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# Aspects, Analysis Of Debt Guarantees By The FDIC

Law360, New York (December 04, 2008) -- The Board of Directors of the Federal Deposit Insurance Corporation (FDIC) recently approved the final version of the rule governing the FDIC's Temporary Liquidity Guarantee Program (TLGP). Most aspects of the final rule became effective on Nov. 21, 2008.[1]

The FDIC adopted the TLGP in response to recent disruptions in the credit markets, which have restricted the credit available to banks and their holding companies. The program seeks to decrease the cost of funding for banks and thereby encourage lending to consumers and businesses.

The FDIC has created two main programs within the TLGP towards fulfilling this goal. First, the FDIC now guaranties many types of non-interest bearing deposit transaction accounts under the TLGP. The FDIC also provides guarantees of newly issued senior unsecured debt of banks and bank holding companies under the TLGP.

This article focuses on the debt guarantee program initiated by the FDIC, and explores some ways in which these guarantees differ from full, unconditional guarantees of payment with which potential beneficiaries under the TLGP's debt guarantee program may otherwise be familiar. The article also analyzes how the bankruptcy of a debt issuer may condition the FDIC's performance under a TLGP guarantee.

*The Debt Guarantee Program*

Under the TLGP, the FDIC's guaranties "newly issued senior unsecured debt" of an entity which is, as of Dec. 5, 2008, an insured depository institution, a U.S. bank holding company (assuming it controls at least one subsidiary that is a chartered and operating insured depository institution), a U.S. savings and loan holding company (assuming it controls at least one subsidiary that is a chartered and operating insured depository institution), or an affiliate of an insured depository institution (subject to case-by-base approval of the FDIC), and which has not opted out of the program. (Entities that first become eligible for the program after Dec. 5, 2008 may become participants if the FDIC permits.) 12 CFR §370.2(a) and (g).

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To qualify for the guarantee program, debt issued by a participating entity must be identified as guaranteed under the TLGP and have been issued by a participating entity on or after Oct. 14, 2008 and before June 30, 2009.

The debt must be evidenced by a written agreement or trade confirmation, have a specified and fixed principal amount, be noncontingent and contain no "embedded options, forwards, swaps or other derivatives." The debt may not be subordinated to any other liability by its terms. After Dec. 5, 2008, the guaranteed debt must also have a stated maturity of more than thirty (30) days. 12 CFR §§370.2(e) and (f) and 370.5(h).

A debt guarantee under the TLGP will expire on the earliest of the debt's maturity, June 30, 2012, or the date upon which the participating entity in question opts out of the debt guarantee program. 12 CFR §370.3(d).

The FDIC does not expect that many qualified entities will opt out of the debt guarantee program. In any case, a decision to opt out must be made by Dec. 5, 2008. 12 CFR §370.5(c). (Given the broad entity participation anticipated and the latest guarantee expiration date of June 30, 2012, there will likely be a significant amount of guaranteed debt of participating entities maturing at or just prior to the end of the second quarter of 2012.)

The TLGP imposes limits on the amount of guaranteed debt that a participating entity may issue. 12 CFR §370.3(b). However, it appears that otherwise qualified debt which is issued by a participating entity in excess of its debt guarantee limit and identified as being guaranteed would still benefit from the FDIC's program, as the rule provides for such debt issuer to pay additional assessments to the FDIC for the debt guarantee under these circumstances. 12 CFR §§370.3(b)(7) and 370.6(e).

*Payments on Guaranteed Debt of Participating Entities in Default*

Under the rule, "[t]he FDIC's obligation to pay holders of FDIC-guaranteed debt issued by a participating entity shall arise upon the uncured failure of such entity to make a timely payment of principal or interest as required under the debt instrument (a 'payment default')." 12 CFR §370.12(b)(1).

Upon a payment default, the FDIC fulfills its guarantee obligation by "making scheduled payments of principal and interest pursuant to the terms of the debt instrument through maturity (without regard to default or penalty provisions)." 12 CFR §370.12(b)(2).

