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# FRAUDULENT TRANSFER REMEDIES AVAILABLE TO BANK HOLDING COMPANY BANKRUPTCY TRUSTEES AFTER GRAMM-LEACH-BLILEY

JAMES D. HIGGASON, JR.

*The author examines the scope of the limitations imposed by a provision in the Gramm-Leach-Bliley Act that shields the FDIC from certain preference and fraudulent transfer actions and discusses claims and arguments that still can be used in the post-GLBA environment.*

In the late 1980s and early 1990s the collapse of the real estate and energy markets caused scores of banks across the United States to fail, and the federal fund used to insure bank deposits was nearly exhausted. In 1989, in the midst of this turmoil, bank regulators<sup>1</sup> conducted onsite examinations of one of the largest banks in New England, the Bank of New England, N.A. (“BNENA”), and discovered catastrophic asset quality and control problems that caused its allowance for loan and lease losses to be dramatically understated and severely limited the bank’s ability to identify and manage risk going forward. Although BNENA’s prognosis for survival was bleak at best, the regulators nevertheless encouraged its parent company, Bank of New England Corporation (“BNEC”), to raise additional capital in a \$250 million debt offering and downstream the bulk of the proceeds to BNENA. The regulators also instructed BNEC to downstream other valuable assets, like, for example, its information services subsidiaries and a mortgage servicing

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company, into BNENA. After most of BNEC's non-bank assets were transferred to BNENA, BNENA and other banks owned by BNEC (collectively the "BNEC Banks"), were declared insolvent and their assets, including the downstreamed assets, were placed into FDIC receiverships. The next business day, with hundreds of millions of dollars in debt and most of its assets in the coffers of the FDIC, BNEC filed for Chapter 7 bankruptcy protection.

The events that unfolded in connection with the failure of the BNEC system demonstrate the tension that invariably exists between a bank holding company and bank regulators when the holding company and its subsidiary bank(s) are in danger of failing. Bank regulators have an interest in shifting the risk of loss away from the bank insurance fund and on to the holding company and often will cause the holding company to transfer assets to the troubled bank even if it is in no position to act as a source of strength.<sup>2</sup> Directors and officers of a bank holding company in or near insolvency, on the other hand, have an obligation to protect the interests of creditors, and in most instances those interests would be better served by preserving assets for distribution in the event of bankruptcy, rather than funneling them to an entity destined for seizure by the FDIC.

In the BNEC bankruptcy, the Chapter 7 bankruptcy trustee (the "Trustee") brought "actual intent" and "constructive intent" fraudulent transfer claims against the FDIC and against the banks that acquired the transferred assets from the FDIC (the "FDIC Litigation").<sup>3</sup> The actual intent claim sought to avoid transfers pursuant to Bankruptcy Code Section 548(a)(1)(A) on the grounds that they were made with "actual intent to hinder, delay, or defraud" BNEC creditors. The constructive intent claim alleged that transfers should be avoided pursuant to Bankruptcy Code Section 548(a)(1)(B) because BNEC was insolvent at the time the transfers were made and because BNEC did not receive reasonably equivalent value in exchange for the transfers. The Trustee ultimately recovered \$140 million from the FDIC.

The financial industry is now experiencing the type of major down cycle it has not seen for almost two decades, and the problems are accelerating. After several years with no significant bank failures, the failure rate increased dramatically in 2008, when 25 banks with \$371.9 billion in assets failed.<sup>4</sup> In 2009, 140 banks failed.<sup>5</sup> There were 552 banks on the FDIC's troubled bank watch list at the end of the third quarter of 2009, up from 416 the previous

quarter, scores of additional banks are predicted to fail, and the bank insurance fund has been reported to have a negative balance.<sup>6</sup> Bank regulators will thus have an incentive to shift the risk of loss for bank failures away from the bank insurance fund by encouraging bank holding companies to downstream assets to failing banks. Bankruptcy trustees and debtors-in-possession of bankrupt holding companies will want to explore if such transfers occurred prior to bankruptcy and whether there are grounds to avoid them.

