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Articles

WHY *D'OENCH, DUHME*? AN ECONOMIC, LEGAL, AND PHILOSOPHICAL CRITIQUE OF A FAILED BANK POLICY

RICHARD E. FLINT*

> But the goat chosen by lot . . . shall be presented alive before the Lord to be used for making atonement by sending it into the desert as a scapegoat.[1]

I. INTRODUCTION

In 1942 the Supreme Court handed down its decision in the case of *D'Oench, Duhme, & Co. v. FDIC*[2] establishing an equitable estoppel under the umbrella of federal common law[3] to protect the insurance fund of the Federal

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1. *Leviticus* 16:10 (New International Bible). Under Hebrew law on the Day of Atonement something more than just a sin offering needed to be made to preserve the purity of the nation. The reason for this was that the sin offering did not atone for all sins, but only for those done unwittingly, in ignorance. The scapegoat was a male goat selected by lot, whose purpose was to carry the remaining sins of the people beyond human habitations. *Id.* at 16:22. Thus, the scapegoat provided the means for the full release of sins and the purification that God demanded. The procedure required the High Priest to lay his hands on the live goat [the scapegoat] and confess all the inequities, transgressions and sins of the people of Israel, and then push the scapegoat off to the wilderness where it carried all the sins of the people of Israel. *See generally* R.A. BARCLAY, THE LAW GIVERS 40-41 (1964). In contemporary America, a scapegoat is the one who is made the object of blame, the fall-guy, or patsy. ROGET'S INTERNATIONAL THESAURUS 86 (4th ed. 1978).

2. D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447 (1942).

3. *Id.* at 458-59 (implicitly applying federal common law as a matter of public policy). The concurring opinion of Justice Jackson explicitly asserted that the decision was an application of federal common law. *Id.* at 468, 475. Although Justice Brandeis had earlier pronounced that "[t]here is no federal general common law," Erie R.R. v. Tompkins, 304 U.S. 64, 78 (1938), it is undisputed that in areas that require federal solutions or they involve uniquely federal interests federal courts have the power to create rules of federal law which have not been expressly suggested by federal enactments. *See* United States v. Kimbell Foods, Inc., 440 U.S. 715, 726-27 (1979) (holding that because the SBA and FHA perform federal functions in their respective loan programs

Deposit Insurance Corporation (FDIC) from secret agreements between borrowers and banks which misrepresented the value of a bank's assets.[4] In the

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and derive their authority from legislative acts, federal interests were sufficiently implicated that federal common law controls their lien priority rights); Clearfield Trust Co. v. United States, 318 U.S. 363, 366-67 (1943) (in a case involving the obligation of the government to inform an endorser of a payee's forgery on a federal check, the Court noted that in the absence of congressional guidance a federal court could fashion a federal common law rule). *See also* Martha A. Field, *Sources of Law: The Scope of Federal Common Law*, 99 HARV. L. REV. 881, 890 (1986) (arguing that the only limitation on the power of a federal court to fashion a federal common law rule is the existence of "a federal enactment, constitutional or statut[ory], that it interprets as authorizing the federal common law rule"); Alfred Hill, *The* Erie *Doctrine in Bankruptcy*, 66 HARV. L. REV. 1013, 1050 (1953) (stating that federal common law applies "only in effectuation of a policy derived from the Constitution or from a valid act of Congress"). Judge Friendly described those areas sufficient for the creation of a body of [federal] decisional law to be limited only by the "grant of federal jurisdiction . . . adorned with a bit of legislative history." Henry J. Friendly, *In Praise of* Erie *– and of the New Federal Common Law*, 39 N.Y.U. L. REV. 383, 413 (1964). In Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398, 426 (1964), the Court referred to the *D'Oench* case as involving the judicial protection of a "uniquely federal interest, . . . the ultimate statement of which is derived from a federal statute." Adorning federal common law with the cloak of statutory rationalization has exacerbated the difficulty courts have had in attempting to circumvent such rulings.

4. D'Oench, Duhme & Co. v. FDIC, 315 U.S. at 457. Writing for the majority Justice Douglas stated that the deposit insurance legislation revealed "a federal policy to protect respondent [FDIC] and the public funds which it administers against misrepresentations as to the [value of] securities or other assets in the portfolios of the banks which respondent insures or to which it makes loans." *Id.* *See infra* notes 48-63 and accompanying text for a detailed discussion of the case.

Today the issue of valuation of the assets of financial institutions is of substantially more interest and concern because issues of bank solvency justifying intervention by a receiver generally revolve around book value not market value. *See* Kenneth E. Scott, *Deposit Insurance and Bank Regulation: The Policy Choices*, 44 BUS. LAW 907, 918 (1989) [hereinafter *Policy Choices*] (noting that the banking supervisors as a discretionary action determine closure "around the time of book value insolvency"). *See also* Smith v. Witherow, 102 F.2d 638, 640 (3d Cir. 1939) (noting that insolvency status of a bank should not be determined by "the theoretical state of its balance sheet which may include assets whose actual value is far less than that at which they are carried on its books"). The use by financial institutions of book values instead of market values to determine asset valuations leads to substantially more actual losses in market value terms upon insolvency. *See* Kenneth E. Scott, *Deposit Insurance – The Appropriate Roles for State and Federal Governments*, 53 BROOK. L. REV. 27, 36 (1987) [hereinafter *Deposit Insurance*].

Although the term insolvency is not defined in the banking statutes, statutorily it encompasses both the inability of a bank to meet its obligations as they mature and the closing of its doors. 12 U.S.C. § 191 (1989). *See also* FDIC v. Goldberg, 906 F.2d 1087, 1093-94 (5th Cir. 1990) ("An insolvent bank is, by definition, one that lacks sufficient assets to pay every claimant in full.") (footnote omitted). The Comptroller of Currency, who has been entrusted with the superintendency of national banks, 12 U.S.C. § 1 (1989), is authorized to make the determination of insolvency and appoint a receiver for national banks. 12 U.S.C. §§ 191, 192 (1989). The FDIC becomes receiver for insolvent national banks as a matter of law. 12 U.S.C. § 1821(c)(2)(A)(ii) (1989). Under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 [hereinafter FIRREA] (codified at scattered sections of 12, 15 and 26 U.S.C.) the FDIC now has the authority to appoint itself receiver of state chartered banks, although it is also empowered to accept appointment from state authorities. 12 U.S.C. §§ 1821(c)(3)-(5) (1989). When a bank fails and the FDIC is appointed receiver, it has two separate roles to perform. In its corporate capacity, as insurer and administrator last fifty years the *D'Oench* doctrine[5] has been greatly expanded by the courts.[6]

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of FDIC insured banks, it is obligated to protect insured deposits. 12 U.S.C.A. §§ 1811, 1818, 1819, 1821(a) (West 1989 & Supp. 1991). While in its capacity as receiver for a failed institution the FDIC has the statutory duty to "preserve and conserve the assets and property" of the failed institution and to "pay all valid obligations" and "insured depositors". 12 U.S.C. §§ 1821(d)(2)(D), (d)(2)(H), (f) (1989).

5. For purposes of this article the term *D'Oench* doctrine will be all encompassing -- that is, it will be used to refer collectively to the *D'Oench* case itself, the interpretation given the case by subsequent courts, section 1823(e) [12 U.S.C. § 1823(e) (1989)] and the interpretation given the section by the courts, and the burgeoning federal common law area of holder in due course. The author is well aware of the explicit and subtle differences between these divergent legal approaches to protect the insurance fund administered by the FDIC, but is of the opinion that for the purposes of this article they may be treated as one, for each is part and parcel of the erroneous failed bank paradigm discussed in this article. *See infra* notes 94-144 and accompanying text. For a recent article containing a detailed discussion of the differences in the three related legal concepts see W. Robert Gray, *Limitations on the FDIC's* D'Oench *Doctrine of Federal Common Law Estoppel: Congressional Preemption and Authoritative Statutory Construction*, 31 S. TEX. L.J. 245, 249-58 (1990).

6. *See, e.g.*, FSLIC v. Gordy, 928 F.2d 1558, 1568 (11th Cir. 1991) ("the absence of bad faith, recklessness or negligence . . . does not preclude application of the *D'Oench* doctrine"); Kilpatrick v. Riddle, 907 F.2d 1523, 1529 (5th Cir. 1990), *cert. denied*, 111 S. Ct. 954 (1991) (*D'Oench* precludes alleged defrauded borrowers from bringing action under federal securities law against FDIC and its assignees, even if FDIC had prior knowledge of claim); Porras v. Petroplex Sav. Ass'n, 903 F.2d 379, 381 (5th Cir. 1990) (extending *D'Oench* doctrine to assignees of the FDIC); Bell & Murphy & Assoc. v. Interfirst Bank Gateway, 894 F.2d 750, 754-55 (5th Cir. 1990), *cert. denied*, 111 S. Ct. 244 (1990) (*D'Oench* protections extend to bridge bank that takes over operation of failed bank); Beighley v. FDIC, 868 F.2d 776, 784 (5th Cir. 1989) (doctrine applies even if "borrower does not intend to deceive banking authorities."). During the expansive growth of the doctrine courts have relied upon the original opinion as authoritative precedent by virtue of the doctrine of *stare decisis*, without any analysis of whether its major premise -- preservation of the insurance fund -- had or continues to have any valid justification. For an interesting discussion of the distinctions between precedent as informative analogy and precedent as authority see RICHARD A. POSNER, THE PROBLEMS OF JURISPRUDENCE 89-98 (1990) [hereinafter JURISPRUDENCE]. Posner's insights are useful in understanding the underlying normative issues involved in the use of precedents. He noted:

> [t]he use of cases as informative analogies must be distinguished from their use as authorities, that is, from the policy of decision according to precedents -- . . . . Paying attention to precedents thus does not commit one to stare decisis; the issues of authority and analogy are distinct. . . . But unless a precedent is authoritative in the sense of announcing a major premise that cannot be questioned, it can be a source only of data that are anecdotal in character or of reasons, considerations, values, policies. . . .
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> The distinction between legal precedent as information and as authority may seem to overlook the fact that the values, considerations, policies, and ethical insights found in previous decisions of the same or a coequal or a higher court are entitled to greater weight -- are more authoritative -- in the decision of the present case than are the values, considerations, and so forth that might be gleaned from other sources.

Id. at 89-90, 93-94. The problems generated by bad authoritative precedent are well known. In fact, Shakespeare once mused:

> 'Twill be recorded for a precedent,
> And many an error, by the same example

Its purported legislative counterpart,[7] Section 1823(e)[8] has enjoyed similar

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Will rush into the state.

WILLIAM SHAKESPEARE, THE MERCHANT OF VENICE act IV, sc. 1 (Richardson ed., 1923).

7. It was not until 1950 that Congress enacted what is often erroneously referred to as the codified counterpart of the *D'Oench* doctrine. Federal Deposit Insurance Act of 1950, Pub. L. No. 81-797, § 13(e), 64 Stat. 873, 889 (1950) (codified at 12 U.S.C. § 1823(e) (1950), as *amended by* 12 U.S.C. § 1823(e) (1989)). Such enactment did not actual codify *D'Oench*, as the specific requirements of section 1823(e) are not mentioned or eluded to in the case. *See, e.g.*, Kilpatrick v. Riddle, 907 F.2d at 1529 n.2 (Brown, J., dissenting) (noting that "[t]he often recited statement that § 1823(e) is a codification of *D'Oench, Duhme* does not bear analysis."); Gray, *supra* note 5, at 250-52 (noting that while section 1823(e) is widely regarded as a codification of the doctrine, he sees it as merely a clarification and extension of the doctrine); Marsha Hymanson, Note, *Borrower Beware:* D'Oench, Duhme *and Section 1823 Overprotect the Insurer When Banks Fail*, 62 S. CAL. L. REV. 253, 269 (1988) [hereinafter Hymanson] (asserting that the statute partially codifies the *D'Oench* doctrine). *Cf.* Robert W. Norcross, Jr., *The Bank Insolvency Game, FDIC Superpowers, The* D'Oench *Doctrine, and Federal Common Law*, 103 BANKING L.J. 316, 328 (1986) (asserting that the legislation was an attempt to limit the scope of *D'Oench*).

8. The statute reads:

> No agreement which tends to diminish or defeat the interest of the Corporation in any asset acquired by it under this section or section 1821 of this title, either as security for a loan or by purchase or as receiver of any insured depository institution, shall be valid against the Corporation unless such agreement -- (1) is in writing, (2) was executed by the depository institution and any person claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the depository institution, (3) was approved by the board of directors of the depository institution or its loan committee, which approval shall be reflected in the minutes of said board or committee, and (4) has been, continuously, from the time of its execution, an official record of the depository institution.

12 U.S.C. § 1823(e) (1989). It is clear that the specific requirements of 1823(e) are not provided, nor for that matter, are they mentioned in *D'Oench*. The initial legislative history of section 1823(e) was silent as to congressional intent. H.R. REP. NO. 2564, 81st Cong., 2d Sess., *reprinted in* 1950 U.S.C.C.A.N. 3765, 3774 [hereinafter FDIC REPORT] (reflecting only that the entirety of section 1823 related "to authority of the Corporation to make loans or purchases of assets of banks to avert losses was amended" to prevent agreements from diminishing the right, title, or interest of the Corporation unless satisfying the four specified conditions). A statement made during the floor debate could be said to support the proposition that the intent of the section was to restrict *D'Oench*. 81 CONG. REC. 10,732 (1950) (Representative Walters concluded "[i]t was never the intention of Congress to give to the Corporation a stronger position than that of the bank and the adoption of the amendment, my amendment is offered to prove heretofore it was the intent of Congress that any agreement in the absence of fraud is binding on the Corporation."). Of course, recourse to legislative history is necessary only if the statutory language is ambiguous. Furthermore, to the extent that legislative history may be considered, it is the official committee reports that provide more authoritative expression of legislative intent. Garcia v. United States, 469 U.S. 70, 76 (1984). One court, after reviewing what it viewed as the legislative history, determined that it was not congressional intent that section 1823(e) apply to all defenses, only those contemporaneous, secret and unwritten. FDIC v. Blue Rock Shopping Center, Inc., 766 F.2d 744, 753 (3d Cir. 1985) (the section does not bar defenses that are independent of any "side agreement"). This narrow interpretation of the reach of section 1823(e) has been rejected. *See* Langley v. FDIC, 484 U.S. 86, 94 (1987) (holding that the statute bars even fraud in the inducement which renders a note voidable). *But see* Gunter v. Hutcheson, 674 F.2d 862, 869 (11th Cir.), *cert. denied*, 459 U.S. 826 (1982) (holding that claims making an entire transaction invalid from its incipiency are valid under the

expansion.[9] More recently, courts have even created a fiction[10] by holding that the FDIC enjoys rights as a holder in due course under federal common law as a necessary extension of the original *D'Oench* doctrine.[11] One consideration

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section).

In this author's opinion, if Congress had desired to remove the whole panoply of defenses it would have expressly provided for that in the statute. However, in the absence of explicit legislation, and assuming that it was the intent of Congress to impliedly bar most defenses, one would logically expect that an extensive discussion would appear on the pages of the authoritative legislative history. *See, e.g.*, Tennessee Valley Authority v. Hill, 437 U.S. 153, 209 (1978) (Powell, J., dissenting) ("we can be certain that there would have been hearings, testimony, and debate concerning consequences so wasteful, so inimical to purposes previously deemed important, and so likely to arouse public outrage."). As noted above no discussion of the extent or coverage of section 1823(e) is contained in the legislative history of the Federal Deposit Insurance Act of 1950. The recent banking law reform legislation recodified section 1823(e) in substantially the same wording, but extended its coverage to include protection for assets acquired by the FDIC in its receivership role, as well as in its corporate role. FIRREA, Pub. L. No. 101-73, Title II, § 217(e), 103 Stat. 183, 256 (1989). The only passing reference to the purpose of this change noted in the legislative history stated that the changes were designed to clarify the current provision and to make it clear that the protection extended to all assets acquired by the FDIC in any capacity. H.R. REP. NO. 101-54 (I), 101st Cong., 1st Sess. 335 (1989) [hereinafter FIRREA REPORT], *reprinted in* 1989 U.S.C.C.A.N. 86, 131 (It should be noted that the House Report was discussing section 215(4) of House Bill 1278 which was enacted as Section 217(e) of FIRREA). Furthermore, not one word of congressional intent for these changes is found in the Congressional Record. FIRREA also extended section 1823(e) coverage to the Resolution Trust Corporation. 12 U.S.C.A. § 1441(a)(b)(4) (West Supp. 1991).

9. *See* Langley v. FDIC, 484 U.S. at 91 (holding the term "agreement" for purposes of section 1823(e) broader than a mere promise). In *Langley* the Court extended the protection of the statute to obligations of a failed bank procured through fraud in the inducement, and held that knowledge by the FDIC of the misrepresentation prior to acquisition is irrelevant to the application of the statute. *Id.* at 91-93. *See also* Vernon v. RTC, 907 F.2d 1101, 1105 (11th Cir. 1990) ("[C]ourts have referred to section 1823(e) and the cases interpreting it as guidelines for the application of the *D'Oench* doctrine."); FDIC v. Cardinal Oil Well Servicing Co., 837 F.2d 1369, 1372 (5th Cir. 1988) (holding that the statute bars defense of oral misrepresentation as to scope and duration of written guarantee). The application of Section 1823(e) to bar state law defenses has been upheld against constitutional challenges based on the Fifth Amendment. *See* Chatham Ventures, Inc. v. FDIC, 651 F.2d 355, 362-63 (5th Cir. 1981), *cert. denied*, 456 U.S. 972 (1982).

10. By the use of the word "fiction" it is meant that the FDIC is given the status of holder in due course under principles of federal common law even though few, if any, of the technical requirements for application of the doctrine are satisfied. *See* U.C.C. § 3-302 (1978) (specifying the conditions for acquiring the status of holder in due course). In fact, one recent court stated that the requirements of "for value," "without notice of prior dishonor," "without notice of contrary claims," and acquisition in a non-bulk transfer, were mere technical state-law requirements that "cannot be allowed to defeat the policy behind federal holder in due course doctrine." Sunbelt Sav. v. Montross, 923 F.2d 353, 355-56 (5th Cir. 1991). Ironically the *Montross* court held that the federal holder in due course doctrine did not extend to non-negotiable instruments. *Id.* at 358.

11. *See, e.g.*, FDIC v. Wood, 758 F.2d 156 (6th Cir.), *cert. denied*, 474 U.S. 944 (1985). The *Wood* court determined that *D'Oench* and Section 1823(e) were intended to "clothe the FDIC with the protections afforded a holder in due course," but that Section 1823(e) did not authorize such status. *Id.* at 159 The *Wood* court then found such status for the FDIC in federal common law, arguing that to permit the assertion of personal defenses stemming from the underlying transaction

has, however, remained constant during this expansive development. The goal sought to be preserved by this unbridled growth of the doctrine was the protection of the insurance fund as an integral part of regulatory failed bank policy.[12] The core value inherent in this goal was, and continues to be, economic.

