. (Of course, bulk sales of loans must be pre-approved by the FDIC and banks should closely observe restrictions such as making additional loan advances on loss share credits.) Banks should instead focus on documenting that their decisions are in line with policy or in line with regulatory guidance (e.g., the regulators' policy statement on prudent commercial real estate loan workouts) and the advice of counsel.

What about accelerating the chargeoff of loss share assets, particularly as the loss share period nears its end? The bank's examiners are particularly alert to this tendency or temptation for acquiring banks. However, it may well be the case that loss share loans are quite properly being charged off at a higher rate than the bank's pre-acquisition portfolio. If the bank's policies and procedures dictate a chargeoff is proper, the bank should not hesitate to do so. Similarly, if a commercial loan modification is the best solution, the bank should proceed with the modification even if the extended term takes the loan past the loss share expiration date. In December 2011, the FDIC changed its policy to allow loss share banks to extend the term of commercial loans past the date of shared loss coverage without affecting coverage for that loan.

As a practical matter, banks have discretion to not pursue recoveries against guarantors or other sources of recovery such as title companies or other potentially liable parties. Historically, the

FDIC has had difficulty in monitoring pursuit of such recoveries and in challenging the bank's decision. Usually there is little or no clear evidence that pursuing such recoveries will be cost-effective.

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