# THE FDIC LOSS SHARE PROGRAM: HOW TO EXTRACT EVERY LAST DOLLAR

Mark D. Belongia and Mark A. Bradford

Presented in Conjunction with Thomas Rees and Tilcia Toledo of FTI Consulting

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# FIRM OVERVIEW

For decades, Duane Morris has provided leading national and international financial institutions with the full range of legal services they require. From commercial loan documentation and workouts to commercial litigation, intellectual property, bankruptcy and employment law, Duane Morris offers experienced and comprehensive business and legal guidance for clients in the banking and financial services industry. Guiding our service to our bank clients is a simple, unwavering focus on thoroughly understanding their business and providing the legal solutions that enable them to reach their goals. By practicing law this way, *we've* built strong relationships with more than half of the top 50 U.S. bank holding companies and more than 100 banks and financial services companies.

# MARK D. BELONGIA

**Mark D. Belongia** has extensive regulatory experience, encompassing the representation of bank and thrift organizations of all sizes in diverse geographic locations, ranging from money center and regional financial institutions to small community institutions. He has represented bank holding companies, financial service affiliates and their joint venture partners. He has dealt with both state and federal regulators, including the Department of Treasury, Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation ("FDIC"), the Securities and Exchange Commission, the Financial Crimes Enforcement Network and state banking, securities and insurance regulatory agencies. In addition to regulatory experience, Mr. Belongia practices in the areas of business and commercial litigation, focusing on matters in the banking, commercial, sports and entertainment areas. Mr. Belongia has represented clients in a wide variety of matters in areas including white collar litigation, government enforcement actions, compliance, entertainment and sports law. Mr. Belongia is a graduate of DePaul University College of Law and of Drake University.

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# MARK A. BRADFORD

**Mark A. Bradford** focuses his practice on financial services and reinsurance. He routinely advises on financial technology; the E-Sign Act; Truth in Lending; UDAAP; non-deceptive financial and insurance advertising; regulatory issues related to the extension of credit; admissions, registration and licensing; solvency; financial regulations pertaining to personally identifiable information (Reg. P.); professional liability matters; and claims by and against receivers. Mr. Bradford maintains an active regulatory litigation practice and has favorably resolved matters and prevailed on behalf of his clients in federal and state courts as well as prevailing upon regulatory bodies throughout the United States. He has successfully opposed and pursued claims adverse to state and federal regulators in their capacity as the receiver of an insolvent financial institution or insurance company. Mr. Bradford also maintains an active commercial litigation practice and has successfully handled commercial disputes in state and federal courts throughout Illinois. He regularly appears in matters in the Circuit Court of Cook County and the United States District Court for the Northern District of Illinois. Mr. Bradford advises a number of private and closely held businesses and has experience defending these businesses as well as litigating private and closely held business disputes including claims for breach of fiduciary duty, to expel members and for an accounting. Mr. Bradford is a 2004 *summa cum laude* graduate of the University of Illinois College of Law, where he was Symposium Editor for the *University of Illinois Law Review* and elected to the Order of the Coif, and a 2001 graduate of the University of Illinois. **Areas of Practice include:** Financial Services, Financial and Insurance Regulation, Reinsurance, Insurance, Commercial Litigation, Professional Liability Litigation, Class Action Litigation and Arbitration

# FTI Bios


## Thomas G. Rees

Senior Managing Director

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- Co-leader of FTI Consulting's Bank Governance & Regulation practice
- Over 25 of diverse regulatory, industry and consulting experience, primarily for financial institutions
- Focus on accounting, litigation, forensic investigation, internal control, compliance, risk management and financial institution regulatory matters
- Worked for the Office of the Comptroller of the Currency (OCC) serving in various capacities, including Deputy Chief Accountant and Manager, Treasury and Market Risk
- Former Vice President at MBNA America, Chief Accounting Officer at Penn Mutual and Senior Auditor at a large international accounting firm
- Holds an M.B.A. from the University of Delaware and a B.S. in accounting from Arizona State University