The regulatory landscape has, however, shifted since the BNEC Trustee brought the FDIC Litigation. Soon after the FDIC Litigation concluded, a provision was inserted in the Gramm-Leach-Bliley Act (“GLBA” or the “Act”) that shields the FDIC from certain preference and fraudulent transfer actions.<sup>7</sup> This article examines the scope of the limitations imposed by the Act and discusses claims and arguments which were effective for the BNEC Trustee in the FDIC Litigation that still can be used in the post-GLBA environment.

## THE SCOPE OF GLBA SECTION 730

Section 730 of the Act is designed to “in certain instances, protect[] the federal banking agencies and the deposit insurance funds from claims brought by the bankruptcy trustee of a depository institution holding company...for the return of capital infusions.”<sup>8</sup> Specifically, GLBA Section 730 states:

No person may bring a claim against any Federal banking agency (including in its capacity as conservator or receiver) for the return of assets of an affiliate or controlling shareholder of the insured depository institution transferred to, or for the benefit of, an insured depository institution by such affiliate or controlling shareholder of the insured depository institution, or a claim against such Federal banking agency for monetary damages or other legal or equitable relief in connection with such transfer, if at the time of the transfer (A) the insured depository is subject to any direction issued in writing by a Federal banking agency to increase its capital....<sup>9</sup>

## **TRUSTEES CAN STILL SUE THE FDIC TO RECOVER TRANSFERS MADE WITH THE INTENT TO BENEFIT THE FDIC AT THE EXPENSE OF A BANK HOLDING COMPANY'S CREDITORS**

Section 730 does not protect the FDIC from all fraudulent transfer actions. Indeed, the definition section of Section 730 states that a “claim” barred by the provision “does *not* include any claim based on *actual intent to hinder, delay, or defraud* pursuant to such a fraudulent transfer or conveyance law.”<sup>10</sup>

Although no case has yet considered the issue, the plain language of the statute and its legislative history indicate that the provision was designed to protect and encourage good faith efforts on behalf of regulators and bank holding companies to recapitalize distressed banks. Section 730 clearly does not give the regulators *carte blanche* to use their substantial leverage to intentionally loot a holding company for the benefit of the FDIC. On the contrary, if regulators realize that a bank holding company is likely to fail, they are courting risk by causing it to downstream assets to a failing subsidiary bank, and ultimately the FDIC, because GLBA Section 730 specifically authorizes actual intent fraudulent transfer claims against the FDIC.

## **REGULATOR CONTROL MAY GIVE RISE TO ACTUAL INTENT FRAUDULENT TRANSFER CLAIMS**

As a general rule, to prevail on an actual intent fraudulent transfer claim a plaintiff must prove fraudulent intent on the part of the debtor/transferor.<sup>11</sup> There is, however, an exception to this rule when the transferor is dominated or controlled by the transferee or the entity for whose benefit the transfer is made.<sup>12</sup> In such circumstances the transferee’s intent can be imputed to the transferor if the plaintiff can show: (1) the controlling transferee had the intent to hinder, delay, or defraud the transferor’s creditors; (2) the transferee was in a position to dominate or control; and (3) the domination and control was exercised in connection with the disposition of the property in question.<sup>13</sup>

Bank regulators have a number of means available to exert control over distressed banks and bank holding companies, pursuant to which they can cause the downstreaming of holding company assets and shift the risk of loss

of a bank failure to the holding company. The most commonly employed methods are (1) the Federal Reserve's so-called "Source-of-Strength Doctrine," which provides that a bank holding company is obliged to "use available resources to provide adequate capital funds to its subsidiary during periods of financial stress;"<sup>14</sup> (2) "Prompt Corrective Action" provisions, which authorize and limit certain steps to be taken to recapitalize undercapitalized banks;<sup>15</sup> and (3) formal and informal OCC agreements and orders, including Memoranda of Understanding, Formal Agreements, Consent Orders, and Cease and Desist Orders.<sup>16</sup> Such provisions give the regulators extraordinary power over troubled banks and bank holding companies to compel asset transfers and other actions, and the level of control increases as their financial condition deteriorates.<sup>17</sup>

