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Caution: Know the Law Governing Insolvent Bank Tenants

Federal Deposit Insurance Act may determine lease rejection.

NEWSCOM

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AS MOST LANDLORDS and real estate professionals know, the Bankruptcy Code gives debtors the right to reject certain contracts, including leases, entered into prior to the debtors' bankruptcy.[1] Most landlords are far less familiar with the Federal Deposit Insurance Act (as amended, the "FDIA"), the statute governing bank insolvencies.

In the wake of recent bank failures[2] and the continuing credit crisis, many landlords are inquiring about their rights with respect to troubled bank tenants and considering how new leases with banks should be structured. While the FDIA is similar to the Bankruptcy Code in certain respects, there are key differences between the treatment of repudiated (or, in Bankruptcy Code parlance, "rejected") leases under the two schemes.

FDIA Background

When a federally insured bank becomes insolvent, the FDIC (the Federal Deposit Insurance Company) is appointed as a conservator or receiver of the bank pursuant to the FDIA.[3] In that role, the FDIC has the right to repudiate leases to which the failed bank is a party.[4] As a result, real property leases under which a bank is a lessee, whether for office space on Park Avenue, bank branches on Main Street or street-corner ATMs, can be rejected.

The FDIA governs the insolvency of only FDIC-insured depository institutions.[5] Non-depository institutions, holding companies and non-bank affiliates are subject to the Bankruptcy Code.[6]

The FDIA was amended by Congress in 1989 by the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) to address "monumental problems involved with the unprecedented costs of the savings and loan crisis."[7] This amendment strengthened the powers of the FDIC as conservator or receiver in significant ways by, among other things, giving it the power to repudiate contracts, including real property leases.

The FDIA vs. the Bankruptcy Code

The right to repudiate. Like debtors under the Bankruptcy Code, the conservator or receiver has broad discretion under the FDIA to repudiate leases based on its business judgment, which is rarely challenged successfully in court.

However, the FDIA and the Bankruptcy Code diverge with respect to the timing of lease repudiation. Under the Bankruptcy Code, a debtor must assume or reject a nonresidential real property lease within 120 days after the filing of the bankruptcy petition.[8] Upon a motion by the debtor "for cause" this period can be extended by 90 days, leaving the debtor with a maximum of 210 days to make a decision.[9]

In contrast to the specified periods set forth in the Bankruptcy Code, the FDIA does not set a fixed time period within which a lease must be repudiated. Under the FDIA, a receiver or conservator must repudiate a lease within a "reasonable period."[10] Courts have consistently held that what constitutes a "reasonable period" is a fact-sensitive determination, which should be made in light of the particular circumstances.

For instance, in one case, a court found that the receiver's repudiation of a lease eight months after the receiver's appointment was reasonable because the parties had been negotiating modifications to the lease for seven months.[11] Fortunately for landlords, courts do not interpret "reasonable period" as giving the FDIC an unlimited time to decide whether to repudiate or assume a lease. Prior drafts of FIRREA, which called for a 90-day period, have been found by certain courts to be useful in determining reasonableness.[12]

While in most cases a receiver is appointed directly, occasionally a conservatorship is used as a prelude to receivership. In those cases, further uncertainty results with respect to the length of the repudiation window because

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the conservator and the receiver each have an independent right of repudiation.[13] The result is that if a conservator is appointed and does not repudiate the lease, and a receiver is later appointed, the receiver's "reasonable period" for repudiation starts on the day of its appointment. This independent right, together with the fact-specific determination as to the reasonableness of the period, means that failed banks generally have significantly more time to determine which leases to repudiate than debtors under the Bankruptcy Code.

Landlords' damage claims. Another important distinction between the Bankruptcy Code and the FDIA is the treatment of landlord damage claims if a lease is rejected.