## Tilcia Y. Toledo

Senior Director

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- Senior member of FTI Consulting's Bank Governance & Regulation practice
- Over 20 years of diverse banking, regulatory and consulting experience
- Focus on risk management, federal regulatory governance, litigation support, capital markets and corporate finance
- Worked for the Federal Deposit Insurance Corporation (FDIC) Division of Resolutions and Receiverships as a Sr. Capital Markets Specialist and completed detail assignment with the Office of Complex Financial Institutions
- Former leverage finance banker with senior roles at GE Capital, BNP Paribas, Scotia Capital and JPMorgan
- Holds an M.B.A. in Finance from New York University Stern School of Business and a B.S. in Industrial Engineering from Northwestern University

# FTI Consulting: Experts with Impact

**FTI Consulting is an independent global business advisory firm dedicated to helping organizations manage change, mitigate risk and resolve disputes. Due to our unique mix of expertise, culture, and depth of industry experience, we provide a tangible impact on our clients' most complex opportunities and challenges**

**3,600**
Consultants & Professionals

**430+**
SMDs

## Definitive Expertise

- **2016** List of America's Best Management Consultant Firms, *Forbes*
- **2016** Winner AMCF Spotlight Award for Finance and Risk Management
- **Best Economics Firm** in the World, *Global Competition Review's Economics 21*
- **PR Firm of the Year**, *2016 M&A Atlas Awards*

**FCN**
NYSE

**$1.9BLN**
Market Capitalization(1)

## A Culture That Delivers

**Practical** in our communication and approach to outcomes

**Judicious** in complex, multi-party situations

**Collaborative** with clients and colleagues

**Professional** in our commitment to provide our clients with the highest caliber service

## Comprehensive Services

- Financial
- Legal
- Operational
- Political & Regulatory
- Transactional
- Reputational

Advisor to **97** of the world's top **100** law firms

**56** of Fortune Global **100** corporations are clients

Advisor to world's top **10** bank holding companies

## Industry Experience

- Construction
- Retail & Consumer Products
- Energy Power & Products
- Healthcare & Life Sciences
- Financial Institutions
- Mining & Mining Services
- Insurance
- Insurance
- Real Estate & Infrastructure

**29**
Countries

**81**
Cities

(1)Total Shares outstanding times the closing share price as of December 30, 2016.

# Bank Governance Services

**We help the board and senior management meet their responsibilities through timely assessment and development of governance policies and practices that promote effective regulatory compliance and risk management oversight in an efficient manner**

- Regulatory Compliance Advisory Services
  - We provide a wide range of advisory and consulting services to help clients comply with regulations and effectively respond to and resolve issues raised by regulatory agencies, such as the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Consumer Finance Protection Bureau and the Securities and Exchange Commission.
- Litigation Support
  - Our experienced financial services consultants work with clients to respond to and mitigate litigation and enforcement actions. Our experienced subject matter experts serve as expert witnesses and provide related consulting services at numerous trials and depositions in matters regarding governance, risk, and compliance.
- Pre- and Post-Examination Assessments and Advisory Services
- Internal Control Assessments
- Forensic Investigations
- Enterprise Risk Management (ERM) Services
- Third Party / Vendor Risk Management
- Board, Management and Organizational Assessments
- Incentive-Based Compensation Analyses and Advisory Services

## Credit Risk Services

**We help Boards meet regulatory mandates by evaluating and enhancing critical components of the credit life cycle, including risk appetite statements and frameworks; underwriting; risk management; administration; loss reserve analysis; loss mitigation; and recovery strategy and execution. Our primary services include:**

- Credit Risk Strategy and Execution
- Credit Related Enforcement Action and Management Reviews
- Counterparty Credit Risk and Third-Party / Vender Relationship Management
- Credit Risk Rating Design, Implementation and Testing
- Independent Loan Review
- Credit/Loan Loss Reserve (Allowance for Loan and Lease Losses)
- Loan Portfolio Management Diagnostics
- Pre-examination and Readiness Reviews
- Credit Risk Modeling, Scoring Evaluation and Quality Control Assessments
- Leveraged Lending Reviews
- Shared National Credit Review Services
- Credit Training Services