After June 30, 2012, the FDIC may choose to make a final payment of all outstanding principal and interest due under a guaranteed debt instrument, even if the instrument's maturity is beyond that date. The FDIC would not be liable for any "prepayment penalty" in that case. 12 CFR §370.12(b)(2).

Regardless of a payment default's occurrence, the FDIC will have no liability under its guarantee if proper written demand, including a properly-authorized proof of claim, is

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not submitted by or on behalf of the debtholder within sixty (60) days of payment default. A failure to meet this deadline will "deprive the holder of the FDIC-guaranteed debt of all further rights and remedies with respect to the guarantee claim." 12 CFR §370.12(b)(3)(iv).

The FDIC also requires that any demand be accompanied by an assignment of the debtholder's right, title and interest in the FDIC-guaranteed debt to the FDIC, as well as a transfer to the FDIC of the debtholder's claim in any insolvency proceeding. "This assignment shall include the right of the FDIC to receive any and all distributions on the debt from the proceeds of the receivership or bankruptcy estate." 12 CFR §370.12(b)(3)(i) and (ii).

Beyond this assignment, the rule also provides that "the FDIC will be subrogated to the rights of any debtholder against the issuer, including in respect of any insolvency proceeding, to the extent of the payments made under the guarantee." 12 CFR §370.12(b)(4).[2]

*Consideration 1: The FDIC Guarantee Provides No Default Interest, Reimbursement Of Costs Or Expenses, Or Any Yield Protection Or Other Prepayment Or Similar Fees*

The rule specifies that the FDIC's obligation to pay on a properly-submitted demand includes only the scheduled principal and interest payments. 12 CFR §370.12(b)(2). The rule expressly excludes payment based on "default or penalty provisions." Id.

The FDIC, thus, will certainly not pay any default interest. The omission of any reference to costs or expenses of administration or the like indicates that the FDIC will not be liable for these amounts either, even if they are part of the primary obligor's liability under the debt instrument.

Debtholders should also not count on any yield protection payment or early payment fees (charges that might otherwise assure them of their expected return on the loaned funds) for debt with a maturity beyond the middle of 2012, particularly because the FDIC maintains the right to prepay the principal and interest then due under a debt instrument at any time after June 30, 2012, without funding any "prepayment penalty." Id.

*Consideration 2: The FDIC Guarantee Prohibits The Debtholder From Collecting Any More Than The Amounts Paid By The FDIC Under The Guarantee*

Submission of a timely demand and claim under a TLGP debt guarantee will trigger a payment of scheduled principal and non-default interest payments, but it will not provide the debtholder with, among other things, payment of any costs or expenses, or any default interest.

Despite these omissions from the FDIC's guarantee coverage, the debtholder appears to retain no ability to recover these amounts directly from the primary obligor. In fact, the rule requires that a party submitting a demand for guarantee payment assign its entire

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right, title and interest in the FDIC-guaranteed debt to the FDIC. 12 CFR §370.12(b)(3)(i).

Similarly, if the debt issuer is subject to an insolvency proceeding, the FDIC must be assigned the entire "debtholder's claim," granting to the FDIC the right "to receive any and all distributions on the debt from proceeds of the receivership or bankruptcy estate." Id.

Thus, the FDIC requires the transfer not only of the portion of the debt that is actually paid or to be paid by the FDIC (i.e., principal and non-default interest), but also of any other liabilities of the obligor under the debt instrument in question.

As a consequence, none of these other amounts will ever be available to the debtholder, whether from the FDIC or the debt issuer, even if the FDIC were to recoup from the debt issuer the amounts that that the FDIC will have funded under its guarantee of the debt issuer's obligations.

*Consideration 3: The Trigger Of The FDIC's Payment Obligation Under The Rule Likely Requires The Debtholder To Wait For Any Cure Period To Expire*

The final version of the rule states that the FDIC's obligation to pay on a guarantee would arise upon "the uncured failure" of the participating entity to make a "timely payment" as required by the debt instrument. 12 CFR §§370.3(a) and 370.12(b)(1).

