If Your Bank Dies Is Your Deal Dead?

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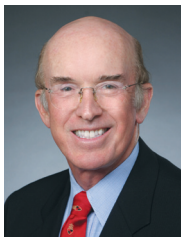
by Leslie A. Nicholson and Alex M. Phipps



Les Nicholson
Senior Counsel, Litigation
+1.202.663.8704
les.nicholson@pillsburylaw.com

Alex M. Phipps, III
Associate, Real Estate
+1.202.663.8403
alex.phipps@pillsburylaw.com

Leslie A. Nicholson is a Senior Counsel in the firm's Washington, DC office. He has been a Member of ACREL since 1984 and is the immediate past General Counsel of the Government Services Administration of the United States and former Executive Vice President and General Counsel of Chevy Chase Bank, now Capital One Bank.

Alex M. Phipps is an Associate in the firm's Washington, DC Real Estate practice.

Although current economic conditions in the banking industry appear to have improved marginally from the depths of the recent recession, 157 banks failed last year, up from the 140 banks that failed in 2009, and far exceeding the 25 that failed in 2008.[1] Others remain deeply troubled, burdened with delinquent assets, and on the brink of failure. The number of banks on the Federal Deposit Insurance Corporation's (FDIC) "problem" list was the largest since 1993, with 860 banks, approximately 10% of the nation's total, classified by the FDIC as the banks most likely to fail next.[2]

This article deals with the following questions facing borrowers: What happens to a bank when it fails? Is your bank likely to fail? And most importantly, if your bank fails, will your loans, commitments, letters of credit and other financial arrangements survive?

What Happens To A Bank When It Fails?

When banks large or small reach the point of insolvency, the FDIC, acting in concert with the chartering authority of the bank, closes the institution and moves the failed institution quickly into receivership. The FDIC's involvement begins before any public acknowledgement of the troubled institution's status. The behind-the-scenes negotiations by the FDIC and the bank's management are highly confidential.[3] The FDIC gathers information on the various assets and liabilities of the institution and then selects a plan for its resolution based on the "least cost analysis" of the potential options.[4] "Least Cost" means the least costly alternative to the deposit insurance fund; thus, potential bids for acquisition are weighed against the cost of total liquidation and payoff of the bank's insured deposits.[5] Once the FDIC makes a determination as to what form of resolution will be pursued, the chartering authority and the FDIC act quickly to close and take control of the bank, and transfer or liquidate the assets.

In practice, the process of bank closure and appointment of the FDIC as receiver traditionally takes place on a Friday night with no practical interruption for the bank's deposit customers. After this takeover, the bank usually reopens under new ownership on the next scheduled business day, and the assets are transferred to the successful bidder. The FDIC publicly announces the name of the institution that has assumed the deposits, instructs borrowers where to direct their payments, and provides answers to other general questions about the closed institution through press releases and information posted on

its website, along with links to general information about the closing process.[6] However, the troubled assets, claims, and obligations of the failed bank not assumed by a successful bidder remain with the FDIC to be resolved through its powers as receiver.

A relatively recent example was the closing of Corus Bank in Chicago, one of the most active condominium construction lenders to fail. Corus' difficulties were well known and highly publicized, as the bank had built its reputation on aggressive financing of condominium projects, amassing a portfolio of assets based heavily on deals that faltered during the real estate bust.[7] On September 11, 2009 (a Friday) the Office of the Comptroller of the Currency closed Corus Bank, and the FDIC was appointed as receiver.[8] In the press release announcing the closure, the FDIC simultaneously announced that MB Financial Bank would be assuming all deposits of Corus Bank and that all Corus Bank branches would open as branches of MB Financial Bank on the next scheduled business day.[9] However, MB Financial Bank assumed only $3 billion of Corus' $7 billion in assets, leaving the FDIC to dispose of the remainder in "private placement transactions."[10]

Is Your Bank Likely to Fail?