In the FDIC Litigation, the Trustee alleged that the FDIC, the OCC, and the Federal Reserve were all aware of the desperate financial condition of BNEC and BNENA, that they controlled all significant activities of BNEC and the BNEC Banks from 1989 until they failed in January 1991, and that as a result of that control they caused BNEC to transfer assets to BNENA with knowledge that such transfers would benefit the FDIC. To the extent such a scenario is repeated in the current environment the FDIC may once again be subjecting itself to exposure to an actual intent fraudulent conveyance claim.

## **GLBA SECTION 730 DOES NOT APPLY UNTIL THE BANK IS SUBJECT TO A WRITTEN DIRECTION TO RAISE CAPITAL**

GLBA Section 730 provides that constructive intent fraudulent transfer and preference claims are barred only if the transferee bank is "subject to any direction issued by a Federal bank agency to increase capital."<sup>18</sup> The circumstances surrounding the issuance (or non-issuance) of such a directive are critical. If a regulator never issues a directive or issues it after the transfers in question, then Section 730's protections are never triggered and there are no limitations on bringing any avoidance action against the FDIC.<sup>19</sup> If, however, it is issued at a time when the bank holding company is in or near insolvency and the bank is doomed for FDIC receivership, then what the directive gives with one hand it may take away with the other. In other words, while it may shield the FDIC from a constructive intent fraudulent transfer

action, the directive also may support an actual intent claim, which is specifically authorized by Section 730, by providing strong evidence of domination and control necessary to impute the FDIC's intent to the transferor.<sup>20</sup>

## **CLAIMS AGAINST SUBSEQUENT TRANSFEREES**

The FDIC is not in the business of operating banks, so in most instances an FDIC receivership sells a failed bank's assets as soon as possible. It is unclear whether the protection afforded the FDIC by the Act will extend to private parties that purchase fraudulently transferred property from an FDIC receivership. Section 730 only prohibits suits against "any federal banking agency" and contains no reference to or explicit prohibition of avoidance suits against such an agency's subsequent transferee(s).<sup>21</sup> Plaintiffs may argue that if such protection were meant to extend to non-governmental entities the statute would have said as much and claim that avoidance actions against them are justified based on cases which provide that a bankruptcy trustee may recover from subsequent transferees of avoidable transfers pursuant to Bankruptcy Code Section 550(a)(2) without first suing the initial and/or intermediate transferees.<sup>22</sup> The purchasers of assets from the FDIC receivership may counter that the protection given the FDIC from avoidance actions should extend to the FDIC's transferees.<sup>23</sup>

## **CONCLUSION**

In the current economic down cycle bank regulators will have an interest in shifting the risk of loss of bank failures away from the FDIC bank insurance fund by using their substantial leverage to cause bank holding companies to transfer assets to subsidiary banks in danger of failing and being placed in FDIC receivership. If the bank holding company of a failed bank files for bankruptcy protection, the debtor-in-possession or bankruptcy trustee will want to explore whether there are any grounds to avoid any such transfers. The GLBA placed limitations on claims to recover such transfers from the FDIC. The protection afforded is, however, limited, and parties contemplating bringing actions to recover avoidable transfers should consider the following:

- The GLBA does not protect the FDIC from claims to avoid transfers made with actual intent to hinder, delay, or defraud creditors.
- If a transferee or the party for whose benefit a transfer is made controls the transferor, then it may be appropriate to impute the transferee's intent to the transferor.
- To the extent bank regulators cause a bank holding company to transfer assets to a troubled subsidiary bank in order to benefit the FDIC at the expense of the holding company's creditors, then it may be appropriate to impute the FDIC's intent to the transferor.
- The protections afforded the FDIC by the Act are not triggered unless and until the transferee bank receives a written directive from a bank regulator to raise capital. Such directives may be a double-edged sword for the FDIC. While they protect the FDIC from constructive intent fraudulent transfer claims, they may also provide evidence of regulator control that supports an actual intent claim.
- It is unclear whether GLBA Section 730 will be construed to prohibit claims against subsequent transferees who purchase fraudulently conveyed assets from an FDIC receivership.