While a reference simply to a failure of payment could have been interpreted as triggering the right of a debtholder to submit a claim under the FDIC's guarantee simply upon a debt issuer's missed payment or the declaration of a payment default, the specification that the failure must be "uncured" appears to require that any opportunity for the participating entity to cure a payment default must have lapsed before the FDIC could become liable on its guarantee.

Thus, for example, if the underlying debt instrument required the debtholder to give the participating entity notice of the failed payment and provide it a period of time in which to cure, the rule indicates that such notice would need to have been given and the cure period would need to have lapsed without payment before the FDIC could face liability under its guarantee.

*Consideration 4: The Requirement Of An "Uncured Failure" Of Payment May Cause Delay Of The FDIC's Guarantee Liability And Payment If The Participating Entity Enters Bankruptcy*

The possibility of a bankruptcy filing by the issuer of debt which is guaranteed under the TLGP raises at least one potential issue: what happens if the underlying debt instrument requires notice from the debtholder to the obligor who has missed a payment in order to begin a prescribed cure period under the loan agreement, and the participating entity files for bankruptcy before the holder issues this notice?

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The lack of notice from the debtholder to the debt issuer before the bankruptcy filing would mean that the cure period would not yet have begun upon the bankruptcy's commencement. Once the bankruptcy begins, the automatic stay in bankruptcy would likely prohibit notice by the debtholder to the debt issuer initiating the cure period (or, if the notice were sent anyway, would likely make it void or voidable). 11 U.S.C. § 362(a).

From the debt issuer's perspective, therefore, the cure period would not have begun and could not begin (absent relief from the automatic stay in bankruptcy). In this scenario, the FDIC would likely argue (and an adjudicator could certainly conclude) that, despite any demand which the debtholder might make under a guarantee, the FDIC would not be liable to pay any amount because there would have been no uncured failure of payment – in fact, the payment cure period would have not have even begun.

While this interpretation would prove frustrating for a lender, it certainly represents a logical reading of the word "uncured" in the rule.

This interpretation would also be consistent with the Bankruptcy Code's provision allowing a Chapter 11 debtor to cure a default under pre-bankruptcy debt and reinstate the underlying loan agreement as part of a Chapter 11 plan, even if the creditor opposes the reinstatement and the loan agreement or applicable non-bankruptcy law would otherwise have allowed the creditor to demand or receive accelerated payment outside of bankruptcy. 11 U.S.C §1124(2).

In light of the rule's wording and the Bankruptcy Code's provision granting a Chapter 11 debtor this right to cure a debt default, an adjudicator could easily interpret the rule as supporting the preservation of a debtor's right to reinstate a defaulted loan agreement in the context of a bankruptcy plan, especially where the cure period under the debt instrument in question had not begun as of the bankruptcy filing.

For these reasons, lenders seeking to enjoy the benefits of a debt guarantee under the TLGP should consider with particular care the notice and cure features of their loan documents, and carefully monitor the administration of the debt in this regard if the issuer fails to make a timely payment or otherwise defaults on its loan obligations.

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[1] The interim rule governing the TLGP was published on October 29, 2008. The FDIC later made changes to the interim rule. The amended interim rule was published on Nov. 7, 2008. The final rule, as discussed in this article, was published in the Federal Register on Nov. 26, 2008. It appears in Volume 73, Number 229 of the Federal Register, 73 FR 72244. The final rule is codified as 12 CFR Part 370. All citations to the Code of Federal Regulations (the CFR) in this article are to the final rule.

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[2] In light of the compulsory assignment of the debt instrument to the FDIC, described above, it is unclear why the rule also provides the FDIC with subrogation rights, since the original debtholder appears to have no further unassigned rights in the debt. One explanation is that the FDIC has adopted a “belt and suspenders” approach to avoid potential problems if, for example, the validity of the assignment to the FDIC were to be challenged.

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