Even before the collapse of the saving and loan industry,[13] and the

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would prevent the FDIC from carrying out its statutory mandate in choosing a failure resolution technique. *Id.* at 161. *See also* Campbell Leasing, Inc. v. FDIC, 901 F.2d 1244, 1249 (5th Cir. 1990) (extending the status to successors of federal agencies even though the technical state law requirements for holder in due course status are not met); FSLIC v. Murray, 853 F.2d 1251, 1256 (5th Cir. 1988) (extending the federal common law status to the FSLIC). The application of the holder in due course doctrine to bar state law defenses has been upheld against constitutional challenge. *See* Campbell Leasing, Inc. v. FDIC, 901 F.2d at 1250.

12. This was, of course, the stated policy reason given by Justice Douglas. D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447, 457 (1942). For the most part, however, courts have blindly followed the doctrine, with little if any critical evaluation of the underlying economic or philosophical values that are inherent in the professed underlying policy. *See, e.g.*, FSLIC v. Gordy, 928 F.2d 1558, 1563 (11th Cir. 1991) (asserting that undisclosed conditions in the assets of failed institutions are not the concern of the FDIC); FDIC v. Kasal, 913 F.2d 487, 492 (8th Cir. 1990), *cert. denied*, 111 S. Ct. 1072 (1991) (applying *D'Oench* and section 1823(e) even when the results appear harsh or inequitable); FDIC v. McCullough, 911 F.2d 593, 600 (11th Cir. 1990) (applying *D'Oench* while noting that "on its face, such a policy may appear inequitable"); Campbell Leasing, Inc. v. FDIC, 901 F.2d at 1249 (5th Cir. 1990) (extending the ambit of federal holder in due course to FDIC and successors in a bulk sale); FSLIC v. Stone-Liberty Land Ass'n, 787 S.W.2d 475 (Tex. Civ. App. -- Dallas 1990, writ granted) (permitting FSLIC to raise *D'Oench* for the first time on appeal). *Contra* Sunbelt Sav. v. Montross, 923 F.2d at 358 (refusing to extend the holder in due course doctrine to cover non-negotiable notes); FDIC v. State Bank of Virden, 893 F.2d 139, 143 (7th Cir. 1990) (holding setoffs accomplished before the assignment of a debt to FDIC-Corporate outside the protection of section 1823(e)); Olney Sav. & Loan Ass'n v. Trinity Banc Sav. Ass'n, 885 F.2d 266, 275 (5th Cir. 1989) (refusing to permit assertion of section 1823(e) protections for the first time on appeal); FDIC v. Republic Bank Lubbock, 883 F.2d 427, 429 (5th Cir. 1989) (holding section 1823(e) does not invalidate subordination agreement existing prior to receivership); Astrup v. Midwest Fed. Sav. Bank, 886 F.2d 1057, 1059 (8th Cir. 1989) (holding *D'Oench* does not bar tort claims).

13. The savings and loan fiasco motivated President George Bush only eighteen days after his inauguration to announce a comprehensive plan to resolve the crisis. The result was the FIRREA. At the time of its passage approximately twenty-five percent of the savings and loan industry was in serious financial difficulty. *See* FIRREA REPORT, *supra* note 8, at 303, *reprinted in* 1989 U.S.C.C.A.N. at 99. The insolvency of Federal Savings and Loan Insurance Corporation [hereinafter FSLIC] as a result of the savings and loan crisis of the late 1980's is well documented. *See, e.g., id.* at 304, *reprinted in* 1989 U.S.C.C.A.N. at 100 (mentioning that the FSLIC was in a deficit position of over $56 billion on December 31, 1988). FIRREA abolished FSLIC [12 U.S.C. 1725(a) (1980), *repealed by* FIRREA, Pub. Law 101-73, § 407, 103 Stat. at 363 (1989)] and all of its insurance responsibilities were assumed by either the FDIC or the Resolution Trust Corporation [hereinafter RTC]. 12 U.S.C. § 144199a0(h) (West Supp. 1991); 12 U.S.C. § 1811 (1989). Recently the administration has asked for another $80 billion to clean up the savings and loan mess in addition to the $80 billion already spent. Paulette Thomas, *FDIC Expects to be Insolvent by Year End*, WALL ST. J., June 27, 1991, at 3 (Southwest ed.).

increasing rise in bank failures,[14] the necessity for a change in the direction of bank regulatory policy to deal more effectively with the problems generated by excessive bank risk and its resulting negative impact on the insurance fund was widely acknowledged.[15] In fact, today it is generally recognized that the present

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14. Between 1943 and 1974, fewer than ten banks failed in any given year. FED. DEPOSIT INS. CORP., 1989 ANNUAL REPORT 101 (1990) (table 122). By contrast, 221 banks failed in 1988 and 207 failed in 1989. TREAS. DEP'T, MODERNIZING THE FINANCIAL SYSTEM: U.S. TREASURY DEPARTMENTS RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS, *reprinted in* Fed. Banking L. Rep. (CCH) No. 1377 (pt. II), at ch.I (table I) (Feb. 14, 1991) [hereinafter TREASURY REPORT giving the respective chapter and page number, except that reference to its conclusions and recommendations will be hereinafter TREASURY REPORT, *Conclusions and Recommendations*]. *See also* GENERAL ACCOUNTING OFFICE, OPINION LETTER ACCOMPANYING 1989 ANNUAL REPORT OF THE FDIC 3 (June 28, 1990) (noting that the "performance of the commercial banking industry deteriorated in 1989 compared to 1988"). The GAO found that at the end of 1989 there were 1,109 problem institutions, thirty-five of which were in serious financial trouble and needed to be recapitalized, and several others that could fail if regional economies continued to deteriorate. *Id.* at 4. As a direct result of the increasing numbers of bank failures the FDIC's deposit insurance fund has declined drastically. From 1987 through the end of 1990, the FDIC fund will have declined from over $18 billion to about $9 billion. TREASURY REPORT, *Conclusions and Recommendations*, *supra*, at I-11. William Seidman, chairman of the FDIC, has recently asserted that the FDIC will be insolvent by the end of 1991. *See* Thomas, *supra* note 13, at 3, col. 1. *See also* TREASURY REPORT, *Conclusions and Recommendations*, *supra*, at ch.I (table 1) (showing that in 1989 the FDIC lost $6.090 million). This has motivated the FDIC to request an increase in its statutory authority [12 U.S.C. § 1824(a) (West Supp. 1991)] to borrow from the Treasury. *See* Paulette Thomas, *Seidman Raises Estimate of Size of FDIC Deficit*, WALL ST. J., June 28, 1991, at 2, col. 3 (Southwest ed.) (stating that the fund will need to borrow $50.2 billion by the end of 1991).

15. *See, e.g.*, EDWARD J. KANE, THE GATHERING CRISIS IN FEDERAL DEPOSIT INSURANCE 145-65 (1985) (outlining six different proposals to deal with the excessive risk in the banking and savings and loan industry including risk-rated premium and market-value accounting); Kenneth E. Scott & Thomas Mayer, *Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform*, 23 STAN. L. REV. 857, 886-94 (1971) (advocating classified variable premium rates based on the individual risks facing a bank or savings institution). More recently, as the economic problems generated by the crisis have increased in magnitude the level of debate among academicians concerning how to reduce bank risk and provide a "safer banking system" has heightened. *See, e.g.*, Helen A. Garten, *What Price Bank Failure?*, 50 OHIO ST. L.J. 1159, 1161 (1989) [hereinafter Garten, *Bank Failure*] (noting that the recent crisis has turned focus "on the cost of bank failure to the bank insurance fund"); Jonathan R. Macey, *The Political Science of Regulating Bank Risk*, 49 OHIO ST. L.J. 1277, 1277 (1989) (noting that the massive losses to the federal deposit insurance has made "[T]he leading edge issue in banking law today is -- or ought to be -- bank risk"). *See also* Helen A. Garten, *Banking on the Market: Relying on Depositors to Control Bank Risks*, 4 YALE J. ON REG. 129, 131 (1986) [hereinafter Garten, *Banking on the Market*] (concluding that depositor discipline does not cause banks to control their risk-taking); Jonathan R. Macey & Geoffrey P. Garrett, *Market Discipline by Depositors: A Summary of the Theoretical and Empirical Arguments*, 5 YALE J. ON REG. 215, 239 (1988) (asserting that empirical data supports the proposition that depositor discipline can control risk-taking by bankers); Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1172-93 (1988) (explaining how the FDIC's choice of a failure resolution technique can exacerbate excessive risk taking); Geoffrey P. Miller, *The Future of the Dual Banking System*, 53 BROOK. L. REV. 1, 19 (1987) (noting that the existence of deposit insurance creates a moral hazard on the part of depository institutions giving them an incentive to take risk).

regulatory structure and policies have encouraged the very risks that exacerbate bank failure.[16] As a result legislative focus is moving from an emphasis on failed bank policy (ex post)[17] toward the development of healthy bank policy·

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16. *See, e.g.*, Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 314 (1987) (noting that federal deposit insurance creates incentives for banks to make risky loans); Garten, *Banking on the Market*, *supra* note 15, at 172 (acknowledging that "bank risk is increasing"); Michael C. Keeley, *Deposit Insurance, Risk, and Market Power in Banking*, 80 AM. ECON. REV. 1183, 1183 (1990) ("It has long been recognized that a fixed-rate deposit insurance system, . . . can pose a moral hazard to excessive risk taking"). Although acknowledging the existence of excessive risk in the banking industry and the resulting possibility of bank failure, academicians do not agree on the solution. The principal debate centers on whether market forces or regulatory policies should be used to create an atmosphere to correct the problem. *Compare* TREASURY REPORT, *Conclusions and Recommendations*, *supra* note 14, at 10 (advocating changing the scope of deposit insurance, increasing supervision of banks, and creating asset risk-based insurance premium to increase market discipline to reduce risk) *and* Stephen K. Halpert, *The Separation of Banking and Commerce Reconsidered*, 13 J. CORP. L. 481, 527-32 (1988) (arguing that the repeal of the separation of the investment banking and commercial banking activities is desirable to counter excessive risk taking) *and* Macey, *supra* note 15, at 1290-98 (positing that current regulations [including the prohibition of investment banking, the pricing of deposit insurance, and administration of failed banks which give creditors no incentive to control risk taking] subsidize excessive risk taking by federal insured banks.) *and* Macey & Miller, *supra* note 15, at 1154 (arguing that regulatory policies destroy market discipline as a method of controlling excessive risk by banks) *with* Helen A. Garten, *Banking on the Market*, *supra* note 15, at 172 ("greater reliance on market discipline to reduce bank risk is likely to prove counterproductive") *and* Helen A. Garten, *Still Banking on the Market: A Comment on the Failure of Market Discipline*, 5 YALE J. ON REG. 241, 249 (1988) [hereinafter Garten, *Still Banking*] (asserting that market discipline can not control risk taking by banks).

17. By "failed bank policy" is meant policies and resulting government supervision of which the primary focus is on the handling of problems generated by insolvency or other severe financial condition of banks and the use by the FDIC of bank failure resolution techniques. FIRREA enhanced the powers of the FDIC to structure assistance to banks and to fund failed bank resolutions, but its major failure resolution techniques remain the same: open bank assistance, deposit payoff, and purchase and assumption transaction and bridge-bank transactions. 12 U.S.C. §§ 1821(d)(2)(F), (d)(2)(G), (f) (m), (n), 1823(c),(d) (1989). In a deposit payoff, the FDIC draws from the insurance fund to pay the balance of all insured deposits. Open bank assistance involves the use of loans and other techniques to prevent failure of a financial institution. These procedures are used by the FDIC in its corporate capacity primarily in the case of banks considered to be "too big to fail." The phrase "to big to fail" relates to those banks which the FDIC "is unwilling to inflict losses on uninsured depositors and even creditors in a troubled bank for fear of adverse macroeconomic consequences or financial instability of the system as a whole." TREASURY REPORT, *Conclusions and Recommendations*, *supra* note 14, at III-29. However, because of the costs such a transaction imposes on the insurance fund, it is not favored by the FDIC. *Id.* at I-34-37 (discussing the cost of several open bank assistance cases). The use of open bank assistance has led to a generally FDIC policy of preferring uninsured depositors, i.e., those in excess of the insured amount, over creditors. In fact uninsured deposits are routinely "insured" as a result of the resolution techniques used by the FDIC in failed bank situations. *Id.* at I-40 ("[B]ecause the FDIC has provided full coverage to uninsured depositors in very large bank failures [open bank assistance] for the sake of financial stability it is difficult from the standpoint of fairness to inflict losses [in purchase and assumption transactions] on uninsured depositors in smaller banks."). This special protection of uninsured depositors has received criticism. *See id.* at III-31 (recommending that the

(ex ante).[18] This development reflects a growing realization that the present

FDIC use failure resolution techniques in large bank situations in such a way to impose losses on the uninsured depositors); KANE, *supra* note 15, at 37 (noting that the FDIC shows "a de facto commitment to minimize the risks of cumulative failures that surpass[es] their de jure commitment to safe and sound banking"); Macey & Miller, *supra* note 15, at 1181 (arguing that open bank assistance weakens the banking system by taking away incentives for large depositors to monitor risks). The failure resolution technique favored by the FDIC is the purchase and assumption transaction, which can be viewed as "a merger or acquisition of the failed bank by a successful bank, with the successful bank paying a certain amount for the goodwill value of the failed bank." EDWARD L. SYMONS, JR. & JAMES J. WHITE, BANKING LAW: TEACHING MATERIALS 624 (3d ed. 1991). *See also* TREASURY REPORT, *Conclusions and Recommendations, supra* note 14, at ch. I, (table 8) (showing that 805 purchase and assumption type transactions were undertaken during the period 1980-89 out of a total 1098 failure resolution transactions). The advantages of a purchase and assumption transaction are that it requires no immediate expenditure of FDIC reserve funds because the assuming institution assumes the liabilities of the depositors, it avoids even the temporary disruption of banking services, and preserve the "going concern" value of the failed institution. *See. e.g.*, Macey & Miller, *supra* note 14, at 1183. A bridge-bank transaction involves the creation by the FDIC of a limited-life institution [bridge bank] into which the insolvent institution is merged through a purchase and assumption transaction. The bridge bank can continue operations in the place of the failed institution until an ultimate purchaser is found. TREASURY REPORT, *supra*, at I-33. *See generally* Gunter v. Hutchinson, 674 F.2d 862 (11th Cir.), *cert. denied*, 459 U.S. 826 (1982) (describing a purchase and assumption transaction); Garten, *Bank Failure, supra* note 15, at 1163-65 (giving a brief description of these failure resolution alternatives); Macey & Miller, *supra* note 14, at 1174-93 (containing a detailed pre-FIRREA analysis of various failed bank resolution techniques). The use of failure resolution techniques by the FDIC are considered to be merely exercises of the constitutional bankruptcy power [U.S. CONST. art. I, § 8.]. *See* Christopher T. Curtis, *The Taking Clause and Regulatory Takeovers of Banks and Thrifts*, 27 HARV. J. ON LEGIS. 367, 372 (1990) ("Regulatory disposition of financially troubled banks and savings associations is an exercise of the bankruptcy power.").

18. By "healthy bank policy" is meant policies and supervision focused on making banking safer and more competitive by reducing the risks inherent in banking. *See, e.g.*, TREASURY REPORT, *Conclusions and Recommendations, supra* note 14, at 9 ("the most effective way to minimize taxpayer exposure is through a strong, competitive, well-capitalized banking system."). Healthy bank policy must, however, have a method for dealing with bank failures when they occur. In such an event healthy bank policy focuses on a value-based approach to resolving the crisis, not on a straightforward economic cost approach which is and has been the linchpin of failed bank policy. Thus, the use of the terms healthy bank policy or failed bank policy is more than a mere semantic argument, it is a matter of inherent underlying philosophical values. *But see* Garten, *Bank Failure, supra* note 15, at 1161-62 (grouping "healthy bank policy" and "unhealthy bank policy" together as components of bank failure policy for the reason that since not just badly managed banks fail, bank failure policy cannot just focus on encouraging healthy banks). Garten argued that "bank failure policy" is designed to facilitate rapid reallocation of banking resources following bank failure at the minimum cost to the FDIC and its insurance fund. *Id.* at 1175, 1195-96. In this author's opinion Garten's focus is misplaced and her approach is flawed, although it is consistent with the outdated policies that have created the very crisis our country is now suffering. Garten's approach begins correctly by identifying the underlying goal of bank policies – to provide a stable money supply. But her approach lends justification for only those policies which achieve that goal at the least economic cost – her overriding value. Healthy bank policy stresses methods of encouraging accountability through better managed and supervised banks and the creation of disincentives for excessive risk taking. The old adage "an ounce of prevention is worth a pound of cure" is synonymous with the underlying premises of a healthy bank policy. In the event of failure, bank

ex post regulatory policies have not only created liquidity problems for the insurance fund, but have also placed significant social costs[19] on the public and have led to increases in federal deposit insurance premiums for healthy banks.[20] The erosion of public confidence in the banking industry has motivated legislative interest in reforming the deposit insurance system,[21] recapitalization

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policy should focus on the plight of the depositors, creditors, and debtors in terms of social costs and ethical values irrespective of the overall economic costs. Both this author and Garten see the need for a stable money supply as an appropriate goal of governmental banking policies. However, this author believes that the policies that achieve that goal are justified only if the underlying values of commutative justice and accountability are encouraged and supported. For a detailed discussion of these different approaches *see infra* notes 94-144 and accompanying text (failed bank paradigm); and *see infra* notes 145-57 and accompanying text (healthy bank paradigm).

19. The recognition of the existence of possible divergences between social costs and private costs is largely attributed to the work done by A.C. Pigou. A.C. PIGOU, THE ECONOMICS OF WELFARE, pt II, ch. IX (4th ed. 1932). By private cost Pigou was referring to the opportunity cost to society of using an amount of input in one manner as opposed to another; while a private cost referred to the cost to the firm of using the input. *Id.* at 134-35. According to Pigou divergences between the two might result from external diseconomies related to the use of the input, such as pollution of a stream by waste material from a factory. *Id.* at 183-88. Pigou argued that the divergences needed to be measured so that the welfare of society from the use of the input could be evaluated. *See generally* Ronald H. Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 28-42 (1960) (critically analyzing Pigou's theory). More recently, Richard Posner distinguished between the two types of costs by saying "[A] social cost diminishes the wealth of society; a private cost merely rearranges that wealth." RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 7 (3d ed. 1986) [hereinafter POSNER, ECONOMIC].