# Real Estate Valuations

**The unique nature of real assets and the absence of a readily available, market-based pricing mechanism requires expertise in appraisal/valuation of real property assets and debt. Our team of experienced real estate specialists assist our clients with valuations of single assets as well as large national real estate portfolios, through valuing real property based on projected cash flows and by providing due diligence for third-party purchasers.**

**We provide the following residential & commercial mortgage services:**

- Valuation and Assessment
- Loss Mitigation
- Asset Dispositions
- Asset Restructuring
- Other-than-Temporary Impairment assessments
- Loan Loss Reserves
- Securities Analysis
- Collateral Due Diligence
- Servicer Due Diligence

# History of Shared Loss Agreements

- Loss share is a feature that the Federal Deposit Insurance Corporation (FDIC) first introduced into selected purchase and assumption transactions in 1991. Under loss share, the FDIC absorbs a portion of the loss on a specified pool of assets which maximizes asset recoveries and minimizes FDIC losses. Loss share also reduces the FDIC's immediate cash needs, is operationally simpler and more seamless to failed bank customers and moves assets quickly into the private sector.
- When the FDIC calculates the estimated cost of a failure, it takes into account all expected losses on the assets covered in shared-loss agreements (SLAs). These current market assumptions are built into the cost of failure at the time of resolution. Thus, the cost of all expected future payments are recognized at the time of bank failure and no losses are deferred. Any loss sharing payments are made from receivership funds from the specific failed bank or thrift or, if those are insufficient, from the FDIC's Deposit Insurance Fund (DIF). The DIF is funded by assessments paid by insured banks and thrifts. It is not taxpayer funded.

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# How Loss Share Works

- The FDIC uses two forms of loss share. The first form is for commercial assets and the second for residential mortgages.
- For commercial assets, the SLAs cover an eight-year period with the first five years for losses and recoveries and the final three years for recoveries only. The FDIC typically will reimburse 80 percent of losses incurred by the acquirer on covered assets up to a stated threshold amount (generally the FDIC's dollar estimate of the total projected losses on loss share assets), with the assuming bank absorbing 20 percent.
- Loss coverage may also be provided for loan or note sales, but such sales require prior approval by the FDIC. Recoveries on loans which experience loss events are split, in most instances, with 20% of the recovery going to the assuming bank and 80% to the FDIC.
- For single-family mortgages, the SLAs are for ten years and have the same 80/20 split as the commercial assets. The FDIC provides coverage on three basic single-family first lien mortgage loss events: modification, short sale, and when the property is sold after foreclosure. Second liens are permitted to be charged off according to regulatory criteria when the first lien is not held by the assuming bank.

# Percentage Loss Share Changes Over Time

- Since the inception of SLAs, the basis for sharing losses with an assuming bank has undergone some change. Until March 26, 2010, the FDIC shared losses with assuming banks on an 80/20 basis until the losses exceeded an established threshold defined in the SLA, after which the basis for sharing losses shifted to a 95/5 basis. Sharing losses on a 95/5 basis was eliminated for all SLAs executed after March 26, 2010.

# Recoveries and Other Covered Expenses

- If there are recoveries on assets that have been charged off by the failed bank or the assuming bank, then the FDIC receives the majority of the benefit. The assuming bank will reimburse the FDIC for 80 percent of the recoveries.
- The FDIC covers credit losses as well as certain types of expenses associated with troubled assets (such as advances for taxes and insurance, sales expenses, and foreclosure costs). The FDIC does not cover losses associated with changes in interest rates.
- For single-family loans, the assuming bank is paid when the loan is modified or the property is sold. For commercial loans, the assuming bank is paid when the assets are written down according to established regulatory guidelines or when the assets are sold.