If recent history is any guide, the answer to this question depends to a greater degree on your bank's size and the kinds of loans it makes and to a lesser degree on its location. Despite the public perception that larger lenders were more vulnerable during the economic downturn, small banks with limited geographic reach failed in far higher numbers than larger commercial banks.[11] Most of these failed regional and community banks had became overly engaged in real estate and construction lending. For all the apparent complexity of the current crisis, residential and commercial real estate loans represent the largest share of troubled and delinquent assets on lenders' books. One study found that 94% of failed banks since 2008 had either residential or commercial real estate as the bank's largest category of delinquent loans.[12] Lenders who specialized in construction lending and commercial real estate present some of the most common examples of failed banks when the recent failures are tallied. The average delinquency rate for the banks that failed in 2008 was a whopping 17% for construction loans, as compared to an average rate of 5.5% for all loans nationwide.[13] These numbers mean that even as the fortunes of larger institutions improve, smaller lenders will remain vulnerable, requiring vigilance on the part of commercial real estate borrowers.

Indeed, the vast majority of failed banks since 2007 have been smaller community banks, which tended to focus on specific areas of lending. The largest group of bank failures consists of banks with assets in the $100 million to $500 million range.[14] This group of banks also had the most concentrated range of commercial real estate and construction loans, as opposed to the commercial bank category at large[15] These loans, particularly construction loans, have proven troublesome in areas like Florida and Georgia, where overbuilding has produced a crash in real estate values.[16] Georgia, Florida, Illinois, and California have had the most failed banks since 2007, respectively.[17] This period saw the largest decrease in U.S. house prices since the Great Depression, and the impact fell disproportionately on smaller lenders who specialized in construction lending.[18] However, even larger institutions, like Washington Mutual Bank, failed under the burdens of underperforming assets.

Although the banking industry in the U.S. is far more consolidated than it was during former crises, such as the Savings & Loan Crisis of the late 1980s, failure rates still reflect the economic conditions of the geographic areas where banks are located.[19] Not surprisingly, these effects fall most heavily on smaller banks, the same banks that tended to invest heavily in construction and commercial real estate loans as a percentage of their assets. Even so, in the final analysis, the stability of your bank depends far more on the diversification and quality of its asset classes than its location, as shown by the failure of Washington Mutual.[20]

If Your Bank Fails, Will Your Loans Survive?

As explained below, the loans and other financial agreements entered into by a failed financial institution will be either transferred to another entity or retained by the FDIC in its capacity as receiver. Loans and other financial arrangements retained by the FDIC are likely to be repudiated or disaffirmed, particularly if they involve future credit extensions. Since a transfer is the outcome

sought by the FDIC, it will be discussed first.

Loans Transferred by the FDIC Remain in Full Force and Effect

If your loan is well secured and performing, the failure of your bank may be a non-event or even an improvement for you. However, the transfer of your loan will both require and offer the opportunity for the formation of new relationships, and should be so viewed from a business perspective. If your loan is not current or if the failed bank had been "extending and pretending," then the transfer of your loan may well have worsened your situation. Forbearances and other informal accommodations that were in place with your prior lender may now be challenged. Potential claims against your prior lender that played a role in preventing a foreclosure may no longer be available to play that role since transfers by the FDIC are structured so that all claims against the failed institution remain with the FDIC.

Borrowers May be Barred from Asserting Certain Defenses as a Matter of Law Against Entities That Acquired Their Loans from the FDIC

The federal common law doctrine of *D'Oench, Duhme* was created by the U.S. Supreme Court in 1942 to protect the FDIC in its role as receiver against defenses or claims based on an "agreement" not properly reflected in the official records of the failed institution.[21] The *D'Oench, Duhme* doctrine enables the FDIC to disaffirm such agreements so the FDIC can wrap up the assets of a failed bank quickly and accurately by relying only on the books of the failed bank. Congress has passed various statutes, beginning in 1950 with the Federal Deposit Insurance Act, reflecting the concepts embodied in the D'Oench, Duhme doctrine as it was developed by the courts over the years.[22] These statutory provisions are now codified in 12 U.S.C. § 1823(e), often referred to as the statutory counterpart of *D'Oench, Duhme*.