20. *See, e.g.*, TREASURY REPORT, *Conclusions and Recommendations*, *supra* note 14, at 34 (acknowledging the decline in consumer confidence caused by increasing taxpayer potential exposure in light of failing banks and resulting losses to the federal insurance fund); FIRREA REPORT, *supra* note 8, at 302, *reprinted in* 1989 U.S.C.C.A.N. at 98 (noting the waning of consumer confidence in the savings and loan industry). *See also* KANE, *supra* note 15, at 142-44 (noting that because of the various political constraints, the President and Congress will see that taxpayers and well-managed financial institutions will underwrite the cost of the Treasury Department's promise underlying the deposit insurance guarantee). Macey and Miller have identified the parties affected by the externalities of bank failure as healthy banks whose contributions to the FDIC and the then-existing FSLIC insurance funds paid off depositors and ultimately the federal taxpayers whose taxes paid for the FDIC administrative costs and would replenish the federal insurance fund soon when the funds were depleted and borrowing from the Treasury was necessitated. Macey & Miller, *supra* note 15, at 1162. In the case of present failed bank policies the divergences between private and social costs have in this author's opinion led to an significant additional external diseconomy – a lack of public confidence in bank regulation because of the inequities in *D'Oench* type legal proceedings and the failure of regulators to seriously address the microeconomic issue of individual bank credit risk. From a purely welfare economic standpoint society will be better served by policies that encourage safer banks, than policies that wait to resolve bank failures with their resultant social costs.

21. *See, e.g.*, S. 261 (Deposit Insurance Reform Act of 1991), 102d Cong., 1st Sess., 137 CONG. REC. S.1161-1167 (daily ed. Jan. 24, 1991); S. 713 (Financial Institutions Safety and Consumer Choice Act of 1991), 102d Cong., 1st Sess., 137 CONG. REC. S.3739- 3777 (daily ed. March 21, 1991) (containing the Treasury Department's proposals for changing the banking industry to deal with the banking crisis). These proposals seek changes in some of the basic structures of the banking system and as a result are dissimilar to the original deposit insurance act which was enacted as a "method of controlling the economic consequences of bank failures without altering the

of that system,[22] and structural reform in the nature of deregulation of financial services.[23]

However, neither courts, legislators, nor academicians have suggested any major reconsideration of one of the most misguided disciples of failed bank policy -- the *D'Oench* doctrine.[24] With the tidal wave of litigation involving the FDIC, RTC,[25] and successor financial institutions[26] attempting to collect upon the improvident loans made by the collapsed industry as a means to replenish the insurance fund,[27] serious focus needs to be given to *D'Oench*, the

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basic structure of the banking system." Carter H. Golembe, *The Deposit Insurance Legislation of 1933*, 75 POL. SCI. Q. 181, 200 (1960) (noting that the bill was a compromise between those advocating basic changes in the banking structure and those advocating no government intervention).

22. *See, e.g.*, S. 262 (Deposit Insurance Fund Assistance Act of 1991), 102d Cong., 1st Sess., 137 CONG. REC. S.1170 (daily ed. Jan. 24, 1991).

23. *See, e.g.*, S. Bill 263 (Proxmire Financial Modernization Act of 1991), 102d Cong., 1st Sess., 137 CONG. REC. S.1172-1180 (daily ed. Jan. 24, 1991).

24. Although there has been a recent flurry of articles, notes, and comments concerning *D'Oench* and its progeny in the last few years, none have advocated its repeal and few have been critical of any part of its present application. *See, e.g.*, Jane D. Goldstein, Langley v. FDIC: *FDIC Superpowers -- A License to Commit Fraud*, 8 ANN. REV. BANKING L. 559, 580 (1989) (arguing that extending holder in due course status to the FDIC needs an equitable exception); Gray, *supra* note 5, at 300 (arguing for a restriction of the *D'Oench* case to its statutory counterpart); Steven A. Weiss & Kenneth E. Kraus, D'Oench *Protection for Private Institutions Assisting the FDIC: A Necessary Component of Thrift and Bank Bailout*, 108 BANKING L.J. 256, 284 (1991) (concluding that *D'Oench* protection extends to third parties); William A. MacArthur, Comment, *Who Will Stop the Rain? Repairing the Hole in the* D'Oench, Duhme *Umbrella by Protecting the FDIC Against Fraudulent Transferee Liability Under the Bankruptcy Code*, 23 LOY. L.A. L. REV. 1271, 1335-36 (1991) (advocating extension of D'Oench doctrine to protect FDIC from fraudulent transferee liability); Stephen W. Lake, Note, *Banking Law: The* D'Oench *Doctrine and 12 U.S.C. § 1823(e): Overextended, But Not Unconstitutional*, 43 OKLA. L. REV. 315, 337 (1990) (asserting that extending to the FDIC the status of holder in due course is an appropriate balance between the protection of the banking system and the borrower); Hymanson, Note, *supra* note 7, at 319 (asserting merely that giving the FDIC the status of a holder is not consistent with the equitable roots of the doctrine); E. Douglas Welch, Note, D'Oench, Duhme *Protections Extend to Private Parties Who Purchase a Failed Institutions's Assets From the FSLIC*: Porras v. Petroplex Savings Association, 903 F.2d 379 (5th Cir. 1990) 22 TEX. TECH L. REV. 237, 254-55 (1991) (noting that the extension of *D'Oench* protection to assignees may not bolster confidence in the banking system but advocating no change).

25. The Resolution Trust Corporation was established by FIRREA to manage and resolve all cases involving FSLIC-insured institutions placed in conservatorship or receivership between January 1, 1989, and the date of the enactment of FIRREA (Aug. 9, 1989) or to be placed into conservatorship or receivership within a three year period following its enactment. 12 U.S.C. § 1441(a)(b)(3) (West Supp. 1991).

26. By successor financial institution is meant the financial institution which acquires all or a part of the assets of the failed bank as a result of a failed bank resolution technique chosen by the FDIC acting in its capacity of receiver of the failed institution.

27. Under FIRREA the FDIC became the administrator of two separate and distinct deposit insurance funds: the Bank Insurance Fund (BIF), which was formerly the Deposit Insurance Fund, which insures all BIF-member banks, and the Savings Association Insurance Fund (SAIF) which

Neanderthal of failed bank policy. This doctrine has its origin in the "fiscal revolution"[28] which followed the Great Depression.[29] This liberal revolution's macro-focus was on remedying the perceived evils of the then-existing economic system in general. The solutions selected involved immediate and massive government intervention, regulation, and redistribution of wealth[30] to solve the nation's economic crisis and to rebuild public confidence. In the area of financial services this philosophy led most directly to the separation of

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insures the deposits of all SAIF-member savings associations (formerly a function of the FSLIC). 12 U.S.C. §§ 1821(a)(5)-(7)(A) (1989). These funds are derived from assessments paid by the member financial institutions based on a flat rate percentage of insured deposits [12 U.S.C. § 1817(b) (West Supp. 1991)] and, if necessary, from borrowing from the Treasury Department. 12 U.S.C. § 1824(a) (West Supp. 1991). A FSLIC Resolution Fund was also established by FIRREA to deal with pre-FIRREA savings and loan liquidations to be managed by the FDIC. The fund consists mainly of the assets and liabilities transferred from the FSLIC. 12 U.S.C. § 18219(a) (1989). To the extent this fund is insufficient to satisfy the liabilities of the former FSLIC, the Treasury Department is required to fund the difference. 12 U.S.C. § 1817(a)(c) (1989).

28. The term fiscal revolution refers to the drastic and significant changes in policies about the large aggregates in the national budget "as directed toward affecting certain overall characteristics of the economy, such as employment and unemployment, price levels, and the total share of government activity in the economy" that occurred during the New Deal. HERBERT STEIN, THE FISCAL REVOLUTION IN AMERICA 4 (1969) [hereinafter STEIN]. The revolution had the effect of challenging the underlying values and related goals and policies of the alleged outdated *laissez faire* economic and political order and replacing them with policies that reflected an expansive role for government in economic decision-making. *Cf.* William M. Isaac, *The Role of Deposit Insurance in the Emerging Financial Services Industry*, 1 YALE J. ON REG. 195, 197 (1984) (noting that banking law changes of the New Deal reflected a "pervasive belief . . . that excessive competition was a primary cause of the economic collapse").

29. The need for some level of government spending to relieve the pressures of the depression was recognized by both Presidents Hoover and Roosevelt. *See, e.g.*, STEIN, *supra* note 28, at 24-26, 147-51. However, it was not until the publication of *The General Theory* in 1936 by John M. Keynes, that the recognition for the need of substantial increases in government aggregate demand to make up for the lack of private investment diverted to savings became apparent to the Roosevelt Administration. *Id.* at 167 ("The only error of the New Deal was its failure to send enough."). Keynes posited that under his liquidity preference analysis there was the possibility that even under conditions of monetary equilibrium, full employment would not be achieved, and thus government spending would be required to assist the economy to achieve full employment. JOHN M. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 196-99; 247-54 (1936). In his treatise Keynes highlighted the failure of monetary policy to restore equilibrium between savings and investment during the financial crisis of 1932 in the United States. *Id.* at 207-08. *See generally* JOHN K. GALBRAITH, THE NEW INDUSTRIAL STATE 219-32 (1967) [hereinafter GALBRAITH, INDUSTRIAL STATE]; JOHN K. GALBRAITH, AMERICAN CAPITALISM 63-83 (1952).

30. In order to reduce the unemployment ranks and to stimulate aggregate demand, the level of expenditures by the federal government through public assistance projects rose dramatically. *See, e.g.*, GALBRAITH, INDUSTRIAL STATE, *supra* note 29, at 228; STEIN, *supra* note 28, at 167-68. From one perspective, portions of the New Deal agenda reflected elements of distributive justice in the Aristotelian sense in that its policies more evenly divided the stock of wealth in society among its members. ARISTOTLE, ETHICA NICOMACHEA, Book V.3 (Ross ed., 1925).

commercial and investment banking.[31] Furthermore, in this environment "deposit insurance was advanced and accepted as a method of controlling the economic consequences of bank failures"[32] and thus, of restoring public confidence in the banking system.[33]

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31. Banking Act of 1933, Pub. L. No. 73-66, §§ 16, 20, 21, 48 Stat. 162, 184, 188-189 (codified as amended at 12 U.S.C. §§ 24 (Seventh), 377, 378 (1989 & West Supp. 1991). *See generally* Edwin J. Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 483 (1971).

32. Golembe, *supra* note 21, at 200. Bank failure like the failure of any business involves capital losses to the owners and their depositors and other creditors. However, it has been asserted that unlike other business failures, bank failure has more significant macroeconomic consequences -- the drastic reductions in the supply of money and resultant general economic downturn following bank runs. *See, e.g.*, TREASURY REPORT, *Recommendations and Conclusions*, *supra* note 14, at I-6-11 (listing contraction of money supply, disruption in payment system, interference with financial intermediation among other macroeconomic consequences); Fischel et al., *supra* note 16, at 311-12 (listing decreases in money supply resulting in unemployment and output problems as well as interruptions in the supply of credit for investment projects as potential macroeconomic results of bank failure); Golembe, *supra* note 21, at 181-82 (asserting that the primary purpose of deposit insurance is not to protect the small depositor, but to end the collapse of the circulating medium); Scott & Mayer, *supra* note 15, at 858-59 (listing the dangerous reductions in the money supply and its potential effect on economic activity). There is no doubt that the asymmetry between the maturity structures of bank assets and liabilities makes them "different" from other businesses, however, the alleged macroeconomic effects of bank failure are coming under recent attack. *See, e.g.*, Fischel et al., *supra* note 16, at 310-11 (arguing that bank failures are not inherently contagious); Macey, *supra* note 15, at 1282 (concluding that "there is no reason at all why bank failures should be contagious"); Macey & Miller, *supra* note 15, at 1156-62 (discounting the "spillover" effects of one bank failure upon public confidence and loss of society's stock of wealth); Scott, *Deposit Insurance*, *supra* note 4, at 932 (arguing that bank failure is a powerful tool for promoting efficiency); A. Dale Tussing, *The Case for Bank Failure*, 10 J.L. & ECON. 129, 147 (1967) (advocating a reassessment of the widely held view that banks cannot be permitted to fail). Another commentator as part of his argument for the repeal of the laws forcing the separation of commercial and investment banking asserted that Congress and regulators "misperceive the costs and benefits of bank failure, and pursue excessively the goal of bank 'safety and soundness'." Halpert, *supra* note 16, at 533.

Notwithstanding this current debate on the true macroeconomic costs of bank failure, deposit insurance was put forward as the device to prevent this perceived economic Armageddon, and thus, the viability of the insurance fund became the central policy goal. This macroeconomic crisis syndrome with its resultant incessant demand for the security of the insurance fund has plagued failed bank policy since the New Deal. *See, e.g.*, TREASURY REPORT, *Conclusions and Recommendations*, *supra* note 14, at 41 (noting that the administration's goal is to minimize the "cost of the insurance fund of resolving failed banks."). *But see* K. A. Randall, *The Federal Deposit Insurance Corporation: Regulatory Functions and Philosophy*, 31 LAW & CONTEMP. PROBS. 696, 702 (1966) (asserting boldly that "[t]he Corporation, moreover, is concerned less with keeping the insurance fund intact and more with preserving public confidence in banks.").

33. *See* FDIC REPORT, *supra* note 8, *reprinted in* 1950 U.S.C.C.A.N. at 3765-66 (noting that the FDIC brings "to depositors sound, effective, and uninterrupted operation of the banking system with resulting safety and liquidity in bank deposits."); Scott & Mayer, *supra* note 15, at 858-59 ("The primary function of the insurance system is not to replace the deposits of failed banks, but rather to reduce the incidence of failure by assuring the public that deposits are safe and hence preventing runs that can topple even sound banks.").

Given this arena, the *D'Oench* Court's preoccupation with the goal of preserving the insurance fund may have been justified in economic terms. However, such a fixation eliminated considerations of what other values and/or possible private and social costs the decision would engender.[34] As a result of *D'Oench*, a debtor of a failed institution has not only lost his day in court, but has also become the scapegoat for the inability of failed bank policy to achieve its ultimate macroeconomic goal of minimizing losses to the insurance fund. The *D'Oench* debtor has been forced to bear more than his fair share of responsibility for the recent economic downturn and resulting loan losses as well as those caused by the nonfeasance and/or malfeasance of the institutions and their regulators.[35] Such a result flies in the face of ethical considerations of commutative justice[36] which would militate in favor of applying principles of fairness on a basis.

Furthermore, *D'Oench* creates an incalculable externality by leaving the hapless debtor with the possibility of seeking relief under the bankruptcy laws

34. *See, e.g.*, Hymanson, Note, *supra* note 7, at 319 (arguing that the expansion of the doctrine causes "unwarranted disruption of established commercial practices. . . and results in a grave injustice to innocent, good faith borrowers who have been defrauded by their bankers"). The present preoccupation of failed bank policy to preserve the insurance fund led one commentator to acknowledge that the present regulatory climate "may frustrate attempts to use the bank failure process to achieve other goals." Garten, *Bank Failure*, *supra* note 15, at 1175. Garten expressed no regrets, however, as she is wedded to the failed bank paradigm where the cost of failure resolution is the primary consideration, "despite the consequences of that policy for bank investors, managers, and the banking system." *Id.* at 1195.

35. Poor supervision and performance by regulators was identified as one of the causes contributing to the savings and loan fiasco. FIRREA REPORT, *supra* note 8, at 301-02, *reprinted in* U.S.C.C.A.N. at 97-98. Even the Treasury Department acknowledged that the overlapping scheme of banking regulations and the regulators' supervisory performance accentuated the present banking crisis. TREASURY REPORT, *Conclusions and Recommendations*, *supra* note 14, at 46, 63. The causes of bank failure are many. *See* Macey & Miller, *supra* note 15, at 1154 (listing fraud and self-dealing, insufficient asset diversification, and fluctuation in the business cycle); Garten, *Bank Failure*, *supra* note 15, at 1167 (listing management error, economic conditions, government policies, and lack of public confidence).

36. As used in this article, commutative justice refers to the correction or rectification of inequalities that arise between individuals as a result of interaction between them and calls for fundamental fairness in these exchanges. This approach is similar to the Aristotelian concept of corrective or commutative justice by which Aristotle meant the resolution of disputes according to criteria of fairness and based on the nature of the relationships between the parties. ARISTOTLE, *supra* note 29, at Book V.4. Commutative justice needs to be distinguished from Aristotle's concept of distributive justice or distributional equity which relates to the fairness of the overall societal distribution of wealth as opposed to fairness in the resolution of a particular dispute. *Id.* at Book V.3-5. For a discussion of the relation between commutative justice and distributive justice in Aristotle, see J.M. FINNIS, NATURAL LAW AND NATURAL RIGHTS 178-84 (1980).

because of his inability to repay debt.[37] These concerns in and of themselves should raise eyebrows, perhaps even more so today, in light of the fact that the ultimate values sought to be achieved through bank regulatory policy appear to be shifting. The purpose of this article is to consider whether the *D'Oench* doctrine has any continued economic or philosophic validity in an era of "healthy bank" policy.

The first part of this article will investigate the legal basis for *D'Oench* in light of the then-existing bank liquidation law. From this examination it will become apparent that the decision was merely another example of ad hoc decision making by the Roosevelt Court[38] to reach a desired economic result. The article will then move to a discussion of the bank failure paradigm which has been the basis of bank regulatory policy since the New Deal. This paradigm's underlying objective has been to achieve the macroeconomic goal of a sound and stable money supply.[39] However, to reach this goal, bank failure policies have been implemented which emphasize bottom line FDIC accounting costs with little concern or regard for other private or social costs, or for that matter concepts of fairness. The justification for these policies was and is purely economic -- that is, to the extent that bank failures can be handled at the least cost, the policies are justified. *D'Oench* is supposedly justified under this paradigm.[40]

Then this article will turn its focus to presenting an alternative paradigm, which shares with the failed bank paradigm, the underlying goals of preserving public confidence and a stable money supply. However, the policies proposed

37. In 1990, 718,107 families filed for personal bankruptcy; in 1991 the figure is expected to be around 900,000. Michael Allen, *Personal Bankruptcy Claims New Victims: Wealthier Americans*, WALL ST. J., (Southwest ed.) June 26, 1991, at 1. A growing number of these cases were highly paid professionals reeling from high personal debt and falling real estate values. *Id.*

38. By 1942 Roosevelt was successful in "packing" the Court. Seven of the nine justices were hand-picked by the Roosevelt Administration, while an eighth, although appointed by Coolidge, was elevated to the position of Chief Justice by Roosevelt. Justice Douglas, the *D'Oench* author was a legal positivist who firmly believed that judge-made law was necessary as an adaptation to the circumstances. *See* Beryl H. Levy, *Realistic Jurisprudence and Prospective Overruling*, 109 U. PA. L. REV. 1, 29-30 (1960). *Cf.* POSNER, JURISPRUDENCE, *supra* note 6, at 465 ("for on the whole the law *has* been shaped by practical needs").