## Parallels to Professional Liability (PL) Cases

- As receiver for a failed financial institution, the FDIC may sue professionals who caused losses to the institution. These individuals may include former officers and directors of the institution, attorneys, accountants, appraisers, brokers, securities underwriters and issuers, or others. Professional liability claims also include direct claims against insurance carriers such as fidelity bond carriers and title insurance companies.
- Professional liability suits are only initiated if they are both meritorious and expected to be cost-effective. Before seeking recoveries from professionals, the FDIC conducts a thorough investigation into the causes of the losses. Most investigations are completed within 18 months from the time the institution is closed. All lawsuits require review by senior FDIC staff and, with, limited exceptions, approval by the FDIC Board of Directors. Prior to filing a lawsuit, staff in most cases will attempt to settle with the responsible parties. If a settlement cannot be reached, the FDIC will initiate litigation.

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# FDIC Causes of Action in PL Lawsuits

- Professionals may be sued for, among other things, simple negligence, gross negligence, breaches of fiduciary duties, violations of law or policy, malpractice, or breach of contract. With respect to claims against directors and officers, the Supreme Court has held that the FDIC may pursue simple negligence claims if state law permits (*Atherton v. FDIC*). Federal law preempts state law that insulates directors and officers from gross negligence or worse conduct. Bank directors are allowed to exercise business judgment, and under the business judgment rule, they generally will not be subject to liability if they acted on an informed basis, reasonably, and in good faith. In keeping with these propositions of law, the FDIC pursued claims against directors and officers in 24 percent of the bank failures between 1985 and 1992. In the more recent crisis, from 2008 through 2015, the FDIC pursued claims against directors and officers in 39 percent of the bank failures.

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# Professional Liability Cases From 1986 to 2016

- From 1986 through 2015, the FDIC (and from 1989-1995 the former Resolution Trust Corporation) recovered $9.07 billion from professional liability claims. Over that same time, they spent $2.24 billion to fund all professional liability claims and investigations. Early in the process of investigating and litigating professional liability claims, expenses will often exceed recoveries because professional liability program recoveries often lag expenses by several years until settlements occur and judgments are awarded.
- From January 1, 2009 through December 13, 2016, the FDIC has authorized suits in connection with 151 failed institutions against 1,213 individuals for D&O liability. This includes 109 filed D&O lawsuits (99 of which have fully settled, and 3 of which resulted in favorable jury verdicts) naming 832 former directors and officers. The FDIC also has authorized 73 other lawsuits for RMBS, LIBOR suppression, fidelity bond, insurance, accounting malpractice, appraiser malpractice, securities, and attorney malpractice claims. In addition, 48 residential mortgage malpractice and fraud lawsuits are pending, consisting of lawsuits filed and inherited.

# FDIC Trends in PL Cases and Lessons Learned

- *FDIC as Receiver of Heritage Community Bank v. Saphir,* Case No. 1:10-cv-07009 (U.S. District Court for the Northern District of Illinois Filed Nov. 1, 2010).
- Independent Bankers Bank
- Strategic Capital Bank
- Bank of Danville
- *FDIC as Receiver for Shorebank v. Amy,* Case No. 1:2013-cv-05888 (U.S. District Court for the Northern District of Illinois Filed Aug. 16, 2013).
- *FDIC as Receiver for New City Bank v. Baldermann,* Case No. 1:15-cv-02027 (U.S. District Court for the Northern District of Illinois Filed Mar. 6, 2015).

# FDIC Oversight

- The FDIC conducts annual on-site reviews and regular off-site monitoring of records of covered losses and overall compliance with the SLAs. It also requires assuming banks to provide quarterly reports to ensure compliance with the program and to monitor the performance of the assets. Lastly, if the assuming bank is not in compliance with the SLA, the FDIC has the right to stop payments until the problem findings are resolved, and, in extreme cases, to sell the assets through a bid process.

# FDIC Share Loss Agreement Program Recent Development

- From 2015 to 2016, the FDIC experienced a $10.7 billion reduction in the remaining shared-loss covered assets primarily due to the liquidation of covered assets from active SLAs, expiration of loss coverage for 42 commercial loan SLAs, and early termination of SLAs impacting 67 receiverships during 2016
- At year-end 2016, there were 148 receiverships with active shared-loss agreements and $20.8 billion in total shared-loss covered assets remained
- A large number of commercial SLAs have reached their 5-year mark, resulting in the end of FDIC loss-share coverage but not the end of the commercial SLAs, which lasts 8 years. The last 3 years of commercial SLA coverage is for recoveries only
- In 2016, the pace of SLA early terminations increased considerably