As articulated by Congress, an agreement cannot be enforced against the FDIC that would diminish or defeat the FDIC's interest in an asset, unless that agreement:

- Exists in writing;
- Was executed contemporaneously by the depository institution and the person claiming an adverse interest when the depository institution received the asset;
- Was approved by the board or loan committee of the depository institution and recorded in its minutes; and
- Was maintained since the time of its execution as an official record of the depository institution.[23]

These protections are also available under a separate statutory provision to "bridge banks," which are banks created by the FDIC to take over the deposits and certain other liabilities and assets of a failed financial institution.[24] Although the statutory protections set forth in Section 1823(e) are not expressly available to other purchasers of loans made by a failed financial institution, courts have routinely used the *D'Oench, Duhme* doctrine and its statutory counterpart, somewhat interchangeably, over the years to defeat borrowers' attempts to raise defenses against parties to whom their loans had been transferred by the FDIC.[25]

However, the validity of the common law *D'Oench, Duhme* doctrine, but not its statutory counterpart, is now in question. After the U. S. Supreme Court issued decisions adverse to the FDIC in *O'Melveny & Myers v. FDIC*[26] and *Atherton v. FDIC*[27], employing a rationale inconsistent with its continued validity, the *D'Oench, Duhme* doctrine was rejected by the Courts of Appeals for the D.C., Third, Eighth, and Ninth Circuits.[28] The Courts of Appeals for the Fourth and Eleventh Circuits viewed the situation differently and have expressly reaffirmed the doctrine.[29] The Courts of Appeals for the First, Second, Fifth, Sixth, Seventh, and Tenth Circuits have not yet spoken.

In essence, the four circuit courts that have rejected the doctrine did so on the grounds that (1) the comprehensive federal statutory scheme set forth in FIRREA was intended by Congress to supplant the federal common law *D'Oench, Duhme* doctrine and (2) the Supreme Court's decisions in the *O'Melveny & Myers* and *Atherton* cases had implicitly overruled the decision creating the *D'Oench, Duhme* doctrine and the appropriateness of using federal common law in such a manner.[30] Whereas, the two circuit courts that have reaffirmed the validity of the *D'Oench, Duhme* doctrine did so on the grounds that (1) a Supreme Court case remains good law unless and until expressly overruled by the Supreme Court and (2) "Congress did not intend FIRREA to displace the D'Oench doctrine, but rather intended to continue the harmonious,

forty-year coexistence of the statute and the D'Oench doctrine."[31]

While academically interesting, the continued validity of the D'Oench, Duhme doctrine is probably immaterial to borrowers whose loans have been sold by the FDIC because the doctrine's statutory counterpart remains alive and well.[32]

Assignees of the FDIC Are Allowed to Invoke the Protections of Section 1823(e)

As noted above, courts have uniformly allowed assignees of loans to avail themselves of the statutory protections provided by Section 1823(e), even though Congress did not include assignees of the FDIC in the statutory language.[33] The extension of the statutory protection to entities other than the FDIC where such entities are assignees, other than a bridge bank, has been justified, as a matter of law, because an assignee acquires the same rights possessed by its assignor and, as a matter of policy, because allowing borrowers to assert oral agreements or agreements not satisfying the statutory criteria against third party assignees would diminish the value of the assets that the FDIC seeks to sell and undermine the deposit insurance system.[34]

Be that as it may, if these courts are correct, then why did Congress believe it was necessary to specifically provide Section 1823(e) protections by statute to bridge banks?

Partially Funded Loans and Other Open Credit Arrangements Retained by the FDIC will be Repudiated

The FDIC's power, as receiver, to repudiate any contract deemed burdensome in order to promote the orderly administration of the institution's affairs is almost always exercised with regard to: (1) loan commitments; (2) lines of credit; (3) letters of credit; (4) construction loans; and (5) all other partially funded loans. The FDIC has publicly acknowledged that it generally concludes that it is not in the interest of the receiver to continue the bank's lending operations.[35] If your bank fails, you should move immediately to replace your commitments and lines of credit, and seek alternative funding for your construction loans and any other partially funded loans.

Obtaining replacement funding for construction loans will be particularly difficult because the project under construction is the security for the outstanding balance on the construction loan, and is therefore not available to secure a new lender's interest. The best alternative is to work with the FDIC to continue funding while you find a new lender and work out an agreement to enable the new lender to step in to replace the failed lender.[36]

The FDIC may continue to fund draw requests if it is clear such expenditures are vital to protect the value of the security for the outstanding balance owed under the loan. Remember, in dealing with the FDIC, it is under no obligation to do anything to advance or protect the interests of borrowers. Its statutory responsibilities are to protect receivership creditors, which in practice means insured depositors.[37] Consequently, efforts to obtain funding from the FDIC should be focused on protecting the collateral for the failed bank's loans and reducing the damages caused by delay and repudiations.