News reports issued almost daily over the past several months provide that congressional committees and regulators are considering a wide range of options that could dramatically change the financial industry. Some of the proposed reforms could substantially change the rights of creditors and shareholders of banks and bank holding companies. Bank holding company bankruptcy trustees, investors, and others with a stake in such issues should monitor developments closely because the legal landscape, including the rights and remedies discussed above, soon may be altered materially.

## NOTES

<sup>1</sup> The regulators primarily involved when national banks become troubled are the Office of the Comptroller of the Currency ("OCC"), which regulates national banks; the Federal Reserve, which regulates bank holding companies; and the Federal Deposit Insurance Corporation ("FDIC"), which oversees the fund that insures bank deposits and acts as receiver of the assets of failed banks. Because FDIC insurance funds are at

risk, the FDIC is consulted early and often when a bank becomes troubled, and great deference is often given to the wishes of the FDIC with respect to the treatment of such banks and their holding companies.

<sup>2</sup> The Comptroller of the Currency discussed the downstreaming of BNEC's assets in congressional testimony, stating, "The loss to the FDIC did not increase, and may well have been reduced, due to the efforts of the new [BNEC] management team [put in place by the regulators]. These efforts included the sale of [BNEC] assets and the downstreaming of the proceeds of the sale to [BNENA]. Had [BNENA] been closed earlier, these assets would have been left behind in the holding company and would not have been available to reduce the FDIC's ultimate cost." *The Failure of the Bank of New England: Hearings Before the Senate Comm. on Banking, Hous., and Urban Affairs*, 102d Cong. 11 (1991)(statement of Robert L. Clarke, Comptroller).

<sup>3</sup> The Trustee brought claims against the FDIC in its corporate and receivership capacities and against Fleet Bank of Massachusetts, N.A., and Fleet Bank, N.A., and Fleet Bank of Maine, who acquired transferred assets from the FDIC. In addition to the fraudulent transfer claims brought pursuant to §548(a)(1)(A) and (B), the Trustee's Complaint also included claims for avoidance of fraudulent conveyances pursuant to Bankruptcy Code § 544(b) via the Massachusetts fraudulent conveyance laws (109 Mass. Gen. Laws Ann. §§4-7); avoidance of preferential payments pursuant to Bankruptcy Code §§ 542 and 543, restitution of estate property in certain accounts and Rabbi Trusts, violation of § 91 of the National Bank Act, and constructive trust and equitable lien.

<sup>4</sup> See 2008 FDIC Annual Report.

<sup>5</sup> See [www.fdic.gov/bank/individual/failed/banklist.html](http://www.fdic.gov/bank/individual/failed/banklist.html).

<sup>6</sup> Matthew Jaffe, *FDIC Bank Insurance Fund Plunges Into Red*, ABCNEWS.GO.COM (Nov. 24, 2009); See Stephen Bernard, *Calif. Bank Becomes 99th in U.S. to Be Shut in 2009*, APNEWS.MYWAY.COM (Oct. 17, 2009); David Ellis, *FDIC Fund in Red Until 2012*, CNN.MONEY.COM (Oct. 19, 2009).

<sup>7</sup> 12 U.S.C. § 1828(u).

<sup>8</sup> 1999 U.S.C.C.A.N. 276 (House Position).

<sup>9</sup> 12 U.S.C. § 1828(u)(1).

<sup>10</sup> 12 U.S.C. § 1828(u)(2)(B)(emphasis added).

<sup>11</sup> See, e.g., *S.E.C. v. Res. Dev. Int'l, LLC*, 487 F.3d 295, 301 (5th Cir. 2007); *Asarco LLC v. Americas Mining Corp.*, 396 B.R. 278, 369 (S.D. Tex. 2008); *In re Bayou Group, LLC*, 362 B.R. 624, 631 (Bankr. S.D.N.Y. 2007).