39. *See* KANE, *supra* note 15, at 32-33 (identifying the goals of deposit insurance as redistributive [as part of the larger New Deal economic programs], economic efficiency, and the macroeconomic goal of avoiding destructive swings in public confidence). *See also* Scott & Mayer, *supra* note 15, at 858 (noting that "[o]n a macroeconomic level deposit insurance acts as a stabilizer by preventing dangerous reductions in the stock of money through bank failures.").

40. *See, e.g.*, FDIC v. Wood, 758 F.2d. 156, 161 (6th Cir.), *cert. denied*, 474 U.S. 944 (1985) (asserting state law defenses would "prevent" the FDIC from performing its statutory mandate). *See also* Weiss & Kraus, *supra* note 24, at 283-84 (concluding that unless successor institutions are protected by *D'Oench* the FDIC will be unable to effectively perform its role).

to achieve these goals are ones that will promote an environment of less risk taking and better managed banks. In that regard the focus will be microeconomic in that the emphasis will be on creating an atmosphere for asset protection in individual banks. The inherent values sought to be promoted by this emphasis is accountability on the part of banks and their regulators in handling and evaluating credit risks. In the event of failure[41] such policies will divorce the treatment of asset liquidation (failure resolution techniques) from that of deposit liability protection. The asset liquidation policies will be ethically value-based and thus, will deal with debtors not as pawns in the larger macroeconomic scheme, but as specific individuals with equitable rights.[42]

The values of commutative justice which are remarkably overlooked under the economic "least cost approach" of the present failure resolution system,[43]

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41. Although the goal of the healthy bank paradigm presented in this article is to implement policies that create a stable money supply and promote public confidence in the banking system through better managed and supervised institutions, there is the inevitable recognition that banks will fail for a variety of reasons. In such an event, the policies create a separation between the treatment of the assets and liabilities of the failed bank. On the liability side of the failed bank's balance sheet, the policies provide some level of deposit insurance to protect depositors and to prevent bank runs. On the asset side, the policies promote a fair and equitable resolution of disputes between the failed bank debtors and the FDIC. *See infra* notes 145-57 and accompanying text.

42. The recognition of competing and sometimes conflicting values of failure resolution policy is known to the Treasury Department. TREASURY REPORT, *supra* note 14, at III-28 (noting that failure resolution policy should maintain public confidence, encourage market discipline, be cost effective, and be as equitable and consistent as possible). The problems underlying the application of the *D'Oench* doctrine are that perception rather than individual factual reality often leads to giving overwhelming weight to one value to the detriment of the others. *See, e.g.*, Bell & Murphy & Assoc. v. Interfirst Bank Gateway, 894 F.2d 750, 754 (5th Cir.), *cert. denied*, 111 S. Ct. 244 (1990) (stating that the *D'Oench* doctrine "favors the interest of depositors and creditors of a failed bank, who cannot protect themselves from secret agreements, over the interest of borrowers, who can").

43. *See* 12 U.S.C. § 1823(c)(4)(A) (1989) (providing that the cost of an alternative failure resolution technique can not be more than the amount that the FDIC would have to pay out if it liquidated the bank, except when the FDIC determines that the "continued operation of such insured depository institution is essential to provide adequate depository services in its community"). This cost test became part of the statutory law as a result of the Deposit Insurance Flexibility Act which was included in the Garn-St. Germain Depository Institutions Act of 1982. Pub. L. No. 97-320, Title I, § 111, 96 Stat. 1469, 1469-71 (codified as amended at 12 U.S.C. § 1823(c) (1989)). Even prior to this amendment the FDIC had, as a result of its internal policies since 1951, pursued the cheapest alternative between the deposit payoff or purchase and assumption transaction. TREASURY REPORT, *supra* note 14, at I-31. The enactment of the least cost test clearly established that Congress valued the preservation of the corpus of the FDIC fund above other values. *See* Macey & Miller, *supra* note 15, at 1179. One commentator noted a rather obvious fact that the method of calculating the costs of alternative methods of failure resolution in a particular case is "left to the discretion of the agency involved." KANE, *supra* note 15, at 46. Another boldly asserted that the methods used by the FDIC in calculating costa in open bank assistance are "flawed". Macey & Miller, *supra* note 15, at 1177 (noting that the FDIC fails to consider the costs of possible eventual failure after the assistance, in calculating the costs of open bank assistance compared to the costs of liquidation). Even the Treasury Department recognized the degree of latitude that the FDIC has in

will play a significant role in evaluating debtors' rights. This approach recognizes that healthy bank regulatory policy is a response to the problem of credit risk inherent in the banking industry, and as such will approach bank failure not only as an economic issue, but as part of a larger social and ethical problem that affects all members of society. This value-based approach to failure resolution differs dramatically from the macroeconomic view of the present failed bank paradigm which only attempts to reduce the costs to the insurance system. In contrast, the value-based account is founded on a deeper understanding of what the concern of banking regulatory policies should address: accountability, credibility, and fairness.

Finally, the article will analyze whether *D'Oench* has any role to play in a value-based approach to bank failure under a healthy bank paradigm. By emphasizing less risk taking and better asset management by banks before failure, the economic justification for *D'Oench* will probably disappear. *D'Oench* has been used to increase the assets of a closed bank or to reduce the dollar amount of creditors' claims[44] under the guise of protecting the insurance

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choosing among the various alternatives. Its recent report stated:

> The FDIC's statutory cost test requires that in the absence of a finding that the bank is "essential" to its community, the FDIC may make uninsured depositors whole if doing so is less expensive than a payoff and liquidation of the bank. The FDIC may choose between a P&A [purchase and assumption transaction] in which all depositors are made whole and an insured deposit transfer, if both transactions are *estimated* to be cheaper than a payoff and liquidation. Then the FDIC need not choose the cheaper transaction under the cost test.

TREASURY REPORT, *supra* note 14, at I-40 (emphasis added). Furthermore, even the courts recognized that this authority is to be exercised in the FDIC's sole discretion. *See, e.g.*, FDIC v. Bank of Boulder, 911 F.2d 1466, 1469 n.1 (10th Cir. 1990) ("FDIC is given sole discretion to determine what method it will use to structure failed bank assistance transactions.").

44. In many *D'Oench* situations, not only is the debtor asserting defenses by way of confession and avoidance, but he is also seeking to recover damages (thus, becoming a creditor) in addition to or as a set-off to the debt the FDIC is seeking to recover. *See, e.g.*, Kilpatrick v. Riddle, 907 F.2d 1523 (5th Cir. 1990), *cert. denied*, 111 S. Ct. 954 (1991) In *Kilpatrick* the borrowers sought rescission of notes due to fraud and damages under both the federal and state securities laws, common law fraud, and breaches of the duty of good faith and fair dealing. *Id.* at 1525. The Fifth Circuit held that *D'Oench* not only barred the borrower's defenses to the FDIC collection on the notes, but was also a defense to the borrower's claims for damages. *Id.* at 1529. However, to the extent that a debtor has claims against the insolvent institution independent of the note, such as tortious interference with contract, breach of security agreements, or intentional infliction of emotional distress he can liquidate those for possible distribution. *See* 12 U.S.C. § 1821(d)(11)(A)(ii) (1989). *See also* Campbell Leasing, Inc. v. FDIC, 901 F.2d 1244, 1249 (5th Cir. 1990).

In any event under FIRREA the FDIC's liability to unsecured *D'Oench* type creditors is the liquidation value of their claim and such supplemental payments out of the insurance fund as the FDIC deems appropriate. 12 U.S.C. §§ 1821(i)(2),(3) (1989). Furthermore, in non-litigation situations FIRREA prohibits judicial review of decisions by the FDIC as receiver to disallow claims not proved to its satisfaction. 12 U.S.C. § 1821(d)(5)(E) (1989). As a practical matter, *D'Oench* fund, and thus promoting the continued stability of the money supply. The overall effect of *D'Oench* has been to shift the burden of financial mismanagement, economic reversals, fraud by bankers, or just poor supervision to the debtors[45] instead of spreading the loss over the entire insurance

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type claims can never be established under FIRREA, as a debtor can not meet the requirements of Section 1823(e).

The FDIC has been criticized in recent years for the manner in which it has discriminated against general unsecured creditors in attempts to reduce the dwindling deposit insurance fund. *See, e.g.*, Peter W. Kronberg, *Failing Banks: Creditors' Rights and the Distribution of Bank Assets*, 7 ANN. REV. BANKING L. 325, 363 (1988) (concluding that the discriminatory treatment of certain creditors' claims by the FDIC under the guise of protecting the insurance fund is misguided); Russell Manning, Note, *Creditors' Remedies Against the FDIC as Receiver of a Failed National Bank*, 64 TEX. L. REV. 1429 (1986) (noting that as the financial integrity of the insurance fund has weakened, the FDIC has taken action directly adverse to a policy of treating creditors fairly). Prior to FIRREA, Congress asserted that creditors as well as depositors need to be protected in failure resolution techniques. *See* S. REP. NO. 536, 97th Cong., 2d Sess. 1, 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 3054, 3054 (stating that the purpose of the Deposit Insurance Flexibility Act, Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified as amended in scattered sections of 12 U.S.C.) was to "protect depositors and creditors of such institutions"). Furthermore, until FIRREA, the receiver of a national bank was required to make ratable distributions among unsecured creditors to enforce the principal of equality. *See* 12 U.S.C. §§ 91, 194 (1989); Pacific Nat'l Bank v. Mixter, 124 U.S. 721, 726 (1888); First Empire Bank v. FDIC, 572 F.2d 1361 (9th Cir.), *cert. denied*, 439 U.S. 919 (1978) (applying the concept of ratable distributions to purchase and assumption transactions).

FIRREA's limitation of FDIC liability to unsecured creditors to the liquidation value of their claims and such supplemental payments that it deems appropriate, creates an obvious incentive to discriminate among creditors. 12 U.S.C. § 1821(i)(2), (3) (1989). Although neither sections 91 nor 191 have been repealed (requiring ratable distributions), FIRREA effectively eliminates the requirement for ratable distributions. 12 U.S.C. 1821(i)(1) (1989) (noting that "[N]otwithstanding any other provision of Federal law . . . this subsection shall govern the rights of creditors (other than insured depositors)"). *See* Note, *Unsecured Creditors of Failed Banks: It's Not a Wonderful Life*, 104 HARV. L. REV. 1052, 1052 (1991) (noting that both before and after FIRREA the FDIC has pursued a goal of "minimizing total distributions to creditors of failed institutions and eliminating payments to less deserving creditors"). Since the FDIC still has the obligation to pay insured deposits in full, 12 U.S.C. § 1821(f) (1989), the largest creditors will be the depositors and/or the FDIC itself to the extent that it has made any payments to depositors. 12 U.S.C. § 1821(g)(1) (1989) (providing that the FDIC is "subrogated to all rights of the depositor. . . to the extent of payment or assumption"). Thus, to the extent that the FDIC can reduce general unsecured creditors' claims through *D'Oench* or otherwise, and to the extent that it can eliminate debtors' defenses under *D'Oench*, it has more funds to distributed to itself as subrogee. This obvious conflict of interest is inherent in the dual roles that the FDIC plays under the current statutory scheme. One of the results of the adoption of the healthy bank paradigm advanced in this article is to minimize the effects of this conflict.

45. *See, e.g.*, FDIC v. Leach, 772 F.2d 1262, 1270 (6th Cir. 1985) (Merritt, J., dissenting) (arguing that the extension of the status of holder in due course to the FDIC following a purchase and assumption transaction redistributes "the cost of bank failure from taxpayers, each of who (sic) bears only a small fraction of the total cost, to a small number of note makers whose individual liability may be significant."); Goldstein, *supra* note 24, at 580 (describing the Supreme Court's decision in Langley v. FDIC, 484 U.S. 86 (1987), as creating a "policy redistributing the cost of bank failures from the taxpayers to individuals whose liability may be significant").

system.[46] Such a result has long been justified politically and economically to

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46. *See, e.g.*, Norcross, *supra* note 7, at 345 (asserting that *D'Oench* and its progeny force debtors to subsidize the insurance fund for the financial "sins" of their former bankers). It needs to be pointed out, however, that there are major distinctions between true insurance and the federal guarantee of $100,000 per insured account. True insurance can be viewed as a method of managing risk by transferring and distributing the potential for loss from particular occurrences among a larger group. Thus, by paying a relatively small sum of money (the premium) an insured (policyholder) can purchase a contract that obligates an insurer (insurance company) to pay the insured, if the insured sustains a loss arising from the risk insured against. The insurer can use the collective premiums received from all its insureds to pay a loss to one insured, "effectively" spreading the risk of loss from the insured to all policy holders. Insurers attempt to set the price of insurance in accordance with the insured's expected loss using the formula of the probability of a loss multiplied by the magnitude of the loss if it occurs. *See generally* ROBERT E. KEETON, BASIC TEXT ON INSURANCE LAW 2-9 (1971). The existence of insurance can give rise to the phenomenon known as moral hazard; the existence of insurance may increase the probability of loss or its size because the insured has less incentive to take precautions. Insurance companies can use deductibles and adjustments of premiums to compensate for this dilemma. *See generally* A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 53-59 (2d ed. 1989).

In the case of the federal guarantee we observe two dramatic differences: first there is no adjustment that an insured institution pays for its premium based upon a risk assessment of its portfolio (12 U.S.C. § 1817(b)(1)(B) (West Supp. 1991) (establishing a flat rate assessment for the BIF at a percentage of "estimated insured deposits")); and second, the moral hazard problem extends beyond the financial institution to the depositors, who because of deposit insurance have no incentive to monitor the risks being taken by the institution. *See, e.g.*, TREASURY REPORT, *Conclusions and Recommendations*, *supra* note 14, at VII-1 (noting that deposit insurance removes any incentive for an insured depositor to monitor the safety and soundness of a financial institution); Garten, *Banking on the Market*, *supra* note 15, at 131 (noting that many depositors have no incentive to monitor bank risk); Macey & Garrett, *supra* note 15, at 237-38 (noting that if there were risk based premiums, depositors would have incentives to monitor risks). The depositor is technically a third party beneficiary to the policy and has no downside risk in the event of failure of the bank except deposits in excess of the insured amount. However, even in this later case the practice has been to fully "insure" such deposits. *See infra* note 124.

The concept of moral hazard in the context of deposit insurance is described as follows:

> [W]ith the introduction of deposit insurance, insured depositors no longer require risk premiums commensurate with the level of risk since their investment is safe and, under a flat-rate premium structure, banks' insurance costs will be the same regardless of their risk position. As a result, banks may take on additional risk without having to pay higher interest rates on deposits or higher insurance premiums. The risk-return trade-off has been altered such that the price of assuming greater risk has been reduced and, consequently, the bank is likely to move to a riskier position.

TREASURY REPORT, *supra* note 14, at VIII-2 (notes omitted). In simple terms, the moral hazard in deposit insurance simply means that a bank can "borrow at or below the risk-free rate by issuing insured deposits and then investing the proceeds in risky assets with higher expected yields." Keeley, *supra* note 16, at 1183. It is the existence of this moral hazard that exacerbates risk taking by banks. *See, e.g.*, *id.* (noting that "[i]t has long been recognized that a fixed-rate deposit insurance system, . . . can pose a moral hazard for excessive risk taking."); Macey and Miller, *supra* note 15, at 1162 (asserting that "it [deposit insurance] gives the shareholders and the managers of insured banks incentives to engage in excessive risk taking because the people who stand to benefit if the risks pay off (bank shareholders) are able to allocate some of their loss the innocent third parties.").

avoid negative cash flows for the FDIC.[47]

However, in a healthy bank paradigm the continued justification for *D'Oench* must be that it plays a role in increasing public confidence or promoting the stability of the money supply. If it does not, then it is not justified and the doctrine should be jettisoned as excess baggage. The analysis in this part of the article will establish that the only virtue possessed by *D'Oench* is the fact that it has been on the books for nearly fifty years. Thus, although there is no doubt that the FDIC plays an integral role in achieving the macroeconomic goal of continued soundness in the banking industry by preventing bank runs, courts and legislators should not give the FDIC *carte blanche* authority to preserve the underlying insurance fund. Instead their focus should shift to a value-based approach of resolving the problems of failed banks by considering inherent concepts of fundamental fairness. It is to the beginning of that task this article now turns.

II. Treatment of Debtors in Bank Liquidation from a Historical Perspective

A. *The D'Oench Case*

The factual setting of *D'Oench* is simple and well known to most banking lawyers. Prior to 1926 the defendant, a dealer in securities in St. Louis, Missouri, had sold some bonds to a bank.[48] The bonds went into default, and to prevent their being shown as delinquent assets on the books of the bank, the bank requested the securities dealer to execute promissory notes payable to the bank at its office in Missouri. The bank gave the securities dealer a receipt for the notes, reciting that the notes would not be called for payment. The note which served as the basis of the suit, was one renewing the original notes and was dated January 1, 1933, payable at the bank's home office in Belleville, Illinois. The bank charged off the notes in 1935. Later in 1938, following the

47. This is a direct result of the political ramifications associated with the myopic macroeconomic paradigm of bank policy where budgetary costs need to be minimized. *See* KANE, *supra* note 15, at 32 (arguing that the "overriding mission [of deposit insurance] is to serve the president and the Congress as agents and shields"). At least one commentator addressed the underlying political considerations that face the FDIC and have driven it to bank failure resolution at the least cost. *See* Garten, *Bank Failure*, *supra* note 15, at 1174-75 (noting that as the FDIC encounters operating deficits and needs additional funds it will be competing for funds with other government programs and its losses may increase the federal deficit). Garten noted that given its limitation on available funds the FDIC bank failure policy has been geared to using as little of its reserve funds as possible. *Id.* at 1174. *See also* KANE, *supra* note 15, at 143-44 (noting that political constraints force the FDIC to compromise actuarial integrity).

48. D'Oench, Duhme & Co. v. FDIC, 117 F.2d 491, 492 (8th Cir. 1941), *aff'd*, 315 U.S. 447 (1942) (the recitation of the facts that follows is taken from the opinion of the Eighth Circuit).

insolvency of the bank, the charged-off note was assigned as collateral to the FDIC to facilitate the transfer of the deposit liabilities of the bank and their assumption by another institution.[49] Subsequently, the FDIC sued the securities dealer in federal court to collect on the note. The case was tried without a jury. The judge held that under Illinois law, the FDIC had taken the note as a holder in due course and ruled in its favor. The Eighth Circuit affirmed the decision of the lower court holding that under Illinois law the FDIC had the same rights as a holder in due course, and thus it had acquired the note free and clear of all personal defenses.[50]

The Supreme Court granted certiorari presumably for the purposes of deciding the choice of law issue.[51] Nevertheless, Justice Douglas took this opportunity to expand the federal common law in the area of bank failure resolution which had just been conceived two years earlier by Chief Justice Stone in *Deitrick v. Greaney*.[52] Douglas asserted that the provisions of the Federal Reserve Act[53] evidenced a federal policy to protect the FDIC and the public funds which it administered from misrepresentations as to the value of assets of insured institutions.[54] Justice Douglas dismissed as irrelevant, arguments concerning the innocence of the securities dealer, the knowledge by

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49. Until 1935, the FDIC was only authorized to use deposit payoffs in failed bank situations. *See* Banking Act of 1933, Pub. L. No. 73-66, ch. 89, § 8, 48 Stat. 162, 173 (codified as amended at 12 U.S.C. § 1821(f) (1989)). It was not until the passage of the Banking Act of 1935 that the powers of the FDIC in resolving bank failures expanded. Banking Act of 1935, Pub. L. No. 74-305, ch. 614, § 101, 49 Stat. 684, 699 (codified as amended at 12 U.S.C. § 1823(c) (1989)) (authorizing the FDIC to "make loans on the security or . . . purchase and liquidate or sell any part of the assets of an insured bank"). Under this authority the FDIC was able for the first time to make purchase and assumption transactions. *See, e.g.*, FED. DEPOSIT INS. CORP., *supra* note 14, at 112 (table 125) (showing that the first purchase and assumption transaction occurred in 1935).