Under the Bankruptcy Code, a lessor generally has an unsecured pre-petition claim for rent due through the date of the filing of the bankruptcy petition.[14] A lessor's claim for rent from the date of the bankruptcy petition through the date of rejection is given administrative priority under the Code.[15] Unlike unsecured pre-petition claims, administrative-priority claims in a Chapter 11 case must be paid in full in order to confirm a plan of reorganization, so claims for such rent are usually paid in full.[16]

A lessor also may be entitled to prospective rejection damages in the form of an additional unsecured pre-petition claim for its provable contract damages arising from rejection. However, such damages cannot exceed an amount equal to the sum of (a) rent for the greater of one year or 15 percent (not to exceed three years) of the remaining term of the lease following the earlier of the date of the bankruptcy filing and the date the tenant vacates and (b) unpaid rent due as of such date.[17]

By contrast, pursuant to the FDIA, a lessor is entitled to "unpaid rent" up to the date of the appointment of the conservator or receiver, and "contractual rent" accrued from the date of appointment to the date of repudiation of the lease.[18] Courts have defined "unpaid rent" to include any payments due at the time of the appointment of the conservator or receiver, including rent payments and other obligations, such as lease obligations to keep the premises in good condition and repair.[19] The scope of "contractual rent" is more narrow and refers only to those sums that are "fixed, regular, periodic charges."[20]

This distinction may result in the landlord not being paid in full for charges that accrue after insolvency and prior to repudiation. However, in most circumstances, a landlord's claim for rent (including any amounts due under a tenant improvement allowance) is a general unsecured claim under the FDIA.

After the payment of secured claims, payments for unsecured claims are distributed in the following priority:

(1) administrative expenses,
(2) deposit liabilities,
(3) general creditor claims,
(4) subordinated creditor claims, and
(5) shareholder claims.[21]

All claims in a given class must be paid before any payments can be distributed to a lower class. After the payment of administrative expenses and deposit liabilities, there are rarely funds left for payment to the remaining classes of claimants. Thus, under the FDIA, a landlord is unlikely to receive any payments for its claim.

Additionally, the FDIA does not appear to permit repudiation damages to a lessor based on lost future rent.[22] That is, a lessor has no claim under any acceleration or penalty clause in a lease and cannot recover any future rents, even if the tenant pledged security for payment of rent.[23]

In most circumstances, a landlord should prefer to lease to an entity other than a federally insured depository institution; because the FDIA does not govern bank holding companies or non-bank affiliates, landlords with prospective bank tenants may want to consider leasing to, or requiring a guaranty from, a credit-worthy non-bank affiliate.

The FDIA's apparent disregard for damages based on future rent may result in significant losses for a landlord. For example, if an insolvent bank is the tenant under a 15-year lease and a conservator or receiver repudiates the lease only five years into its term, the landlord only has a claim for the unpaid rent accrued until the time of the appointment of the conservator or receiver and contractual rent accrued up to the repudiation, even if the landlord is unable to relet the property, is forced to relet it at a discount or is forced to incur expenses refitting the space in order to relet the property.

Conclusions

With the current state of the economy, the possibility of more bank failures is a reality. In most circumstances, a landlord should prefer to lease to an entity other than a federally insured depository institution.

Because the FDIA does not govern bank holding companies or non-bank affiliates, landlords with prospective bank tenants may want to consider leasing to a non-bank affiliate or requiring a guaranty from a credit-worthy non-bank affiliate.[24] Ultimately, this decision will depend on the capital structure of the bank and the location of the assets therein. However, all things being equal, leasing to non-banks will give landlords an opportunity for greater claims and a better chance of payment of those claims in the event of the tenant's insolvency.