Decisions to repudiate contracts retained by the FDIC are often delayed; because the FDIC is required only to repudiate "within a reasonable period of time following appointment,"[38] courts have allowed periods of several months before repudiation.[39] Damages from repudiation are statutorily limited to actual direct compensatory damages, determined as of the date of the receiver's appointment.[40] These damages do not include punitive or exemplary damages, damages for lost profits or opportunities, or damages for pain and suffering.[42] Filing a claim for damages in accordance with the procedures and schedules prescribed by the receivership is the only relief initially available to a claimant whose contract has been repudiated. The courts lack subject matter jurisdiction over the FDIC's actions as receiver; thus, even injunctions are unavailable.

A claim for repudiation damages, limited as it may be, faces an additional, usually fatal, hurdle: there are often little or no funds available to pay such unsecured claims. As noted by the FDIC, since "most liabilities of a failed institution are deposit liabilities, the practical effect of depositor preference in most situations is to eliminate any recovery for unsecured general creditors."[43] Moreover, damages for repudiation claims, as finally determined, are in seventh place on the priority list for such unsecured creditors, behind claims for: (1) administrative expenses of the receiver; (2) the association's administrative

expenses during the thirty (30) days before the receivership; (3) wages, salaries, and benefits of certain retained employees; (4) wages, salaries, and benefits of certain non-retained employees; (5) unpaid taxes to governmental units other than federal income taxes; and (6) withdrawal accounts and all other claims which had accrued and became unconditionally fixed on or before the appointment of the receiver.[44]

No unsecured claim may be paid unless all claims with a higher priority have been paid, or provision made for such payment. [45] In practice, this generally means that the rare payment of a repudiation claim is significantly delayed.

The FDIC Has the Power to Disaffirm Any Claims Based on an Agreement Not Satisfying Section 1823(e)

Under the literal language of Section 1823(e), the FDIC is empowered to disaffirm a multitude of claims, many of which are vulnerable through no fault of the borrower. The harshness of such situations coupled with its two Supreme Court losses, discussed above, and the rulings by the four circuit courts invalidating the *D'Oench, Duhme* doctrine caused the FDIC to issue a "Statement of Policy Regarding Federal Common Law and Statutory Provisions Protecting FDIC, as Receiver or Corporate Liquidator, Against Unrecorded Agreements or Arrangements of a Depository Institution Prior to Receivership" ("Policy Statement"). [46] It is also likely that the Policy Statement was issued to reduce the likelihood of the Supreme Court being called upon to resolve the split among circuit courts over the continuing validity of the *D'Oench, Duhme* doctrine. In its Policy Statement, the FDIC committed not to use common law *D'Oench, Duhme* defenses against agreements or arrangements arising after the effective date of FIRREA (August 9, 1989), and not to assert the provisions of Section 1823(e) against agreements or arrangements arising before the effective date of FIRREA. Neither of these commitments is, however, particularly meaningful now given the passage of time.

What continues to be meaningful is the remainder of the Policy Statement. There the FDIC identified certain situations where authorization from the FDIC's Washington headquarters is required for the use of 12 U.S.C. § 1823(e). Some of these situations apply to borrowers. For example, Washington approval is required:

- Where the borrower took all steps to document the agreement, including attempting to have the appropriate document executed by the failed bank's officers, as well as recorded in the bank's minutes, and through some failure by the institution, the agreement does not satisfy the statutory requirements;[47]
- Where the agreement is reflected in various documents in the bank's books and records rather than in one single document satisfying the requirements of Section 1823(e); and
- Whenever the imposition of contemporaneous requirement of Section 1823(e) would invalidate a "good faith workout or loan modification agreement" because such agreements are almost never created contemporaneously with the bank's acquisition of the asset.[48]

The Policy Statement contains other situations applicable to borrowers and should be carefully reviewed if your loan is being challenged by the FDIC under Section 1823(e). Because these are guidelines issued by the FDIC itself, there are no guarantees that the agency will continue to adhere to these procedures; nor should they be counted upon as exceptions to the statutory requirements of 12 U.S.C. § 1823(e). Moreover, these restraints are not applicable to entities that have acquired loans from the FDIC and borrowers should expect such entities to assert the protections provided by Section 1823(e) against defenses raised by the borrowers.