50. D'Oench, Duhme & Co. v. FDIC, 315 U.S. 455 (1942). The court pointed out that the Illinois statute that permitted a transferee to maintain the status of a holder in due course even though the accommodation paper was transferred to it after maturity was a minority view. *See also* JOSEPH D. BRANNAN, THE NEGOTIABLE INSTRUMENTS LAW ANNOTATED 290 n.21 (4th ed. 1926) (noting that section 29 of the Negotiable Instruments Act as enacted in Illinois represented the minority position).

51. *D'Oench*, 315 U.S. at 455. The securities firm's petition argued that a federal court sitting in Missouri was required under the authority of Klaxon Co. v. Stentor Elec. Mfg. Co., 313 U.S. 487 (1941), to apply the Missouri choice of laws rule. Under that choice of laws rule, the law of Illinois would have been applied to resolve the issue of the enforceability of the side agreement. However, the petitioner noted that as Illinois law had not been plead by the FDIC, Missouri law, not Illinois law, should have been applied by the district court. *D'Oench*, 315 U.S. at 455.

52. Deitrick v. Greaney, 309 U.S. 190 (1940).

53. Justice Douglas was referring to 12 U.S.C. §§ 264(s), (y) [Section 264(s) is now codified as amended at 18 U.S.C. § 1007 (West Supp. 1991); while 264(y) has been repealed]. Those provisions provided for periodic examinations by the FDIC of insured banks and criminal penalties for willfully overvaluing assets of a bank or making false statements to the FDIC to induce it to provide deposit insurance.

54. D'Oench, Duhme & Co. v. FDIC, 315 U.S. 455, 457 (1942).

the FDIC of the dishonor of the note, and the lack of injury to the FDIC as a result of the scheme.[55] He held that the public policy inherent in the federal statutes, created an estoppel which prevented the securities dealer from asserting that the executed agreement not to call the notes, was an enforceable side agreement.[56]

Justice Frankfurter joined by Chief Justice Stone, the architect of federal common law in the area of banking, denounced this needless expansion of federal common law.[57] Justice Frankfurter argued that the extension was unwarranted because the FDIC would have been successful under either the Illinois concept of holder in due course, or the Missouri theory of estoppel.[58] But more importantly, he argued that a federal estoppel could not apply in this case because the alleged scheme was completed before the creation of federal deposit insurance and the FDIC.[59] Finally, he asserted that even if the policies behind deposit insurance could be applied retroactively, there was no evidence that the note in question had any relationship to the bank's subsequent insolvency or more importantly, to the FDIC's decision to insure the bank.[60] In effect, the legal basis for the estoppel propounded by Justice Douglas was non-existent.[61] In a separate concurring opinion, Justice Jackson hailed the expansion of federal common law in this area.[62] He noted that the FDIC could accomplish its purpose to "bolster the entire banking and credit structure" only

55. *Id.* at 459 ("it is the 'evil tendency' of the acts to contravene the policy governing banking transactions which lies at the root of the rule."). Justice Douglas created an estoppel emanating from federal statutes and asserted that the FDIC was a creditor whom the acts were designed to protect. The FDIC was a creditor upon expended funds and in order to assist in the failed bank resolution through the purchase and assumption transaction, the FDIC became statutorily subrogated to the extent of such payments. Banking Act of 1935, Pub. L. No. 74-305, ch. 614, § 101, 49 Stat. 684, 695 (codified as amended at 12 U.S.C. 1821(g) (1989)).

56. D'Oench, Duhme & Co. v. FDIC, 315 U.S. at 461.

57. *Id.* at 465.

58. *Id.* at 462.

59. *Id.* at 464.

60. *Id.*

61. In the strict and technical sense an equitable estoppel arises only when a misrepresentation of an existing fact prejudices another who justifiably relies upon the misrepresentation. *See, e.g.*, 1 SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 139 (3d ed. 1957). *Deitrick* created a federal common law estoppel that derived its source from a plain violation of an explicit statutory provision. As a result of the statutory violation, Justice Stone held that there did not have to be an injury to creditors, or a reliance by the receiver on the misrepresentation. Deitrick v. Greaney, 309 U.S. 190, 197-98 (1940). According to Justice Frankfurter as there was no statutory violation in *D'Oench*, the federal common law created in *Deitrick* was not applicable. D'Oench, Duhme & Co. v. FDIC, 315 U.S. at 464.

62. D'Oench, Duhme & Co. v. FDIC, 315 U.S. 455, 472 (1942) ("The law which we apply to this case consists of principles of established credit in jurisprudence, selected by us because they are appropriate to effectuate the policy of the governing Act.").

if it "may rely on the integrity of banking statements and banking assets."[63]

Notwithstanding the unanimous decision of the Court, *D'Oench* marked a major change in the treatment of debtors of failed banks.[64] However, the decision caused little noticeable concern in banking,[65] legislative,[66] or legal circles.[67] In retrospect, this lack of apparent interest probably reflected the belief that the existence of deposit insurance had been the prescription that had cured the bank runs that dominated the early 1930's and returned public confidence in, and stability to the money supply.[68] Thus, the continued

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63. *Id.* Justice Jackson had no problem in borrowing the estoppel argument from *Deitrick. Id.* at 475 ("I think we now may borrow a doctrine of estoppel from the same source from which the Court borrowed it in that case, and to reach the same result.").

64. *See infra* notes 72-80 and accompanying text.

65. The decision was not mentioned in *The Wall Street Journal, The New York Times, The Washington Post,* or the *Journal of the American Bankers Association.*

66. The purported codification of the doctrine did not occur until 1950. *See supra* note 7.

67. The decision was noted in only three law reviews, and its noteworthiness involved the limited question of whether federal or state law should have been applied to the viability of defenses for an accommodation maker. *See* Recent Cases, 26 MINN. L. REV. 895, 899-901 (1942); Note, *Application of Federal Common Law,* 16 TEMP. L.Q. 336-40 (1942); Recent Decisions, Note, 28 VA. L. REV. 821, 821-22 (1942).

68. *See* MILTON FRIEDMAN & ANNA J. SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES, 1867-1960, at 434 (1963) (asserting that federal deposit insurance was "the structural change most conducive to monetary stability since state bank note issues were taxed out of existence immediately after the Civil War"). Friedman and Schwartz stated that deposit insurance sought to prevent runs by creating public confidence in "the ability to convert deposits into currency." *Id.* at 441. They noted, however, that the reduction in bank failures following the creation of the FDIC was not the result of better bank management or even better supervision by the FDIC, but from the "FDIC assuming responsibility for losses in connection with depreciated assets" in failed banks and the knowledge that bank failure would not result in losses to depositors nor runs on healthy banks. *Id.* at 440 ("Deposit insurance is thus a form of insurance that tends to reduce the contingency insured against."). This "public interest" justification for deposit insurance appears to be a continuing theme. A former Chairman of the FDIC stated that the purpose of the FDIC is "to reinforce public confidence in the banking system and to safeguard bank deposits through deposit insurance." Randall, *supra* note 32, at 698. He continued by noting that the primary difference between the insurance function of the FDIC as compared to a private insurer was that the FDIC's "[p]aramount concern [was] with the broad public interest." *Id.* at 702. Furthermore, a review of the history of deposit insurance in the United States reflects this public interest theme – to preserve the circulating medium (money supply) of the nation. *See, e.g.*, Noble State Bank v. Haskell, 219 U.S. 104, 111 (1911) (upholding the constitutionality of Oklahoma's compulsory deposit insurance program and saying that deposit insurance "is to make the currency of checks secure, and by the same stroke to make safe the almost compulsory resort of depositors to banks as the only available means of keeping money on hand."); Assaria State Bank v. Dolley, 219 U.S. 121, 127 (1911) (sustaining the validity of a Kansas voluntary deposit insurance program noting that one of the main justifications of deposit insurance was to secure the currency of checks). By preserving the sanctity of deposits in banks, the money supply is protected. *See* Tussing, *supra* note 32, at 144 (stating that the "major portion of their [banks'] liabilities [demand deposits] comprises the major portion of the nation's money supply.") *See also* TREASURY REPORT, *supra* note 14, I-1 ("Federal deposit insurance has been highly effective in achieving its fundamental goal, that of eliminating almost all

economic health of the insurance fund was viewed as a necessary and sufficient condition to prevent further financial reversals in the banking industry.[69] In a nutshell, *D'Oench* was an integral piece of the failed bank policy puzzle. The decision enhanced the underlying economic value of the policy by preserving the insurance fund and thus, allegedly supporting the goal of monetary stability.[70]

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panic deposit withdrawals."). This "public interest" theory has recently been challenged by advocates of market discipline and increased competition among banks. *See, e.g.*, Macey, *supra* note 15, at 1282-83 (asserting that insured banks are the primary beneficiaries of deposit insurance); Scott, *Deposit Insurance, supra* note 4, at 32 (mentioning that the public interest approach deserves closer scrutiny both as to its "historical accuracy and its logical validity").

69. *See* Garten, *Bank Failure, supra* note 15, at 1174 (espousing the view that the single aim of bank failure policy is "to minimize the effect of bank failure on the insurance fund."). *See generally* Golembe, *supra* note 21, at 193-94. In response to the bank crisis of the 1930's, Congress passed the Banking Act of 1933, commonly referred to as the Glass-Steagall Act, which created the FDIC and began a program of temporary federal deposit insurance for banks. Banking Act of 1933, Pub. L. No. 73-66, ch. 89, § 8, 48 Stat. 162, 168, 179 (codified as amended at 12 U.S.C. §§ 1811, 1821(a)(5)(A) (1988)). This Act also provided that the FDIC would insure deposits at member banks. *Id.* at § 8, 48 Stat. at 172. But it was not until 1935 that the Permanent Insurance Fund was created. Banking Act of 1935, Pub. L. No. 74-305, ch. 614, Title I, § 101, 49 Stat. 684, 694 (codified as amended at 12 U.S.C. § 1821(a)(5)(A) (1989)).

70. Ironically, President Roosevelt never advocated deposit insurance. In fact it was "the only important piece of legislation during the New Deal's famous 'one hundred days' which was neither requested nor supported by the new administration." Golembe, *supra* note 21, at 181-82. *See also* SUSAN E. KENNEDY, THE BANKING CRISIS OF 1933, at 219 (1973) ("[r]umor said that Roosevelt would kill the . . . bill if it contained deposit guarantee provisions."); Howard H. Preston, *The Banking Act of 1933*, 23 AM. ECON. REV. 585, 597 (1933) (noting President Roosevelt's opposition to the idea of federal deposit insurance).

In any event the FDIC and its insurance fund became the chief policy weapon to protect the nation from the macroeconomic crisis of bank failure. The FDIC was placed in charge of the insurance fund and became responsible for the orderly liquidation and or reorganization of insolvent banks. Bank failure policy has lived and died on the vitality of this agency and its fund and other policy decisions have been made to protect the fund from illiquidity. *See, e.g.*, Scott, *Deposit Insurance, supra* note 4, at 39 (noting that the choice of a failure resolution technique seeks to avoid a drain on the liquid assets of the FDIC). The original funds were provided by the Treasury and from the Federal Reserve Banks. *See* Banking Act of 1933, Pub. L. No. 73-66, ch. 89, § 8, 48 Stat. 162, 168-69; Banking Act of 1935, PUB. L. NO. 74-305, ch. 614, § 101, 49 Stat. 684, 686. *See also* Preston, *supra*, at 591-92 (discussing the initial funding). These sums were repaid by 1948, making the FDIC self-sufficient and dependent upon the assessments charged member banks for the insurance. *See* Randall, *supra* note 32, at 700. The FDIC is unique in that its liquidation and reorganizational efforts on behalf of failed banks is to be self-supporting from the premiums paid by banks for the guarantee. This policy decision has had long-reaching tentacles. In fact Congress placed the "full faith and credit" of the federal government behind the FDIC's guarantee. *See* H. Con. Res. 290, 96 Stat. 2639 (1982). *See also* 12 U.S.C. § 1828(a)(1)(A) (1988) (providing that banks shall display a sign stating that the "insured deposits are backed by the full faith and credit of the United States Government"). In fact it was not until 1950 that the FDIC was given authority to borrow funds from the Treasury in the event of need to supplement its own resources. *See* Federal Deposit Insurance Act, Pub. L. No. 81-797, ch. 967, § 14, 64 Stat. 873, 890 (1950) (codified as amended at 12 U.S.C.A. § 1824(a) (West Supp. 1991)). Congress has recently increased the authorization of the FDIC to borrow from the Treasury as "required for insurance purposes." *See* 12 U.S.C. § 1824(a) (West Supp. 1991) (increasing the borrowing limit to $5

If there had been less concern with the self-sufficiency and liquidity of the insurance fund, perhaps more concern could have been shown to principles of fairness and equity without sacrificing the goal of monetary stability.[71]

B. Pre-D'Oench Bank Liquidation Law

The procedures for the liquidation of affairs of an insolvent bank provided in the National Banking Act were considered exclusive.[72] Under its auspices debtors of failed banks were permitted to assert a wide variety of defenses to

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billion). There are of course other ways to protect the liquidity of the insurance fund. *See, e.g.*, Scott, *Deposit Insurance, supra* note 4, at 39 (suggesting borrowing from the Federal Reserve). In fact the Federal Reserve system has lent support to the FDIC in an open bank assistance plan. *See, e.g.*, *Comprehensive Financial Assistance Program Set for Continental Illinois National Bank*, [1983-84 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶99,972, at 87,842 (Joint News Release of Comptroller of the Currency, Federal Deposit Insurance Corporation, and Board of Governors of the Federal Reserve System, May 17, 1984) (noting the assistance of the Federal Reserve in rescuing the Continental Illinois bank).

71. *Cf.* Scott, *Deposit Insurance, supra* note 4, at 39 (noting that the preoccupation of the FDIC on the liquidity of the insurance fund hampers efforts to determine the requisite size of the fund).

72. *See* Cook Co. Nat'l Bank v. United States, 107 U.S. 445, 450-52 (1883) (asserting that the National Banking Act, as amended, provided everything essential from the formation to the dissolution of banks). In *Cook* the Court held that the right of the United States to payment from an insolvent bank was governed by the National Banking Act as amended, and other statutes providing for a priority to the United States from estates of insolvents or the Bankruptcy Act of 1867 had no application. *See also In re* Manufacturers' Nat'l Bank, 16 F. Cas. 665, 669 (N.D. Ill. 1873) (No. 9051) (holding that Congress in enacting the Bankruptcy Act of 1867, subsequent to the National Banking Act did not intend to repeal the extensive liquidation provisions of the latter).

The first statute creating a system of national banks, commonly referred to as the National Banking Act, provided a method for the voluntary liquidation of national banks. Act of June 3, 1864, ch. 106, § 42, 13 Stat. 99, 112. This act also provided for the appointment of a receiver by the Comptroller of Currency for a national bank and a method of liquidation of national banks that refused to pay their respective circulating notes. *Id.* § 50, 13 Stat. at 114-15. Although the National Banking Act provided a remedy to enforce the liability of shareholders in cases where a receiver was appointed by the Comptroller when a bank failed to pay its circulating medium, the Act did not provide a similar remedy in cases of voluntary liquidation. *Id.* In 1876 the Comptroller of Currency was given the additional power to appoint receivers for national banks in the event of insolvency. *See* Act of June 30, 1876, ch. 156, § 1, 19 Stat. 63, 63. This act also completed the scheme for the liquidation and dissolution of national banks by providing a remedy to enforce shareholder liability in cases of voluntary liquidation of national banks. *Id.* § 2, 19 Stat. at 63. *See also* Richmond v. Irons, 121 U.S. 27, 47-49 (1887) (noting that although the 1876 amendments specifically provided for shareholder liability in the case of voluntary liquidation, such liability was implied from the earlier act).

Originally in the case of national banks the receivership function was split. The Comptroller of Currency executed payment to creditors, while asset liquidation was handled by a receiver appointed by the Comptroller. Act of June 3, 1864, ch. 106, § 50, 13 Stat. 99, 114-15 (addressing procedure in cases involving failure to pay circulating notes); Act of June 30, 1876, ch. 156, § 1, 19 Stat. 63, 63 (addressing procedure in cases of involuntary liquidation). However, since 1935 the FDIC, as receiver, has been in charge of both asset liquidation and payment to creditors for national banks. *See* 12 U.S.C. § 1821(d) (1988).

thwart collection efforts by receivers.[73] In effect, a receiver was deemed to have merely "stepped into the shoes" of a bank and was subject to the same claims and pleas which might have been asserted against the bank.[74] However, in cases of fraud[75] or illegal preference[76] a receiver had the power to assert

73. *See* Scott v. Armstrong, 146 U.S. 499, 507 (1892) ("The receiver took the assets of the [bank] as a mere trustee for creditors, and not for value and without notice, and, in the absence of a statute to the contrary, subject to all claims and defenses that might have been interposed as against the insolvent [bank]"); Kiess v. Baldwin, 74 F.2d 470, 472-73 (D.C. Cir. 1934) (noting that the defense of failure of consideration is an articulable defense both against a bank, and a receiver of an insolvent bank suing to recover on a note). *See also* HIRSCH BRAVER, LIQUIDATION OF FINANCIAL INSTITUTIONS § 1069, at 1236 (1936) ("The receiver occupies no better position than the bank and takes and holds its assets subject to all legal and equitable claims which at the time of his appointment existed against the insolvent bank.") (note omitted); CARL ZOLLMANN, THE LAW OF BANKS AND BANKING § 6291, at 362-66 (1936) ("The receiver will also take and hold subject to all estoppels, pledges, mortgages, payments, legal or equitable claims, set-offs, rights of others, or other defenses, such as failure of consideration, ultra vires, ratification, the statute of limitations, the rights of subrogation, and the defense of usury.") (notes omitted). *Cf.* JOSEPH STORY, COMMENTARIES OF EQUITY JURISPRUDENCE § 1038, at 688 (Legal Classics ed., 1988) ("Assignees under general assignments, such as assignees in cases of bankruptcy and insolvency, take only such rights as the assignor or debtor had at the time of the general assignment. . . ."); Ralph E. Clark, *Set-Off in Cases of Immature Claims in Insolvency and Receivership*, 34 HARV. L. REV. 178, 189-90 (1920) (noting that in the case of receivership there is a right of set-off if a court can find an express or implied contract providing for set-off).

