Client Alert.

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The Colonial BancGroup, Inc.: FDIC Denied Right to Setoff Against Demand Deposit Accounts

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On January 24, 2011, the Honorable Dwight H. Williams, Jr. of the U.S. Bankruptcy Court for the Middle District of Alabama denied the Federal Deposit Insurance Corporation's ("**FDIC**") request for relief from the automatic stay in the *Colonial BancGroup, Inc*. case.[1] The FDIC, in its capacity as receiver for Colonial BancGroup's failed banking subsidiary, Colonial Bank, sought to lift the automatic stay to setoff balances held in various demand deposit accounts (collectively, the "**DDAs**") held by Colonial BancGroup (the "**Debtor**") totaling approximately $38.4 million at Branch Banking and Trust Company ("**BB&T**"). Approximately one and a half years earlier, when the Alabama state banking regulator closed Colonial Bank on August 14, 2009,[2] BB&T had entered into a Purchase and Assumption Agreement (the "**Agreement**") with the FDIC Receiver and the FDIC.

SUMMARY OF POSITIONS

The key issue before the court was whether BB&T assumed the DDAs when it purchased and assumed all of the deposits of Colonial Bank. For reasons noted below, the FDIC's position was that BB&T did not assume the DDAs under the Agreement, and, therefore, the FDIC remained liable to the Debtor for the deposit balances. The FDIC estimated that its claims against the Debtor—which are the subject of pending proceedings on appeal to the district court[3]—totaled several hundred million dollars. The FDIC hoped to partially setoff such amounts with balances held in the DDAs. In the alternative, the FDIC argued that even if BB&T assumed the DDAs, the FDIC had the contractual right to assume the DDAs and offset the debt under section 553 of the Bankruptcy Code.

In support of its position, the FDIC relied on the definition of "Assumed Deposits" under the Agreement, noting that this defined term expressly excluded any deposit balance that, in the discretion of the FDIC, "may be needed to provide payment of any liability of any depositor to the Failed Bank or the Receiver."[4]

BB&T asserted that the DDAs were assumed liabilities of BB&T because BB&T had maintained control over the DDAs since execution of the Agreement. In addition, BB&T had always included the DDA balances in (i) statistics included within its quarterly reports to the Securities and Exchange Commission and its Call Reports; and (ii) calculating its deposit insurance premiums paid to the FDIC. In short, BB&T argued that it had at all times treated the DDAs as liabilities on its books, subject to whatever rights the FDIC bargained for under the Agreement.

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[1] *In re The Colonial BancGroup, Inc.*, No. 09-32303-DHW, 2011 WL 239201 (Bkrtcy. M.D. Ala. January 24, 2011).
[2] The seizure of Colonial Bank, which had $25 billion in assets under management and $20 billion in deposits, represented the biggest bank failure of 2009.
[3] The Debtor filed for Chapter 11 bankruptcy protection August 25, 2009, 11 days after the state regulators closed Colonial Bank. In his opinion, Judge Williams noted that the setoff issue needed to be decided prior to the resolution of the pending litigation because the Debtor needed cash from the DDAs to continue to fund its Chapter 11 case. *In re The Colonial BancGroup*, 2011 WL 239201, at *8.
[4] *Id*.

COURT RULING

The court sided with BB&T, concluding that, based on "overwhelming evidentiary support,"[5] BB&T assumed liability for the DDAs. Because BB&T was liable for the balances in the DDAs, the deposits could not serve as a basis for setoff under section 553. A basic understanding of setoff is useful in understanding the court's analysis.

A traditional setoff in bankruptcy, as defined by section 553(a), involves the offset of mutual, valid, and enforceable prepetition debts between the same parties in the same capacities—i.e., a prepetition debt owing by a creditor ("**Party A**") to a debtor ("**Party B**") against a prepetition claim of Party A against Party B.[6] The requisite elements of a section 553 setoff are met where: (i) the creditor holds a claim against the debtor that arose before the commencement of the case; (ii) the creditor owes a debt to the debtor that also arose before the commencement of the case; (iii) the claim and debt are mutual; and (iv) the claim and debt are each valid and enforceable.[7] Setoff, in effect, elevates an unsecured claim to secured status, to the extent that the debtor has a mutual, prepetition claim against the creditor.[8] Section 553 does not define "mutual." The most common use of "mutual" includes the requirement that the prepetition claim and debt be owed by and among the "same parties" and that the parties be acting in the same "capacity."[9]