Concluding Thoughts

Whether or not your bank is a community or regional bank located in an area of economic distress, you should monitor its financial condition for the same reasons that a lender tracks a borrower's financial condition. If your bank is publicly traded, review its public filings and financial statements carefully. Also, review the Call Reports filed quarterly by your bank with the FDIC at www.FDIC.gov. Among other things, a bank's Call Report shows its income and expenses, including charge-offs and write-downs, along with its assets and liabilities, including detailed breakdowns of its loan portfolio. However, you will not be able to find out if your bank is on the FDIC's list of problem banks. The identity of those banks is closely

guarded to prevent the listing from becoming a self-fulfilling prophecy of failure.

In addition to publicly available information about a bank's financial condition, there are services which evaluate the condition of banks on a regular basis. For example, see the IDC Financial Quarterly Report, www.idcfp.com, which is a written report published after the close of each quarter. The cost is about $500 per report. There is also an online service offered by Financial Information Services which provides many custom templates to analyze and to evaluate your bank's financial condition. www.fedfis.com. This service costs about $1,500 per quarter. The decision to purchase one of these or similar services will depend on the level of your confidence or concern about the condition of your bank.

Obviously, if you believe that your bank's financial condition is weak or worsening, you should consider moving your loans and other financial arrangements to a stronger bank. If this is neither possible nor practicable, as is likely to be the case with existing loans, then carefully review the documentation of any loans or other financial arrangements that cannot be moved. As discussed above, any agreements you have with your existing lender, particularly modifications, interest reductions, extensions or other workout type arrangements, must be properly executed and reflected in the appropriate official records of the bank, such as board or loan committee minutes. Otherwise, they can and probably will be challenged by a subsequent holder of your loan, whether the holder is the FDIC, an assuming or bridge bank, or some third party purchaser of your loan. By making every reasonable effort to be a diligent borrower as defined by the FDIC in its Policy Statement, you protect yourself against the FDIC and enhance your rights against any transferee which acquires your loan from the FDIC if your bank fails.

And, if your bank fails, you must act quickly to establish and maintain communication with the responsible FDIC officials and with the entity to which your loan has been transferred. Fully funded loans may well survive your bank's failure, even if they are underwater. The price paid by the transferee will reflect the loan's economic reality and there may even be opportunities to restructure. However, loans that are seriously underwater or delinquent may have been purchased with the intent of foreclosing to acquire collateral worth more than the amount paid for the loan. In such cases, prompt, effective communications are your best and maybe your only hope, other than a bankruptcy filing if available.

Endnotes

1 FDIC.gov, Historical Statistics on Banking, Failures and Assistance Transactions: Number of Institutions, http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30.

2 Ross Waldrop, Federal Deposit Insurance Corporation, Quarterly Banking Profile: Third Quarter 2010 at 4 (Sept. 30, 2010), available at http://www2.fdic.gov/qbp/2010sep/qbp.pdf.

3 Federal Deposit Insurance Corporation, The Resolutions Handbook, Chapter Two: The Resolutions Process at 6, N. 6. (Apr. 2, 2003), available at http://www.fdic.gov/bank/historical/reshandbook/ch2procs.pdf.

4 Id. at 13.

5 Id.

6 FDIC.gov, Failed Bank List, http://www.fdic.gov/bank/individual/failed/banklist.html.

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9 Id.

10 Id.

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12 Id.

13 Paul Wiseman, The Worst Bet in Real Estate Today: Construction Loans, *USA Today*, Aug. 20, 2010 available at http://www.usatoday.com/money/industries/banking/2010-08-17-banks17_CV_N.htm.

14 Diane Vazza and Cameron Miller, Credit Trends: An Increasing Number Of Failed Small U.S. Banks Is Taking A Toll On Local Economies, *Standard and Poor's*, Sept. 20, 2010, http://www.standardandpoors.com/products-services/articles/en/us/?assetID=1245225768756.

[15] Id.

[16] Id.

[17] Id.

[18] Auduchon and Wheelock, supra note 11.

[19] Id. at 412.

[20] Id. at 405.

[21] *D'Oench, Duhme & Co., Inc. v. Fed. Deposit Ins. Corp.*, 315 U.S. 447, 457 (1942). For decades this policy was upheld virtually without question. *See, e.g. Fed. Savings and Loan Ins. Corp. v. Gemini Mgmt.*, 921 F.2d 241, 244 (9th Cir., 1990) ("In 1942, the Supreme Court articulated a rule designed to implement a "federal policy to protect [the FDIC] and the public funds which it administers against misrepresentations as to the securities or other assets in the portfolios of the banks which [the FDIC] insures or to which it makes loans." *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447, 457 (1942). This policy is as sound today as it was in 1942, if not more so.")