*Source: FDIC 2016 Annual Report*

# FDIC Loss Share Early Termination Process

- Eligibility requirements:
  - Maximum of $200MM outstanding unpaid principal balance for each SLA
  - Maximum total termination payment from the FDIC of $20MM per receivership (no limit when offer is a payment to the FDIC)
  - No maximum unpaid principal balance limit when the termination offer is a payment to the FDIC from the assuming bank
  - If the assuming bank had both SFR and NSF, both SLAS are terminated at the same time
- Benefits:
  - Financial advantages if the loans have started to perform again
  - Eliminate regulatory and administrative expense and burden associated with small portfolios
- Process:
  - Estimate future losses and recoveries and determine take-out amount
  - Submit offer letter to the FDIC loss share representative requesting an early termination and provide:
    - Specific agreement to be terminated
    - Dollar amount the AI is willing to accept or provide to terminate the agreement
    - The as of date of the offer
  - Obtain conditional approval from the FDIC after they complete the asset valuation review
    - FDIC engages third-party Financial Advisor to value the portfolios and estimate future losses and recoveries, which are modeled to account for the remaining term of the SLAs
  - Receive a draft termination agreement from the FDIC
  - FDIC finalizes internal approval process (which includes approval from the Division of Risk Management and Supervision)
  - Offer acceptance is subject to approval by the assuming institution's primary federal regulator
- Timeline:
  - Varies, approx. 90 days from receipt of draft termination agreement

# How FTI Consulting Assists Clients Manage SLAs

- The FDIC has publicly stated they do not negotiate the take-out amount
- Our experienced bank regulation experts:
  - Provide advice on how to manage the expectations of the FDIC and your primary federal regulator
  - Review compliance with SLA Management Standards (financial and non-financial)
  - Review problem asset/charge-off practices for consistency with regulatory guidance/expectations
    - Collection practices
    - Allowance for Loan and Lease Losses
    - Other real estate owned (OREO)
  - Support Board reporting efforts
  - Provide litigation support services with expert reports and testimony, if needed
- We have the loan loss mitigation and real estate valuation expertise to:
  - Conduct preliminary due diligence review of loan portfolios
  - Support estimates of the future losses and recoveries and determining the take-out amount for early termination option
  - Support calculations of “true-up” recoveries at end of agreement
  - Provide litigation support services with expert reports and testimony, if needed

# Dispute Mechanism

- Commercial Shared Loss Agreements evolved
- Should engage counsel to review your specific dispute mechanism
- Acquiring Institution with multiple Loss Shares may be subject to different dispute mechanisms

# Good Faith Negotiation Period

- Elevates matter to counsel within the FDIC
- May have effect of removing RSAM specialist and allow for a fresh set of eyes
- Empowers Acquiring Institution
  - Formal litigation not required
  - Keeps process confidential

# Leveraging Appropriate Forums to Your Advantage

- Arbitration
- Chartering Authority (Examination Criteria)
- Courts

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## Contractual Rights

- *FDIC v. First Am. Title Ins. Co.*, 611 Fed. Appx. 552 (11th Cir. 2015) -- Old Bank insolvency.

- *Owen v. Bank of the Ozarks*, 329 Ga. App. 314 (Ga. Ct. App. 2014) – First Choice Community Bank insolvency.

# Issue for Arbitrators or Court

- *Med. Facilities, Inc. v. Pryke*, 62 N.Y.2d 716 (N.Y. 1984) (holding that in the absence of a contractual alternative a breach of contract claim does not begin to run until there is a failure to pay irrespective of when triggering obligation to pay occurred).
- *In re Brown & Guenther*, 18 A.D.2d 327 (1st Dept. 1963) (holding that contractual time bar in agreement requiring dispute be submitted to arbitration within fifteen days "after the dispute has arisen" was unreasonable and unenforceable such that party could initiate arbitration).