The FDIC claimed a right of setoff under both federal and state law. First, the FDIC asserted a statutory right of setoff under 12 U.S.C. § 1822(d), which generally provides that the FDIC can withhold payment of a portion of the insured deposit of any depositor in a depository institution in default under certain circumstances. Second, the FDIC asserted a right of setoff under Alabama law, which also requires mutuality.[10]

Ultimately, the court rejected both of the FDIC's setoff arguments. The court found that the DDA balances were a BB&T liability, and not an FDIC liability, and thus there was no mutual debt between the FDIC and the Debtor. Once BB&T assumed liability for the Debtor's accounts, the mutual debts between the Debtor and the FDIC "ceased to exist."[11] Judge Williams also noted that the FDIC "had a right under 12 U.S.C. § 1822(d) to offset the mutual debt" upon receivership;[12] however, the FDIC lost that right once BB&T assumed liability.

In this respect, the holding of *Colonial BancGroup, Inc.* appears to limit the FDIC's ability to exercise its setoff right under federal law—barring a circumstance where the FDIC, in its discretion, specifically excludes demand deposit accounts under the terms of a purchase and assumption agreement—to the span of time between receivership and purchase and assumption.

The court also considered whether the FDIC could meet the setoff requirements under section 553 if the FDIC requested return of the Debtor's deposit balances, as provided in the Agreement. The FDIC argued that the postpetition "transfer" or "reassignment" of the debtor's deposits would not violate section 553(a) because section 553 prohibits a creditor from offsetting a debt against a claim transferred to a creditor postpetition; it does not similarly prohibit a creditor from offsetting

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[5] *Id.* at *9.
[6] 11 U.S.C. § 553(a).
[7] *In re Stienes*, 285 B.R. 360, 362 (Bankr. D.N.J. 2002); *see also Scherling v. Hellman Elec. Corp. (In re Westchester Structures)*, 181 B.R. 730, 739 (Bankr. S.D.N.Y. 1995) (noting that mutuality is found only when the debts/credits exist between "the same parties, standing in the same capacity").
[8] *See* 11 U.S.C. § 506(a).
[9] *See SemCrude*, 399 B.R. at 396 ("The overwhelming majority of courts to consider the issue have held that debts are mutual only if 'they are due to and from the same persons in the same capacity'") (citations omitted).
[10] *Rainsville Bank v. Willingham*, 485 So. 2d 319 (Ala. 1986) (providing that "[w]hen . . . mutual debts exist, [the bank may] apply the money it owes the depositor toward the depositor's debt").
[11] *In re The Colonial BancGroup, Inc*., 2011 WL 239201, at *9.
[12] *Id*.

a debt incurred by that creditor postpetition.[13]

The court found, however, that section 553(a) preserves the right of setoff only where both debts were incurred prepetition. A creditor who assumes a liability postpetition necessarily incurs a postpetition debt. Therefore, any request by the FDIC to return the amounts in the DDAs, would create a postpetition debt, which would preclude setoff given the requirement for mutual prepetition debts.[14]

Finally, the court acknowledged the challenges in coordinating a bank closure, but suggested that the FDIC could have specifically identified accounts in the Agreement to withhold payment on, had the FDIC elected to do so.[15] According to the court, the FDIC "could also have anticipated that the bank would have claims against the debtor and that the right of setoff should be preserved, especially given the size of the debtor's deposits."[16]

CONCLUSION

Colonial BancGroup is the latest in a parade of bankruptcy cases that the FDIC has brought against bank holding companies, owing in large part to nearly 300 banks being placed into receivership and seized by the FDIC since the beginning of 2009.[17] The FDIC will likely appeal the court's ruling, so the effects of this case are still undetermined. If upheld, the ruling will likely impact how the FDIC documents purchase and assumption agreements or otherwise seeks to recover holding company assets where there has been a loss to the deposit insurance fund.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

[13] *Id.* at *10 (emphasis in original).
[14] *Id.*
[15] The Agreement provided the FDIC with the discretion to withhold payment on any identified deposits assumed by BB&T, but the FDIC did not identify any such accounts. *Id.* at *6.
[16] *In re The Colonial BancGroup, Inc.*, 2011 WL 239201, at *11.
[17] *See, e.g.*, *Corus Bankshares Inc v. FDIC*, No. 11-CV-00053 (N.D. Ill. January 5, 2011); *BankUnited Financial Corp v. FDIC*, Nos. 10-CV-21307-HUCK & 10-CV-22343-HUCK (S.D. Fla August 20, 2010). *See, generally*, http://www.fdic.gov/bank/individual/failed/banklist.html.