74. *See, e.g.*, Fourth St. Nat'l Bank v. Yardley, 165 U.S. 634, 653 (1897) ("The receiver took no greater rights in the property of the insolvent bank which came into his possession than that which the insolvent bank possessed."); Scott v. Armstrong, 146 U.S. at 512 (holding that the equitable right of set-off survives insolvency and is a defense to a suit by a receiver of a national bank seeking to recover on a note); Burrowes v. Nimocks, 35 F.2d 152, 159 (4th Cir. 1929) (noting that the statute did not give the receiver the status of a purchaser for value or give him a lien on the property of the bank).

75. *See, e.g.*, Texas & Pac. Ry. v. Pottorff, 291 U.S. 245, 261 (1934) ("It is the duty of the receiver of an insolvent corporation to take steps to set aside transactions which fraudulently or illegally reduce the assets available for the general creditors, even though the corporation itself was not in a position to do so.").

76. Since the enactment of the National Banking Act, transfers in contemplation of insolvency or after an act of insolvency, or those having the effect of giving a preference of one creditor to another have been declared illegal. Act of June 3, 1864, ch. 106, § 52, 13 Stat. 99, 115 (codified as amended at 12 U.S.C. 91 (1989)). *See, e.g.*, Ticonic Nat'l Bank v. Sprague, 303 U.S. 406, 412-13 (1938); Earle v. Carson, 188 U.S. 42, 47-48 (1903); Merrill v. Nat'l Bank, 173 U.S. 131, 145 (1899). *See also* Casey v. Cavaroc, 96 U.S. 467, 489-90 (1877) (asserting that a receiver of an insolvent bank can set aside preferences which a general creditor can set aside even though the debtor himself can not). In *Casey*, the Court by way of dicta noted that in the absence of fraud or a law to the contrary, a creditor could retain possession of bank property that the bank itself could not recover because a receiver's rights were no higher than the rights of the bank. *Id.* at 490. In a later case Chief Justice Fuller stated:

> [A]ny disposition by a national bank, being insolvent or in contemplation of insolvency, of its choses in action, securities, or other assets, made to prevent their application to the payment of circulating notes or to prefer one creditor to another, is forbidden; but liens, equities, or rights arising by express agreement, or implied from the nature of the dealings between the parties, or by operation of law, prior to insolvency and not in

defenses even in those situations where the bank itself could not have raised them. Thus, for example, a disposition of the assets of an insolvent national bank or a transfer found to have been in contemplation of insolvency were forbidden. However, liens, equities, and rights arising from an express or implied agreement between the parties or ones arising by operation of law, were upheld as valid.[77]

In *Deitrick v. Standard Surety & Casualty Co.*,[78] the Supreme Court reaffirmed its earlier teachings, and held that the claim of a receiver could rise no higher than that of the failed bank.[79] In *Standard Surety*, a bank president had obtained note-guaranty bonds from an agent of an insurance company to serve as "window dressing", in the event bank examiners sought to see the collateral for certain loans. The president gave the agent written agreements expressly evidencing a release from payment of the bonds. Following insolvency and default on the loans, the receiver sought to recover from the insurance company on the bonds. Relying on the existing state of bank liquidation law, the Supreme Court held that as the evidence failed to establish the illegality of the transaction or injury to creditors, the receiver had no standing to maintain the action.[80]

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contemplation thereof, are not invalidated.

Scott v. Armstrong, 146 U.S. at 510.

The statutory preference prohibition is directed to the giving of a preference, not the giving of security when a debt is created. Thus, if the transaction was free from fraud in fact, and was intended merely to protect a loan made at the same time, the creditor could retain the security until the debt is paid, even if at the time of the transfer the bank was insolvent or the creditor had reason to believe that it was. *See, e.g.*, Armstrong v. Chemical Nat'l Bank, 41 F. 234, 239-40 (C.C.S.D.N.Y. 1890). However, if the security was given for an antecedent debt, the transaction would be void as to the receiver. *See, e.g.*, Stapylton v. Stockton, 91 F. 326, 331 (5th Cir. 1899) (noting that an agreement to give security for an antecedent debt is invalid, but if a creditor acts in good faith and believes that the bank is solvent he can retain his security to the extent of present advances). *See also* FRANCIS B. TIFFANY, HANDBOOK OF THE LAW OF BANKS AND BANKING § 110 (1912).

77. *See, e.g.*, Mechanics Universal Joint Co. v. Culhane, 299 U.S. 51, 56 (1936) (holding that a payment made by an insolvent bank to depositor in ordinary course of business is not a preference); McDonald v. Chemical Nat'l Bank, 174 U.S. 610, 619 (1899) (holding that checks mailed prior to insolvency to correspondent bank under the understanding that they are to be credited to an overdrawn account are not preferences even though they are not received until after insolvency); Scott v. Armstrong, 146 U.S. at 510.

78. 303 U.S. 471 (1938).

79. *Id.* at 480-81.

80. *Id.* The Court stated that there were no pleadings nor evidence that creditors of the bank were misled or suffered any damage as a result of the transaction. *Id.* at 480. In support of this position the Court relied on its earlier decision in Rankin v. City Nat'l Bank, 208 U.S. 541, 546 (1908). In *Rankin*, Justice Holmes asserted that in the absence of illegality or a loss suffered by creditors there were no other exceptions to the general rule that the receiver steps in the shoes of the bank. *Id.* (noting that if the "bank had sued while it was a going concern it could not have recovered, and the receiver stands no better than the bank"). In *Standard Surety* the Court refused

Two years later the Supreme Court in *Deitrick v. Greaney*[81] created the needed precedent for *D'Oench* and tacitly overruled *Standard Surety*. In *Deitrick* a bank purchased shares of its own stock in violation of federal law.[82] Thereafter an elaborate scheme was devised to disguise the illegal purchase. As a result, one of the directors of the bank eventually executed an accommodation note for the value of the stock held by the bank and had the record owner of the stock changed.[83] It was agreed that the bank would retain its interest in the shares held in the name of another and that the note was not to be paid. After the failure of the accommodated bank, its receiver sued to collect the note. In spite of the earlier precedent,[84] Justice Stone writing for the majority of the Court, held that the accommodation maker was estopped from asserting the defense of lack of consideration.[85] The *Deitrick* Court's argument was based upon its perception of the underlying goals sought to be achieved by the implementation of a statute prohibiting a national bank from purchasing its own stock. The Court posited that the statute was designed for the protection of creditors,[86] and to deny recovery to the receiver by not enforcing the illegal contract would circumvent the inherent goals of the statute to the detriment of creditors. In *Deitrick* as in *Standard Surety* the accommodation maker was aware of the purpose for which his indebtedness was to be used,[87] and in both it was clear that the bank itself could not have maintained the suit.[88] However,

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to accept the argument that a party to a fraud perpetuated against the bank examiners is estopped from asserting lack of consideration, release, or illegal contract. *Id.* at 481 (Black, J., dissenting). Thus, in the absence of injury to a creditor or a violation of law, the receiver was in the same boat as the bank would have been in, if it had sought to recover on the note.

81. 309 U.S. 190 (1940).

82. Since the enactment of the National Banking Act in 1864, national banks were generally prohibited from purchasing their own stock. Act of June 3, 1864, ch. 106, § 35, 13 Stat. 99, 110 (codified as amended at 12 U.S.C. § 83 (1989)).

83. Deitrick v. Greaney, 23 F. Supp. 758, 759 (D. Mass. 1938), *rev'd*, 103 F.2d 83 (1st Cir. 1939), *rev'd*, 309 U.S. 190 (1940). The defendant's note had been substituted for that of another given for the same purpose. *Id.*

84. The opinion of the appellate court reviewed the then-existing law and concluded that a maker could set up the defense of lack of consideration to the receiver's collection action, and that the court would not enforce a note given as part of an illegal transaction with the bank. Greaney v. Deitrick, 103 F.2d at 88 ("Appointment of a receiver does not absolve such a note of the taint of illegality.").

85. Deitrick v. Greaney, 309 U.S. at 198.

86. *Id.* at 195 ("The obvious purpose of prohibiting the purchase by a bank of its own stock is to prevent the impairment of its capital resources and the consequent injury to its creditors in the event of insolvency.").

87. *Id.* (discussing the basis for the defendant's knowledge of the fact that the note was given to conceal the illegal stock purchase); Deitrick v. Standard Surety & Casualty Co., 303 U.S. 471, 481-82 (1938) (Black, J., dissenting) (noting that both the president of the bank and the agent of the insurance company knew the bonds were being used to deceive federal bank examiners).

88. Deitrick v. Greaney, 309 U.S. 190, 204 (1940) (Roberts, J., dissenting); Deitrick v. Standard Surety & Casualty Co., 303 U.S. at 479.

Justice Stone distinguished *Standard Surety* by noting that neither the pleadings nor evidence in that case asserted the illegality of the transaction or injury to creditors upon which his decision in *Deitrick* rested.[89] It was a mere two years later that the estoppel principle of *Deitrick* was erroneously relied upon by Justice Douglas in *D'Oench*.

In retrospect, the *Deitrick* decision breached the dam which has left modern borrowers in its flood waters. While the interests of *true bank creditors* (as opposed to the subrogated role of the FDIC or insured depositors) should be protected to the same extent as in the liquidation of other firms,[90] and while

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89. Deitrick v. Greaney, 309 U.S. at 200. In his dissenting opinion Justice Roberts asserted that "it is apparent that, under the guise of distinguishing the earlier case [*Standard Surety*], the court in fact overrules it." *Id.* at 206.

90. Under Chapter 7 of the Bankruptcy Code general unsecured creditors receive a pro rata distribution from the debtor's liquidated estate. 11 U.S.C.A. § 726(a), (b) (West Supp. 1991). The Bankruptcy Code authorizes the trustee following the commencement of the proceeding to assemble the assets from the debtor [11 U.S.C.A. § 541 (West Supp. 1991)], or from third parties [11 U.S.C.A. §§ 542, 543 (1979 & West Supp. 1991)], or through the exercise of his avoiding powers, [11 U.S.C. §§ 544, 547, 548 (1979 and West Supp. 1991)]. However, in attempting to collect assets of the estate for distribution to creditors, the bankruptcy trustee is subject to any and all defenses which the obligor could have asserted against the debtor, except as provided in the statute. *See, e.g.*, Bank of Marin v. England, 385 U.S. 99, 101 (1966) ("[t]he trustee succeeds only to such rights as the bankrupt possessed; and the trustee is subject to all claims and defenses which might have been asserted against the bankrupt but for the filing of the petition"); *In re* Lapiana, 909 F.2d 221, 223 (7th Cir. 1990) ("It is true of course that bankruptcy, despite its equity pedigree, is a procedure for enforcing pre-bankruptcy entitlements under specified terms and conditions rather than a flight of redistributive fancy or a grant of free-wheeling discretion such as the medieval chancellors enjoyed"); *In re* Giorgio, 862 F.2d 933, 936 (1st Cir. 1988) ("a bankruptcy trustee obtains rights of action belonging to the bankrupt subject to the same defenses or limitations that a defendant might have asserted against the bankrupt himself"). The *Giorgio* court noted that the trustee may step outside the bankrupt's shoes to protect the statutory rights of creditors such as under the preference provision of the Bankruptcy Code. *Id.* However, nonbankruptcy entitlements are to be respected unless there is a need for a substantive change in rights in order to preserve bankruptcy collective proceedings. The Supreme Court stated this proposition as follows:

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy').

Butner v. United States, 440 U.S. 48, 55 (1979), *citing* Lewis v. Manufacturers Nat'l Bank, 364 U.S. 603, 609 (1961). *Cf.* Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 351-54 (1985) (holding that "vesting in the trustee control of the corporation's attorney-client privilege most closely comports with the allocations of the waiver power to management outside of bankruptcy"); Ohio v. Kovacs, 469 U.S. 274, 285-86 (1985) (O'Connor, J., concurring) (noting that a state's classification of a property interest as being secured or unsecured generally is sufficient to determine the priority of liquidation distributions in a bankruptcy proceeding).

A bankruptcy trustee seeking to recover on a note would be subject to virtually all defenses which *D'Oench* has stripped from bank debtors following appointment of the FDIC as receiver. *See* banks should not mislead bank examiners about the nature of their assets,[91] the achievement of these objectives does not warrant overruling the value of fairness in dealing with one wholly innocent of endangering these interests. However, Justice Douglas took the *Deitrick* decision and built a statute embedded solely with economic values to achieve these objectives by protecting the insurance fund to the detriment of potentially innocent debtors.

It should be apparent from this discussion that public policy reasons justifying the *D'Oench* decision predominated over any legal precedent or body of logical reasoning. The decision achieved a politically motivated result of protecting the economic essence of the deposit insurance system which had been credited with putting stability back into the money supply. Furthermore, given the fact that *D'Oench* involved a securities firm defendant, the Court's decision supported the underlying economic and political philosophy prevalent at the time; bankers and securities dealers were the responsible players in the financial debacle of the 1930's.[92] The legislative response was explicit governmental

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generally 4 COLLIERS ON BANKRUPTCY ¶ 541.10[1] (15th ed. 1991). But as banks are not permitted to file bankruptcy, the basic protections derived from that statute are unavailable for a bank debtor following insolvency. 11 U.S.C.A. § 109(b)(2), (b)(3), (d) (1979 & West Supp. 1991). One recent article seriously questioned the dual system of liquidation and indicated that a preferable system might integrate the two systems. *See* Fischel et al., *supra* note 16, at 318 ("A preferable system might be to insure small depositors while allowing the bankruptcy laws to operate for larger creditors."). *Contra* Garten, *Bank Failure*, *supra* note 15, at 1196 (asserting boldly without any discussion of bankruptcy law that current failed bank policies are "far less disruptive, than alternative bankruptcy or reorganization procedures").

91. While this proposition is an obvious truism, the present system of regulation and supervision has led to massive irregularities in asset valuation that are more significantly misleading than the "secret agreements" *D'Oench* was designed to void. For example, the regulatory accounting principles (RAP) adopted by the Federal Home Loan Bank Board masked the thrift industry's level of insolvency by permitting accounting "gimmicks" to defer losses and inflate assets. *See* FIRREA REPORT, *supra* note 8, at 298, *reprinted in* 1989 U.S.C.C.A.N. at 94. Furthermore, the use by banks of generally accepted accounting principles (GAAP) which mandate that "assets and liabilities ordinarily be carried at an (amortized) cost basis" has been the subject of severe criticism. *See* TREASURY REPORT, *supra* note 14, at XI-3. *See also* GENERAL ACCOUNTING OFFICE, *supra* note 14, at 7 (criticizing the use of GAAP to value assets in the bank industry noting that such use results in an overstatement of asset values resulting in a delay in identifying troubled banks exposing the bank insurance fund to additional losses); Scott, *Deposit Insurance, supra* note 4, at 36 (noting that at GAAP insolvency the amount of loss is considerable because the market value of the assets is substantial below that of book value); Scott, *Policy Choices, supra* note 4, at 917-19 (advocating early closure rules because the present discretionary action of regulators to close banks at book value insolvency results in substantial losses).

92. The public outcry following the stock market crash of 1929 and the unwillingness of the New York Stock Exchange to restrain excessive speculation led President Hoover to request an investigation of the New York Stock Exchange which eventually uncovered massive speculation in securities on the part of the banking industry. *See* KENNEDY, *supra* note 70, at 104-28. Kennedy noted that although bankers had made profits during the 1920's with their securities speculation, "[d]isillusionment with speculators and securities merchants" during the depression "carried over

control;[93] the legal response in *D'Oench* was to strip a securities firm debtor of defenses in order to preserve a banking institution's economic value for the depositors (in reality the FDIC) following insolvency. The achievement in *D'Oench* of an explicit economic result, when taken in isolation, may be justified. However, when such legal authority is blindly followed, other equally important values are overridden. Rarely, if ever, can one think of a situation where permitting an innocent debtor to successfully assert a defense to FDIC collection of a note, would defeat the very goals behind the deposit insurance system. It should take such a situation to justify the application of the doctrine to the innocent. *D'Oench* had no valid anchor and was in fact, a perversion of legal history. Over time, however, *D'Oench* became accepted and has become a key component of the failed bank paradigm. This article now turns to a discussion of that issue.

III. THE FAILED BANK PARADIGM

A normative view of banking law must be anchored in a definition of the problem to which banking law responds. How we define that problem in large part determines the substance of our theory or approach. In this vein, the regulatory policies dealing with the results of failed and failing banks should not be viewed as existing in a vacuum separate and distinct from regulatory policies seeking to encourage safe banking practices. Together, these regulatory policies should strive for the same goals -- public confidence and a stable money supply. However, a positive account of the history of federal banking regulation since

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from investment bankers to commercial bankers." *Id.* at 104. *See generally* S. REP. NO. 1455, 73d Cong., 2d Sess. (1934); FERDINAND PECORA, WALL STREET UNDER OATH: THE STORY OF OUR MODERN MONEY CHANGERS (1939). The general distrust of securities dealers and bankers at this time, the public's perception of their being responsible for the Great Depression, and the subsequent legislation to restrict their activities are all reminiscent of Cade's rebellion against Henry VI. One subtle difference was the focal point of blame – in Cade's rebellion it was the lawyers. WILLIAM SHAKESPEARE, THE SECOND PART OF KING HENRY THE SIXTH act 4, sc. 2 (Tucker Brooke ed., 1923) ("The first thing we do, let's kill all the lawyers.").