<sup>12</sup> See *Asarco*, 396 B.R. at 369; *In re FBN Food Servs., Inc.*, 175 B.R. 671, 686 (Bankr. N.D. Ill. 1994); *In re Sackman Mortgage Corp.*, 158 B.R. 926, 938 (Bankr. S.D.N.Y. 1993); *In re Parker Steel Co.*, 149 B.R. 834, 855 (Bankr. N.D. Ohio 1992); *In re Formaggio MFG., Inc.* 23 B.R. 688, 691 (Bankr. D. R. I. 1982); COLLIER ON

BANKRUPTCY ¶ 548.24 (15th ed. rev.).

<sup>13</sup> *Asarco*, 396 B.R. at 369; *In re Adler, Coleman Clearing Corp.*, 263 B.R. 406, 443 (S.D.N.Y. 2001).

<sup>14</sup> 52 Fed. Reg. 15,707 (1987). See Christine Bradley & Kenneth Jones, *Loss Sharing Rules for Bank Holding Companies: An Assessment of the Federal Reserve's Source-of-Strength Policy and the FDIC's Cross-Guarantee Authority*, Munich Personal Repee Archive (March 16, 2009) (discussion by FDIC staff members of history and application of Source of Strength Doctrine).

<sup>15</sup> 12 U.S.C. § 1831o.

<sup>16</sup> See 12 U.S.C. § 1831p-1 and 12 C.F.R. 30.

<sup>17</sup> See *An Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution* (January 2001), pp. 27-55 (providing a comprehensive discussion of the bank regulators' powers and how they work together to manage troubled banks).

<sup>18</sup> 12 U.S.C. 1828(u)(1)(A).

<sup>19</sup> The debtors-in-possession of the holding companies of Washington Mutual Bank ("WMB"), which was placed in FDIC receivership on September 25, 2008, have brought constructive and actual intent fraudulent conveyance and preference claims against the FDIC to recover certain amounts transferred to WMB before its failure. See Complaint, ¶¶ 25-44, *Washington Mutual, Inc. v. FDIC*, Case No. 1:09-cv-00533(RMC)(March 20,2009). The FDIC has not raised Section 730 as a defense, presumably because WMB was never issued a directive to raise capital. See Memorandum of Law in Support of the Partial Motion to Dismiss of Defendant FDIC, as Receiver for Washington Mutual Bank, pp. 23-27 (moving to dismiss fraudulent transfer claims on other grounds).

<sup>20</sup> See *Asarco*, 396 B.R. at 369; *In re Alder*, 263 B.R. at 443; *In re Formaggio Mfg.*, 23 B.R. at 691.

<sup>21</sup> 12 U.S.C. § 1828(u).

<sup>22</sup> See, e.g., *IBT Int'l, Inc. v. Northern*, 408 F.3d 689, 706 (11th Cir. 2005) ("[O]nce a trustee proves that a transfer is avoidable he may seek to recover against any transferee, initial or immediate, or an entity for whose benefit the transfer is made"); *Woods & Erickson v. Leonard*, 389 B.R. 721, 724 (9th Cir. 2008) ("[A] trustee is not required to avoid the initial transfer before seeking recovery from subsequent transferees under § 550(a)(2)."); *Kendall v. Sorani*, 195 B.R. 455, 463 (Bankr. N.D. Cal. 1996) (same).

<sup>23</sup> See, e.g., *UMLIC-Nine Corp. v. Lipon Springs Dev. Corp.*, 168 F.3d 1173 n.3 (10 Cir. 1999)(extending special six-year statute of limitations afforded FDIC to purchasers of loans from FDIC receivership); *United States v. Thornburg*, 82 F.3d 886, 890-92 (9th Cir. 1996)(same). Bankruptcy Code Section 550(b) also may protect subsequent transferees if they can demonstrate that they were purchasers who took for value, in good faith, and without knowledge of the voidability of the transfer.