1. 11 U.S.C. §§101 et seq.; see 11 U.S.C. §365.
2. As of Dec. 15, 2008, 25 banks failed in 2008, compared to only three in 2007. Since 1989, 1,514 banks have become insolvent. See FDIC Failed Bank List, http://www.fdic.gov/bank/individual/failed/banklist.html (last visited Dec. 15, 2008) and FDIC Bank and Thrift Failure Report (1989-2008).
3. State-chartered banks may also be governed by the FDIA if state law authorizes the state banking regulator to appoint the FDIC as receiver of a state bank. Under §1821(c)(1) of the FDIA, the FDIC may accept such appointment. 12 U.S.C. §1821(c)(1). Additionally, the FDIC may appoint itself as conservator or receiver of an FDIC-insured state depository institution if certain conditions are met. 12 U.S.C. §1821(c)(4) & (5).
4. 12 U.S.C. §1821(e)(1).
5. Federal Deposit Insurance Act, 12 U.S.C. §1811 et seq.
6. 11 U.S.C. §109. See also, generally, Eileen Fox, "Basics of Banking Law, Commercial Law and Practice Court Handbook Series," PLI Order No. A4-4352, 42 (October 1991); Robert R. Bliss and George G. Kaufman, "U.S. Corporate and Bank Insolvency Regimes: A Comparison and Evaluation," 2 Va. L. & Bus. Rev. 143, 145 (Spring 2007); Cassandra Jones Harvard, "Reconciling the Dormant Conflict: Crafting a Banking Exception to the Fraudulent Conveyance Provision of the Bankruptcy Code for Bank Holding Company Asset Transfer," 75 Denv. U. L. Rev. 81, fn. 270 (1997).
7. *Resolution Trust Corp. v. Cedarminn Bldg. Ltd. P'ship*, 956 F.2d 1446, 1456 (quoting H.R.Rep. No. 101-54(I), 101st Cong., 1st Sess. (1989), reprinted in 1989 U.S.C.C.A.N. 86, 104).
8. 11 U.S.C. §365(d)(4).
9. Id.
10. 12 U.S.C. §1821(e)(2).
11. *Hawke Associates v. City Federal Sav. Bank*, 787 F. Supp. 423 (D.N.J. 1991).
12. See, e.g., *New Hampshire Associated Limited Partnership v. FDIC*, 978 F.Supp. 650, 654 (D.Md.1997); *The Rechler P'ship v. RTC*, 1990 U.S. Dist. LEXIS 18714, *25 (D.N.J. Sept. 4, 1990); *Burnett Plaza Associates v. NCNB Texas National Bank*, 1994 U.S. Dist. LEXIS 7781, *52 (N.D.Tex. May 12, 1994).
13. See *Cedarminn*, 956 F.2d at 1450; *Ave. of Americas Associates v. Resolution Trust Corp.*, 22 F.3d 494, 497 (2d Cir. 1994); *Resolution Trust Corp. v. United Trust Fund Inc.*, 57 F.3d 1025, 1033 (11th Cir. 1995); *Franklin Financial v. Resolution Trust Corp.*, 53 F.3d 268, 272 (9th Cir 1995).
14. 11 U.S.C §§365(g) and 502(g); See also *Adelphia Business Solutions Inc. v. Abnos*, 482 F.3d 602, 606 (2d Cir. 2007).
15. See *Adelphia*, 482 at 606; *In re Chateaugay Corp.*, 10 F.3d 944, 955 (2d Cir. 1993).
16. However, there can be administrative insolvency.
17. 11 U.S.C. §502(b)(6).
18. 12 U.S.C. §§1821(e)(4)(B)(i) and 1821(e)(4)(B)(ii).
19. See, e.g., *First Bank Nat. Ass' v. FDIC*, 79 F.3d 362, 368 (3d Cir. 1996).
20. See, e.g., id. at 368-369.
21. 12 U.S.C. §1821(d)(11)(A).
22. The FDIA on its face states that claims for future rent are not permitted. Few courts have addressed this issue, but all have agreed with the plain reading of the statute. See, e.g., *Resolution Trust Corp. v. Ford Motor Credit Corp.*, 30 Fed. 1384, 1387 (11th Cir. 1994); *Lawson v. FDIC*, 3 F.3d 11, 16 (1st Cir. 1993); *Unisys Finance Corp. v. Resolution Trust Corp.*, 979 F.2d 609, 610-12 (7th Cir. 1992)); *New Hampshire*, 978 F. Supp. at 653; *United Trust Fund Inc.*, 57 F.3d at 1036 (11th Cir. 1995).
23. 12 U.S.C. §1821(e)(4)(B). See also, Id.
24. If a landlord leases to a non-bank affiliate, the bank generally cannot guaranty the lease due to regulatory restrictions. In such an instance, the landlord may consider requiring a guaranty from a second non-bank affiliate.