[22] Federal Deposit Insurance Act, Pub. L. No 797, § 13(e), 64 Stat. 889 (1950).

[23] 12 U.S.C. § 1823(e).

[24] 12 U.S.C. § 1821(n)(4)(I).

[25] *See, e.g., Fed. Fin. Co. v. Hall*, 108 F.3d 46, 49 (4th Cir. 1997) ("We and several other Courts of Appeals have held that the *D'Oench, Duhme* rule protects the FDIC's assignees as well, even though § 1823(e) is silent with regard to assignees.").

[26] 512 U.S. 79 (1994).

[27] 519 U.S. 231 (1997).

[28] *Murphy v. FDIC*, 61 F.3d 34 (D.C. Cir. 1995); *FDIC v. Deglau*, 207 F.3d 153 (3rd Cir. 2000); *DiVall Ins. Income Fund LP v. Boatmen's First Nat. Bank of Kansas City*, 69 F.3d 1398 (8th Cir. 1995); *Ledo Fin. Corp. v. Summers*, 122 F.3d 825 (9th Cir. 1997).

[29] *Young v. Fed. Deposit Ins. Corp.*, 103 F.3d 1180 (4th Cir. 1997); *Motorcity of Jacksonville v. Southeast Bank, N.A.*, 120 F.3d 1140 (11th Cir. 1997).

[30] *Deglau*, 207 F.3d at 171. It should be noted that *Murphy* and *DiVall* predate *Atherton*, thus prefacing their analysis on *O'Melveny & Myers* alone.

[31] *Motorcity,* 120 F.3d at 1144.

[32] See the "Statement of Policy Regarding Federal Common Law and Statutory Provisions Protecting FDIC, as Receiver or Corporate Liquidator, Against Unrecorded Agreements or Arrangements of a Depository Institution Prior to Receivership," *infra* note 46, regarding the FDIC's decision not to apply common law protections post-FIRREA.

[33] *Fed. Fin. Co. v. Hall*, 108 F.3d at 49. Very recent cases have shown that courts continue to extend this protection without question, even in the 8th Circuit, where *D'Oench, Duhme* is presumably dead. See *Outsource Serv. Mgmt. v. Ginsburg*, No. 08-5897 (D. Minn. Dec. 7, 2010) (Mem.) (applying section 1823(e) to bar defendant's affirmative defenses)

[34] 12 U.S.C. § 1821(n)(4)(I).

[35] FDIC.gov, Borrower's Guide to an FDIC Insured Bank Failure http://www.fdic.gov/bank/individual/failed/borrowers/index.html.

[36] Id.

[37] 12 U.S.C. § 1823(c)(4) requires the FDIC to resolve an institution in the least costly manner. These requirements are articulated in the FDIC's regulations at 12 C.F.R. § 360.1, "Least-Cost Resolution." On the other hand, bridge banks have been instructed by Congress to continue to honor commitments made by the failed bank, and not to interrupt secured loans transferred to the bridge bank if they are performing under the original instrument, so as to "prevent unnecessary hardship or losses to the customers of any insured depository institution in default with respect to which a bridge depository institution is chartered, especially creditworthy farmers, small businesses, and households." 12 U.S.C. § 1821(n)(3)(B).

[38] 12 U.S.C. § 1821(e)(2).

[39] 1-20 Banks and Thrifts: Govt. Enforcement & Receivership § 20.02

[40] 12 U.S.C. § 1821(e)(3)(A).

[41] Id. at § 1821(e)(3)(B).

[42] Id. at § 1821(j).

[43] Resolution Handbook Chapter 7—The FDIC's Role As Receiver, at 72, available at http://www.fdic.gov /bank/historical/reshandbook/ch7recvr.pdf.

[44] 12 C.F.R. § 360.1 ("Priorities").

[45] Id.

[46] 62 Fed. Reg. 5984 (Feb. 10, 1997).

[47] 62 Fed. Reg. 5986.

[48] Id. At 5988.

Pillsbury Winthrop Shaw Pittman LLP