93. In the area of the securities industry the immediate results were the passage of the Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C.A. §§ 77a-77bbbb (1988 and West Supp. 1991)) and the Securities and Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C.A. §§ 78a-78ll (1981 & West Supp. 1991). The purpose of this legislative effort was to bring securities dealers and brokers under direct government supervision and control. For an interesting discussion of the investigations conducted during the New Deal in the area of securities abuses see Richard Flint, An Analysis and Evaluation of Policies Concerning the Activities of Specialists Trading on the New York Stock Exchange (1971) (unpublished Ph.D. dissertation, available at the University of Texas (Austin)). In the area of banking the effect was the separation of investment and commercial banking and the creation of federal deposit insurance. *See supra* note 31. *See also* Fischel et al., *supra* note 16, at 303 (noting that the "essential features of New Deal banking regulation were entry control, price control, market allocation through the forced separation of commercial banking from investment banking and securities activities, and close supervision of investments and related activities").

the War Between the States establishes that the major problem addressed has been defined in terms of how to respond to failed and failing banks -- the failed bank paradigm.[94]

The failed bank paradigm had its genesis in the political and economic differences that existed at the inception of our nation. The initial controversies over the proper function and scope of banking institutions reflected the differences in the demands for credit between the merchandising aristocracy, initially led by Alexander Hamilton, and the agrarian majority headed initially by Thomas Jefferson.[95] At first a centralized money monopoly philosophy prevailed providing available credit to the powerful merchandising faction through the guise of the initial[96] and second Bank of the United States,[97] only to fall victim to the new Jacksonian majority's intolerance to restraints in credit and its fear of a centralized money monopoly.[98] The demise of the Second Bank of United States and the subsequent Supreme Court decision sustaining the rights of state chartered banks[99] ushered in a period of free banking under normally lax state supervision and licensing.[100] With no central control over the banking system as a whole, to provide liquidity in times of economic distress, the structure of our nation's banks before 1860 rested upon a

94. The "failed bank paradigm" refers to the supervisory regulatory model, with emphasis solely on failed bank policy. The term paradigm is meant to refer to a conceptual framework or model which embodies two separate components. The first is an economic theory from which can be derived economic results of any given policy; the second is a set of assumptions in the form of goals to be achieved by the various policy arrangements. *See, e.g.*, TREASURY REPORT, *supra* note 14, at III-45 n.8.

95. *See, e.g.*, BRAY HAMMOND, BANKS AND POLITICS IN AMERICA FROM THE REVOLUTION TO THE CIVIL WAR 118-22, 740-42 (1957) (noting that the merchants desired a federal bank because as a class they were creditors of the new nation who financed the revolution, while the agrarians had a general dislike for the central government).

96. *See, e.g.*, RICHARD TIMBERLAKE, THE ORIGINS OF CENTRAL BANKING IN THE UNITED STATES 8 (1978) (noting that although the First Bank was not a true central bank, it reflected Hamilton's ideals; it served both as a private commercial bank and as a public bank, as well as fiscal agent for the Treasury in his issuance of a uniform national currency).

97. *See, e.g.*, HAMMOND, *supra* note 95, at 304-05 (noting that the Second Bank was able to secure a uniform currency at the expense of state bank notes). *See also* TIMBERLAKE, *supra* note 96, at 27-49 (discussing the Second Bank of the United States as the first true "incipient" central bank in that it attempted to stabilize the unrestrained state banking system). The validity of the charter of the second bank was upheld by the Supreme Court. McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819).

98. President Andrew Jackson vetoed the recharter bill in 1832. *Message by President Andrew Jackson Vetoing the Bank Recharter*, July 10, 1832, *reprinted in* SYMONS & WHITE, *supra* note 17, at 14-19 (stressing Jackson's belief that the bank was an intrusion by the federal government upon the rights of the states). For a detailed discussion of the first and second banks *see* HAMMOND, *supra* note 95, at 144-450.

99. Briscoe v. Bank of Kentucky, 36 U.S. (11 Pet.) 257 (1837).

100. *See, e.g*, Howard H. Hackley, *Our Baffling Banking System*, 52 VA. L. REV. 565, 570 (1966) [hereinafter Hackley, *Baffling Banking*].

foundation of undercapitalized small banks which was allegedly subject to periodic collapse.[101]

It was the beginning of hostilities in 1861, that provided the initial impetus for a consensus realization of the need for some sort of modest federal supervision and control over the banking system in order to achieve national goals. At first the need to finance the war to put down the rebellion of the southern states led to the passage of the National Currency Act of 1863.[102] The Act created the Comptroller of Currency as head of the Treasury Department whose initial function was to assist in the issuance and regulation of a national currency secured by United States bonds[103] that were sold to finance the war effort. However, it was the National Bank Act of 1864,[104] which first established a system of federally chartered banks[105] as the answer to the banking industry's immediate need to restore public confidence in currency as a result of the "multiplicity of state bank notes in circulation at depreciated values."[106] This initial effort to eliminate state banks and their depreciated bank notes was so disappointing,[107] that Congress imposed a tax upon state bank notes to expedite the surrender of state charters and reincorporation under the national banking system.[108] Despite efforts to eliminate state banks, and

101. *See, e.g.*, TIMBERLAKE, *supra* note 96, at 84-85 (noting that the common belief of a chaotic banking system on the eve of the War Between the States has "very little authentication"). Timberlake noted that the independent treasury and the state banks worked well and even the financial panic of 1857 was "relatively harmless" on the economy as a whole. *Id.* at 85. *See also* Howard H. Hackley, *Our Baffling Banking System – Part II*, 52 VA. L. REV. 771, 824 (1966) [hereinafter Hackley, *Part II*] ("from 1836 until the Civil War, state-chartered banks flourished without competition from any bank organized under federal law and without regulation by the federal government"). *But see* HAMMOND, *supra* note 95, at 620-21 (discussing the economic problems of free banking in Indiana prior to the War Between the States).

102. Act of Feb. 25, 1863, ch. 58, 12 Stat. 665, *repealed by* Act of June 3, 1864, ch. 106, § 62, 13 Stat. 99. The Act was designed to make banking a "federal responsibility" as it was hoped that state-chartered banks would abandon their state charters and become national banks. *See* HAMMOND, *supra* note 95, at 727-28.

103. Act of Feb. 25, 1863, ch. 58, § 1, 12 Stat. 665.

104. Act of June 3, 1864, ch. 106, § 62, 13 Stat. 99.

105. *See* Act of June 3, 1864, ch. 106, § 5, 13 Stat. at 100-01. The statute also provided a method for state banks to become national banks. Act of June 3, 1864, ch. 106, § 44, 13 Stat. at 112.

106. Randall, *supra* note 32, at 697. *See also* HAMMOND, *supra* note 95, at 730-32 (noting that the 1864 act addressed a major criticism of the earlier act by prohibiting state-chartered banks from issuing national currency).

107. *See, e.g.*, HAMMOND, *supra* note 95, at 732 (noting that the Act led to new national banks and not state chartered banks switching to national bank charters).

108. Act of March 3, 1865, ch. 78, § 6, 13 Stat. 469, 484 (imposing a ten percent tax on the amount of state bank notes paid out by another bank). The Act was subsequently extended and reenacted. Act of July 13, 1866, ch. 184, § 9, 14 Stat. 98, 146. The constitutionality of this tax was upheld by the Supreme Court. Veazie Bank v. Fenno, 75 U.S. (8 Wall.) 533, 549 (1869) ("[W]ithout this power, indeed, its attempts to secure a sound and uniform currency for the country

bring the industry under sole federal control, competing political forces have guided the American banking system down the road of a dual banking system with overlapping state and federal control and regulation.[109]

Most of the current federal policies dealing with banking regulation, including those relating to the handling of failed and failing banks, as well as many of the current problems facing bank regulators, arose from the same underlying competing political interests[110] that created the dual banking

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must be futile."). The increase in loanable funds from demand deposits and the ability to provide trust services, which national banks could not provide, provided more than enough business for state banks after the elimination of state bank notes. *See. e.g.*, Hackley, *Part II*, *supra* note 101, at 824. In fact, by the time of the passage of the Federal Reserve Act of 1913 the number of state banks substantially exceeded the number of national banks. *See* EUGENE N. WHITE, THE REGULATION AND REFORM OF THE AMERICAN BANKING SYSTEM: 1900-1929, at 13 (table 1.1) (1983).

109. One of the most striking features of banking history has been the rivalry between federal and state regulatory authorities over the control of banks. *See generally* WHITE, *supra* note 108, at 10-62 (discussing the rivalry between state and national banks from the passage of the National Banking Act of 1864 to the Federal Reserve Act of 1913). The existence of both a state and federal banking regulatory scheme which differed on chartering requirements, capital requirements, and portfolio restrictions has created a dual system of banking. This dual nature of banking regulation is the subject of criticism. *See* William Niskanen, *Commentary of Scott, The Dual Banking System*, in ISSUES IN FINANCIAL REGULATION 46 (Franklin R. Edwards ed., 1979) (arguing that the dual system creates unhealthy competition). *Contra* Miller, *supra* note 15, at 1-22 (advocating that given the rise in competitive banking, dual banking continue with more emphasis on state-chartering); Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 49 (1977) (noting that if the growing body of opinion is correct [that federal regulation is ineffectual and costly] there is a good deal to be said on behalf of the dual banking system).

Although the National Banking Act of 1864 and the subsequent tax on state bank notes were unable to stop the growing tide of state banks, one of the primary purposes of the Federal Reserve Act of 1913 [Federal Reserve Act of 1913, ch. 6, § 9, 38 Stat. 251] was to reduce the growth of state banks and to bring them under federal control. WHITE, *supra* note 108, at 4. The Act provided that state banks could voluntarily become subject to the supervision of the new federal banking agency while retaining their state charter. Federal Reserve Act of 1913, ch. 6, § 9, 38 Stat. at 259. However the Act did not supersede the intricate structure of dual banking, for the Federal Reserve System exercised only limited supervisory powers over those state banks who chose to join. KENNEDY, *supra* note 70, at 8-9; Hackley, *Baffling Banking*, *supra* note 100, at 577 (noting that even state banks which voluntarily joined, remained subject to state control and supervision). The bulk of the Federal Reserve System's authority rested on influence and leadership -- "the expectation that it could point out a proper direction for commercial banks through its changes of discount rates and open-market operations, and that they [banks] in turn, would alter their own policies to conform to the general good." KENNEDY, *supra* note 70, at 9.

110. These conflicting political forces also had their effect on the monetary policies of the United States during the period between the War Between the States until the eve of the creation of the Federal Reserve System in 1914. *See generally* FRIEDMAN & SCHWARTZ, *supra* note 68, at 90-119 (discussing the political and economic implications of the free and unlimited coinage of silver which was advocated during this period). Friedman and Schwartz asserted that the agrarian heartland of the country, debtors, and western silver producing states supported the free coinage of silver in the belief that it would increase the money supply and thereby lower the real burden of their debts and reduce the number and severity of recurrent money panics. *Id.* at 115-17.

system. At the beginning of this century that system was composed of thousands of undercapitalized single office banks under conflicting regulatory control[111] with no effective reserve liquidity, thus increasing the industry's vulnerability to financial crisis and panic.[112] The diverse political interests created and preserved this industry structure; federal banking legislation was relegated to respond to financial crises and panics by establishing new regulatory institutions in an effort to correct the immediate macroeconomic malfunctioning of the banking industry.[113] These same political forces have forced banking legislation to focus on correcting perceived evils of the system which allegedly

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111. *See, e.g.*, WHITE, *supra* note 108, at 12-13 (table 1.1) (showing that at the turn of the century more than half of the over 8,000 banks in the United States were state banks); KENNEDY, *supra* note 70, at 7 (noting that at this same time the banking industry failed to embrace large unified banking but preferred small unit banks).

112. *See, e.g.*, FRIEDMAN & SCHWARTZ, *supra* note 68, at 156-68 (discussing the big city clearinghouses' concerted refusal to convert deposits into currency during the Panic of 1907); KENNEDY, *supra* note 70, at 8 (arguing that the restrictions of payment during the Panic of 1907 established an awareness of the need for a more elastic currency); WHITE, *supra* note 108, at 81-83 (discussing the failure of the clearinghouses to act as lenders of last resort during the Panic of 1907).

113. As such, the focus of such legislation was ex post -- to resolve the purported macroeconomic causes for crisis after the damage to the economy had been done with little effort to change the underlying structure of the industry. *See, e.g.*, Randall, *supra* note 32, at 698 (asserting that our "present federal bank supervisory structure has . . . evolved largely in response to crisis situations"). The impetus leading to the passage of the Federal Reserve Act of 1913 was the inability of clearinghouses and corresponding banks to provide a more elastic money supply during the Panic of 1907. *See, e.g.*, WHITE, *supra* note 108, at 83-99; Hackley, *Baffling Banking*, *supra* note 100, at 573. There is no doubt that the Federal Reserve Act changed the existing structure of the banking industry, however, its true function was "to coordinate banking reserves in time of emergency" not to meddle with the structure of banking. *See* KENNEDY, *supra* note 70, at 9. The creation of federal deposit insurance was a direct result of the banking crisis of the 1930's and was designed to remedy the macroeconomic problems generated by bank runs. *See* FRIEDMAN & SCHWARTZ, *supra* note 68, at 441; Golembe, *supra* note 21, at 200; Scott, *Policy Choices*, *supra* note 4, at 90; Scott & Mayer, *supra* note 15, at 858-59. The failure of Congress to focus on the structural problems of banks and the banking industry at this time should not come as any surprise to students of banking history. The conflict between the Federalist centrist philosophy and the Jefferson-Jackson independent state banking philosophy, has been a way of life in the banking industry since the founding of our nation. *See generally* HAMMOND, *supra* note 95, at 740-42; Golembe, *supra*, at 182 (noting that the passage of the deposit insurance program was a compromise between two diverse groups -- those who were determined to stop the illiquidity of the supply of money and those who desired to preserve the existing banking structure). The political power of the banking industry itself has had a substantial impact on the course of banking regulation. *See, e.g.*, KANE, *supra* note 15, at 163-65 (noting that because of political realities regulators and politicians focus on short-sighted solutions instead of the long term problems plaguing the banking industry); Macey, *supra* note 15, at 1290-98 (discussing how failure resolution choices and deposit insurance pricing are consistent with his conclusion that banking regulators are "captured" by the industry). *See generally* TIMBERLAKE, *supra* note 96, at 220-22 (noting that a Jeffersonian philosophical abhorrence of power accounted for the delay in the creation of central banking in the United States).

spawned each succeeding macroeconomic crisis.[114] Thus, the primary feature of banking regulation has been on the elimination of alleged abusive banking practices,[115] as well as entry control,[116] price control[117] and closer supervision of investment and related activities.[118] However, the major microeconomic issue inherent in the very nature of banking business -- individual bank credit risk[119] -- was for the most part left to the banks

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114. *See, e.g.*, Randall, *supra* note 32, at 696 ("Almost from the very beginning, federal supervision of banks was directed toward shielding the public from the damage stemming from unsafe and unsound banking practices or from a general weakening of the banking system.").

115. One of the popular beliefs for the causes of the bank and business failures of the 1930's was the excessive competition among banks during the boom years of the 1920's. *See, e.g.*, Fischel et al., *supra* note 16, at 302. Under this thesis banks participated in cutthroat interest rate competition to lure depositors with the end result of raising their own costs of capital and forcing them into riskier business practices through securities activities. *Id.* Thus, when increasing liquidity demands surfaced during the Depression, banks were faced with a conflict of interest between protecting themselves and their securities activities or protecting their depositors. *See* Investment Co. Inst. v. Camp, 401 U.S. 617, 630-34 (1971). Another theory advanced for the banking crisis was that the prosperity of the 1920's so increased the financial reserves of industrial corporations that they had no need for the resources of banks to finance expansion. As a result, banks turned to riskier activities, including financing securities purchases, providing brokers' loans, and speculating themselves in the stock market. *See, e.g.*, KENNEDY, *supra* note 70, at 13. As the banking crisis of the 1930's escalated, the bank liquidity problem remained unanswered because the Federal Reserve System refused to intervene believing the crisis to be a problem of bank management. *See, e.g.*, FRIEDMAN & SCHWARTZ, *supra* note 68, at 358 (noting that the federal reserve board regarded the bank failures of 1930's as "regrettable consequences of bad management and bad banking practices, or as inevitable reactions to prior speculative excesses, or as a consequence but hardly a cause of the financial and economic collapse in process."). Economists on the other hand do not place the blame for the Depression on conflicts of interest, bad investments, or bad management, but upon the inherently unstable nature of the fractional reserve intermediation system. *See generally id.* at 691-92 (asserting that blaming the crisis on non-monetary factors is erroneous); Milton Friedman, *The Monetary Theory and Policy of Henry Simons*, 10 J.L. & ECON. 1, 11-13 (1967) (arguing that effective monetary policy could have coped with the banking crisis, but instead the actions and inactions of the monetary authorities [Federal Reserve] exacerbated the problem).

116. *See* 12 U.S.C. § 27 (1988).

117. The Depository Institutions Deregulation Act of 1980 eliminated the prohibition of paying interest on demand deposits. Pub. L. No. 96-221, § 202, 94 Stat. 142, 142 (codified as amended at 12 U.S.C. § 3501 (1989)).

118. *See* 12 U.S.C.A. § 24 (Seventh) (West Supp. 1991) (barring banks from operating full time stock brokerage services). *See also supra* note 31 and accompanying text.

119. The scheme of federal regulation of the banking industry has for the most part been successful in eliminating the illiquidity problems arising from the inherent weaknesses of the dual banking structure. However, the other major source of illiquidity is inherent in the individual credit risk assessments made by banks on loans. This is the area that federal supervision and control has failed to adequately address. However, it is in this very area that the *D'Oench* debtor finds himself. He is, in effect, the scapegoat for the errors in judgment made by the banks and those who regulate them. *See generally* Tussing, *supra* note 32, at 132-34 (distinguishing between the two sources of bank illiquidity). There are, of course, certain statutory attempts to reduce risk taking and their resulting illiquidity problems. *See, e.g.*, 12 U.S.C. § 84 (1988) (limiting in most cases a national bank from lending more than fifteen percent of its unimpaired capital stock and surplus to any one person); 12 U.S.C. §§ 375a, 375b, 1828(j)(2) (1988) (governing loans to insiders of national and

themselves as Congress tackled the recurring macroeconomic crisis. As a result, the focus of the bank failure paradigm has been to deal with the results of credit risk ex post as part of the larger macroeconomic problem.

Since the early 1930's federal bank failure policy in the United States has been left mainly in the hands of two separate regulatory agencies.[120] The Comptroller of the Currency has the authority to appoint the FDIC as receiver for a national bank upon being satisfied that the bank is insolvent.[121] The FDIC has the authority not only to liquidate the institution and pay off depositors,[122] but to give financial assistance to weak banks or to plan mergers

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state insured banks); 12 U.S.C. § 3907 (1989) (authorizing the appropriate federal agency to establish "adequate capital"). There is also no doubt that the supervision and examinations by regulatory authorities and requirements for reports of income and condition, have some influence on the individual risk taking of banks. *See, e.g.*, 12 U.S.C. 1817(a) (1988) (requiring insured banks to make quarterly reports of condition and income). *See also* FED. DEPOSIT INS. CORP., STATEMENTS OF POLICY, *Uniform Financial Institution Rating System* 2-3 (1980) (describing the composite rating categories [the system referred to by an acronym, CAMEL -- capital adequacy, asset quality, management ability and effectiveness, earnings quantity and quality, and liquidity] to determine financial soundness). *But see* TREASURY REPORT, *Conclusions and Recommendations, supra* note 14, at 10 (acknowledging that the "fragmented and archaic regulatory system" creates situations where no single regulator has the information or the authority to deal with individual bank problems). Notwithstanding this apparent panoply of power and control, the bottom line is that the federal supervisory regulatory structure has not been able to reduce excessive risk taking and prevent the rising numbers of bank failures. *See supra* note 14.