## Statute of Limitations

- Choice of law for many loss share agreements is New York
  - 6 years, New York Civil Practice and Rules §213

- Other potentially relevant jurisdictions

  - Florida: 5 years, Fla. Stat. Ann. §95.11
  - Georgia: 6 years, Ga. Code Ann. §9-3-24
  - Illinois: 10 years, 735 ILCS 5/13-206

# Case Study #1 – Facts

- Failed Institution made $3.5 million loan secured by 2 parcels of land comprised of 24 unimproved acres zoned commercial;
- Land is located on edge of suburban area that prior to the downturn was developing and viewed as potential big box location;
- In Y4 of Shared-Loss Period, the Acquiring Institution received an "as is" appraisal that valued the collateralized parcels at $3.2 million based on a highest and best use as commercial property;
- In Y5 of Shared-Loss Period, the Acquiring Institution received an "as is" appraisal that valued the collateralized parcels at $300,000 based on a highest and best use as agricultural.

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## Case Study #1 – Issues

- Acquiring Institution took a $2.5M charge off on its quarterly certificate in one of the final Shared-Loss Quarters before entering the Recovery Period;
- The FDIC rejected the charge off because it viewed the appraisal as an improper change to the categorization of the collateral.

# Case Study #1 – Maximizing Results

- Important to challenge FDIC's rejection of charge off in appropriate but assertive manner;
- Review prior appraisals as in this case, the prior appraisals noted potential use as farm land;
- Highlight fact that land had in fact been rented to farmer for several years.

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## Case Study #2 – Facts

- Failed Institution extended $1.7 million commercial line of credit that was personally guaranteed by two midlevel executives at successful technology company who were married to one another;
- Borrower dissolves with no assets to repay commercial line;
- Guarantors have divorced which dissipated most of their assets and both have moved out of state rendering any collection action a non-viable option.

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# Case Study #2 – Issues

- Borrowers offered $300K, representing demonstrable liquidation of remaining retirement accounts, in exchange for release from guarantee;
- Acquiring Institution accepted offer and took $1.4 million charge off on its quarterly certificate;
- FDIC denied charge off for lack of documentation in file.

# Case Study #2 – Maximizing Results

- Expert consultant engaged to provide a least cost analysis which showed that the case settlement exceeded the value of a deed-in-lieu and foreclose;
- Have outside counsel advocate position that against background of least cost analysis and unknowns of potentially costly litigation against out of state guarantors, settlement was reasonable and prudent.

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## Case Study #3 – Facts

- Failed Institution took 100% participation in standby letter of credit (standby LOC was itself issued by another failed institution);
- Successor to issuing institution made demand on Acquiring Institution which was tendered to FDIC for indemnification and defense under P&A Agreement;
- FDIC declined so Acquiring Institution paid participation and submitted $850k on its quarterly certificate.

# Case Study #3 – Issues

- Standby LOC's were retained by the FDIC under P&A Agreement;
- FDIC took the position that participation is different than Standby LOC;
- Not scheduled as a loss share asset.

## Case Study #3 – Maximizing Results

- Have counsel take aggressive position that Acquiring Institution would not be whipsawed;
- Either inadvertently unscheduled asset which would invoke procedure for amending schedule or liability retained by FDIC which should have been indemnified;
- Threatened to bring declaratory judgment action in federal district court.

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# Case Study #4 – Facts

- Loan written down at start of appraisal process to $600K based on appraisal of collateral;
- Purchaser contracted to buy property for $425K;
- Sale fell through but Acquiring Institution still wrote down property to $425K and took charge off of $175K on quarterly certificate;
- FDIC denied the charge off and took the position that prior appraisal and not purchase contract was proper basis;
- OCC is chartering authority.

## Case Study #4 – Issues

- OCC's Office of Chief Accountant issued guidance through its Advisory Series that contracted for amount is better indicator than appraisal;

- Acquiring Institution did not have internal policy on whether to adhere to appraisal or take write down to contracted for price.

## Case Study #4 – Maximizing Results

- Have consultant research and verify potential guidance on challenged charge offs;
- Then have counsel engage FDIC and threaten to submit matter to chartering authority;
- If necessary submit dispute to chartering authority via letter for final decision.