120. The Federal Reserve System also plays a minor role in bank failure resolution. In fact, the system was created to become the lender of last resort -- to provide needed liquidity to the banking system, thereby preventing banking and financial panics. *See* Federal Reserve Act of 1913, ch. 6, § 13, 38 Stat. 251 (1913) (codified as amended in § 409 of 31 U.S.C., and in various sections of 12 U.S.C.) (the title of the Act specifies its purpose to include the furnishing of "an elastic currency"). The ability of the Federal Reserve to rediscount members' commercial paper is a particularly effective way to provide needed reserves immediately to banks. *See, e.g.*, Hackley, *Baffling Banking, supra* note 100, at 574. The fact that insurance fund reserves held by the FDIC to meet its guarantee obligations are substantially less than all deposits, and the existence of large amounts of uninsured deposits, make the Federal Reserve's ability to be a lender of last resort an important part of failed bank policy. *See* FED. DEPOSIT INS. CORP., *supra* note 14, at 114 (table 129) (showing that at the end of 1989 only seventy-six percent of deposits were insured and that the ratio of deposit insurance in the reserve fund to insured deposits was only seventy percent). The Federal Reserve's assistance with Continental Illinois National Bank's difficulties is often cited as a prime example of its role in preventing bank failures and a possible banking panic. *See, e.g.*, TREASURY REPORT, *Conclusions and Recommendations, supra* note 14, at I-36. *See also supra* note 70.

121. *See* 12 U.S.C. § 1821(c)(2)(A)(ii) (Supp. II 1990). *See also supra* note 4.

122. *See* 12 U.S.C. § 1821(f) (Supp. II 1990). If this option is selected, the FDIC draws on the insurance fund to pay the balance of all insured deposits. The fund is funded through an annual flat rate assessment on members' total estimated insured deposits. *See* 12 U.S.C. § 1817(b)(1)(C)(i) (Supp. II 1990). The current rate is 19.5 cents per $100. *See* 12 U.S.C. § 1817(b)(1)(A)(i) (Supp. II 1990) (providing that the FDIC can set the assessment rate for insured depository institutions at such times as it deems appropriate); FED. DEPOSIT INS. CORP., *News Release* (Sept. 27, 1990). *See also supra* note 70.

with healthier ones.[123] One of the principle differences among the various federal resolution techniques is the availability of protection for uninsured depositors or other creditors.[124] The FDIC's choice of a bank failure resolution technique is controlled and directed by the statutory least cost principle. Following this principle helps to minimize the effects of bank failure on the insurance fund[125] without serious inquiry into other policy considerations.[126] Thus, in selecting a technique the FDIC does not attempt to determine the primary cause of individual bank failure but operates only to remedy the results in the most "efficient"[127] manner from a macroeconomic perspective.

D'Oench places the debtor of a failed bank in the middle of this bank failure paradigm. As a necessary consequence of the paradigm, courts have justified their expansion of the *D'Oench* doctrine by defining the problem of bank failure in macroeconomic "least cost" terms with no ethical reflection upon

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123. *See supra* note 17 (discussing various failure resolution techniques).

124. *See* Garten, *Bank Failure, supra* note 15, at 1166. *See also* TREASURY REPORT, *Conclusions and Recommendations, supra* note 14, at 35 (criticizing the FDIC's practice of choosing failure resolution techniques that fully protect uninsured depositors). The continued practice of insulating uninsured depositors, who arguably are better able to monitor excessive risk-taking by financial institutions, has fueled the financial crisis of the 1980's. *See, e.g., id.* at 35 (specifically identifying the practice of the FDIC in covering uninsured depositors as resulting in "too much bank risk with too many costly failures"). Notwithstanding the fact that under a deposit payoff the FDIC is not required to pay more than the insured amount, it has uniformly paid deposit accounts in their entirety by entering into purchase and assumption transactions. *See* TREASURY REPORT, *supra* note 14, at I-39, 40; Macey & Miller, *supra* note 15, at 1183 (noting that purchase and assumption transactions have a supposed advantage in the eyes of the FDIC in that all depositors receive protection); Scott, *Policy Choices, supra* note 4, at 918 (noting that the FDIC's justifications for this policy are its own limitations of financial and personnel resources and to avoid losses to correspondent banks). Uninsured depositors have historically received most of their money through the liquidation process or the failure resolution technique chosen. *See* TREASURY REPORT, *Conclusions and Recommendations, supra* note 14, at 35 (showing that over ninety-nine percent of uninsured deposits were protected during the "record period of bank failures occurring since 1985").

125. *See supra* note 43 (containing a discussion of the least cost requirement).

126. Other policy considerations recognized by the Treasury Department include: maintaining public confidence in the banking system, encouraging market discipline against risk-taking, cost effectiveness, and *equitable considerations*. *See* TREASURY REPORT, *supra* note 14, at III-27-28. The report continued by noting that the choice of failure resolution technique was dependent on the relative priorities given the different policy objectives. *Id.* at III-28.

127. *See, e.g.*, Garten, *Bank Failure, supra* note 15, at 1196 (asserting that present bank failure policies are efficient in that they facilitate the rapid reallocation of banking resources following bank failure). However, even though these policies are generally driven by the least cost principle, they may not be efficient in the true economic sense as they fail to consider the social, pecuniary and non pecuniary costs associated with the failure resolution technique selected. *See, e.g., supra* notes 19 and 20 (discussing the implications of social costs). Furthermore, in the healthy bank paradigm suggested in this article, equity in terms of fairness, not least cost efficiency is the ultimate goal sought be achieved.

the results of their actions. That is, in order for the FDIC to effectively satisfy its statutory obligation, courts have deemed it imperative that the FDIC be able to rely upon the stated asset values of insolvent institutions and structure resolutions to maximize the net present value of assets collected. If these assets were subject to formally undocumented conditions or claims that would reduce the net realizable asset value, the FDIC's ability to make an *accurate* least cost determination would become impossible. One court has stated this proposition as follows:

> If the FDIC's right to collect on returned assets, however, were subject to fraud claims of which the FDIC lacked knowledge, estimating its potential loss from a purchase and assumption transaction would be impossible. . . . Consequently, the FDIC could not make the judgment necessary under § 1823(e) and the purchase and assumption method of handling bank failures would be effectively foreclosed.
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> Such a result would run directly counter to the policies behind the creation of the FDIC. . . . Adopting a state rule of law which would permit asserting unknown fraud claims against the FDIC, therefore, would significantly interfere with the federal policies behind the FDIC.[128]

Courts have also asserted that because these cost determinations must be made "with great speed, usually overnight, in order to preserve the going concern value of the failed bank and avoid an interruption in banking services,"[129] it

128. Gunter v. Hutcheson, 674 F.2d 862, 870 (11th Cir.), *cert. denied*, 459 U.S. 826 (1982). It should be noted that this decision was rendered before the "least cost" test became statutorily required, but after 1950 when the "least cost" approach was an internal policy of the FDIC. *See supra* note 43.

129. Gunter v. Hutcheson, 674 F.2d at 865. *See also* Langley v. FDIC, 484 U.S. 86, 91 (1987) (quoting from *Gunter* the Court notes that if the assets of the institution are subject to undisclosed conditions the FDIC can not perform its function with speed); FDIC v. Wood, 758 F.2d 156, 161 (6th Cir.), *cert. denied*, 471 U.S. 944 (1985) ("the essence of a purchase and assumption transaction is speed"). *See also* Gray, *supra* note 5, at 256-57 (arguing that the immediate transfer of deposits saves the insurance fund); James W. Brewer & Elaine C. Lee, Comment, *Bank Failure and the FDIC: A Survey of Legal Rights and Relationships of the Client and the Insolvent Bank*, 18 TEX. TECH L. REV. 1193, 1228 (1987) (noting that speed in the choice of resolution techniques assists the *D'Oench* doctrine in remaining "as beneficial and necessary as it was when it was established"). *But see* Fred H. Miller & Scott A. Meacham, *The FDIC and Other Financial Institution Insurance Agencies as "Super" Holders in Due Course: A Lesson in Self-Pollinated Jurisprudence*, 40 OKLA. L. REV. 621, 633-36 (1987) (noting that since the cost test is not absolute but based on reasoned judgment the speed of the transaction is not necessarily a relevant inquiry). Miller and Meacham also posited the conclusion that "the allowance of the assertion of state law defenses would make a difference in a purchase and assumption transaction only to the extent that

is essential that the FDIC not be bound by *D'Oench* type "hidden" defenses.[130]

Upon critical analysis the *D'Oench* doctrine is not even justified under the failed bank paradigm. The very assumptions underlying the doctrine's foundation are erroneous[131]; and the doctrine has failed to achieve the stated goal inherent in the policy. The assertion that *D'Oench* is necessary to the FDIC so that quick decisions concerning the value of assets of a failing bank can be made and failure resolution will not destroy public confidence or disrupt the money supply, is a perversion of the truth.[132] In the first place the cost test is really only an educated estimate,[133] which because of accounting leniency is based on inaccurate and incomplete information as to asset values. Secondly, there is no conceivable way that the FDIC can evaluate "overnight" its (or a successor financial institution's) future ability to collect on the assets of a failed bank.[134]

Furthermore, since many of the *D'Oench* type problems arise in situations where assets are already classified or subject to litigation, defenses and claims are open and obvious even from a brief review of a bank's files. It is therefore clear that the realizable value of such assets under a least cost approach is

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there are uninsured deposits or to the lesser extent of the amount of bad assets, if bad assets are less than the amount of uninsured deposits." *Id.* at 635.

130. *See, e.g.*, FSLIC v. Gordy, 928 F.2d 1558, 1567 (11th Cir. 1991) (noting that a hidden agreement is one that the FDIC will not see during an evaluation of the bank's records); FDIC v. Wood, 758 F.2d at 161 (noting that the existence of unknown state law defenses hampers the FDIC because it effects the cost evaluation and forces the FDIC to examine files in that light, preventing the transactions from coming to fruition in the first place).

131. This in itself should be enough to lead to the doctrine's demise. *Cf.* Paul A. Samuelson, *Theory and Realism: A Reply*, 54 AM. ECON. REV. 736, 736 (1964) ("I regard it as a monstrous perversion of science to claim that a theory is all the better for its shortcomings [unrealistic assumptions]").

132. *But see* Garten, *Bank Failure*, *supra* note 15, at 1196 (arguing that an integral part of failed bank policy is "to facilitate the rapid reallocation of banking resources").

133. *See* TREASURY REPORT, *Conclusions and Recommendations*, *supra* note 14, at 40 ("Contrary to widespread perception, current law does not require the FDIC to choose the least costly resolution method."); *supra* note 43. The report recommended a change in the law to require the FDIC to choose the least costly method even though the effect might adversely affect uninsured depositors. *Id.* at 41. *See also* Gunter v. Hutcheson, 674 F.2d at 871 (noting that the statutory language only requires "a reasoned judgment that the risk of a purchase and assumption transaction is not greater than a liquidation").

134. *See* TREASURY REPORT, *supra* note 14, at XI-4 (discussing the obvious problems associated with market value asset realizations versus book value carrying values). The report noted that in recent years the failure resolution costs have averaged about fifteen percent of the total assets of the failed institutions. *Id.* at I-43 (admitting, however, that in some individual cases the costs have been as high as fifty percent). *See also* *U.S. to Lose 40% in S&L Assets*, SAN ANTONIO EXPRESS-NEWS, July 14, 1991, at A2 (citing a Los Angeles Times investigation alleging that there is a growing gap between the dollar value of savings and loan assets seized by the government and the amount the government will get back when these assets are sold).

subject to reduction at the time the failure resolution technique is chosen.[135] The inability of the FDIC to quickly and accurately determine asset value net of defenses does not interfere with the "speed" or the ability of the FDIC to complete a failure resolution technique;[136] it will only effect the projected or estimated cost, if there is a desire on the part of the FDIC to protect the uninsured depositors.[137] In any event the current FDIC practice of "whole-bank" purchase and assumption transactions, encourages prospective purchasers to "reduce their bid by an amount reflecting the estimated difference between book and market values of 'dirty assets'"[138] which further emphasizes the fact that asset values on the books of the failed or failing bank do not reflect realizable values. In such a situation the successor financial institution can bid low, and then take some of the "dirty" assets and subsequently sanitize them

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135. *See, e.g.*, Porras v. Petroplex Sav. Ass'n, 903 F.2d 379, 381 (5th Cir. 1990) (holding that *D'Oench* bars claims raised during litigation prior to appointment of FSLIC as receiver and the protection extends to private purchasers of failed institution's assets); Campbell Leasing, Inc. v. FDIC, 901 F.2d 1244, 1247-48 (5th Cir. 1990) (holding that *D'Oench* applies to bar claims and related defenses raised during litigation prior to the appointment of FDIC as receiver); Bell & Murphy & Assoc. v. Interfirst Bank Gateway, 894 F.2d 750, 754-55 (5th Cir.), *cert. denied,* 111 S. Ct. 244 (1990) (holding that *D'Oench* applies to bar claims raised during litigation prior to appointment of FDIC as receiver and the protection extends to protect bridge bank). However, to protect the FDIC from itself, its knowledge of relevant defenses has been deemed irrelevant to the application of the *D'Oench* doctrine. *See* Langley v. FDIC, 484 U.S. 86, 93 (1987) (knowledge on the part of the FDIC is irrelevant to application of section 1823(e)); D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447, 459 (1942). Arguable knowledge of personal defenses on the part of the FDIC bars the application of the federal holder in due course theory. *See, e.g.*, FDIC v. Wood, 758 F.2d 156, 161 (6th Cir.), *cert. denied*, 471 U.S. 944 (1985). However, it now appears that the FDIC and even its assigns may assert this theory notwithstanding knowledge of personal defenses. *See* Porras v. Petroplex Sav. Ass'n, 903 F.2d at 381.

136. *See, e.g.*, Miller & Meacham, *supra* note 129, at 634-36; Hymanson, *supra* note 7, at 281-82. *But see* FDIC v. Wood, 758 F.2d at 161 (arguing that permitting defenses creates a situation where "the transaction [purchase and assumption] will not take place").

137. *See* Miller & Meacham, *supra* note 129, at 635-36 (arguing that state law defenses are only relevant to the extent of the uninsured deposits that the FDIC makes the acquiring bank assume).

138. *See* TREASURY REPORT, *supra* note 14, at I-45. The report stated that prior to 1985, most purchase and assumption transactions involved the merging bank acquiring only the highest quality assets such as cash and government securities, leaving the FDIC with the remaining assets. *Id.* at I-44. However, in 1985, the FDIC began a program of transferring lower quality assets to acquiring institutions with the right of the acquiring institution to return assets to the FDIC at book value (or sometimes at discounts of five to ten percent) within a specified period of time. *Id.* More recently, the FDIC instituted the whole bank purchase and assumption transaction where the acquiring institution purchases all the assets without the right of returning unwanted or uncollectible assets to the FDIC. *Id.* at 45. *See generally id.* at ch. X (table 6) (listing the numbers of the various types of transaction completed from 1987 through September, 1989). By the use of the term 'dirty asset' is meant any asset whose collectibility is questionable. A problem of collectibility could arise from alleged defenses, as well as the credit worthiness of the debtor or value of the underlying collateral.

through asserting a *D'Oench* defense.[139] Finally, and most important, the doctrine does not even have the salutary effect of encouraging individual banks to control their risk, as they are not the ones who suffer from *D'Oench*.

Federal deposit insurance was established as a regulatory method to protect the circulating medium and had the added benefit of protecting the small depositor.[140] Although our present system of deposit insurance and related regulatory programs have been successful in preventing bank runs and in bringing stability to the money supply, they have done so increasingly at social costs. Even the protection provided by *D'Oench* has not been able to stem the losses sustained by the insurance fund. Those mounting losses are a direct result of the very credit risks that the present regulatory scheme has fostered.[141] The *D'Oench* doctrine was founded on the mistaken assumption of the failed bank paradigm that the goal of monetary stability could be achieved by preserving the deposit insurance fund through reduction of costs to the FDIC in a failed bank context. There is no doubt that the goal of financial stability is and should be one of the major consideration behind federal banking policies.

Indeed, that goal for the most part has been achieved even though the FDIC continues to operate at a loss[142] and its insurance funds are virtually depleted.[143] This success has been accomplished by creating public confidence in the security of demand deposits, the major liability on a bank's balance sheet, and by the federal guarantee of those deposits. The existence of a deposit insurance fund is neither a necessary, nor a sufficient condition for this macroeconomic monetary stability. It is the ability of the government to back its guarantee that is the necessary condition for this stability. However, it is public confidence in that ability that creates the final sufficient condition insuring macroeconomic stability. Equitable application of failure resolution techniques,

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139. *See, e.g*, Porras v. Petroplex Sav. Ass'n, 903 F.2d at 381 (holding that an acquiring institution enjoys the status of federal holder in due course); Campbell Leasing, Inc. v. FDIC, 901 F.2d at 1248 (holding that a successor financial institution can assert a *D'Oench* defense).

140. *See supra* notes 32-33. One recent commentator noted:

> [D]eposit insurance resolved the instability of banking by assuring depositors of the safety and accessibility of their deposits, thereby obviating the necessity of maintaining vigilant attention to bank solvency.. By averting depositors' impulse to withdraw funds in anticipation of withdrawal imbalances, deposit insurance ended the potential for bank panics and brought stability to fractional reserve banking.

Halpert, *supra* note 16, at 495.

141. *See supra* note 46 (discussing the concept of moral hazard). In the final analysis, failed bank policy as presently practiced has been self-perpetuating. That is, it has fostered the very risk that has subsequently led to bank failure. It is this increasing rise in failures and the drain on the insurance fund which has been used to justify its continued existence.

142. FED. DEPOSIT INS. CORP., *supra* note 14, at 82 (showing that for each of the calendar years 1988 and 1989 the FDIC sustained a net operating loss).

143. *See supra* note 14.

in and of themselves, can be a part of instilling that public confidence, as can policies that reduce excessive risktaking by banks.

The failed bank paradigm's obsession with macroeconomic considerations together with its failure to invest in microeconomic policies which would encourage better management through responsible regulation, has led to the demise of public confidence in the basic integrity of the banking system. This lack of public confidence has created a basic institutional instability in the system that needs to be addressed. Nonetheless, the regulatory focus of failed bank policy, although having achieved a fair degree of monetary stability, has proved incapable of creating an atmosphere that either fosters healthy well-managed banks or encourages public confidence in the banking and regulatory system. Thus, the time has come to consider the adoption of a value-based healthy bank paradigm.[144]

IV. THE HEALTHY BANK PARADIGM

The problem addressed in the healthy bank paradigm is defined in terms of how to deal with individual bank credit risk. However, the central reference point is not how to eliminate it, or how to deal with its results ex post, but how to create a regulatory atmosphere that encourages ex ante accountability and responsibility for bank risk-taking. The ultimate goals of the healthy bank paradigm are public confidence and a stable money supply. Public confidence is achieved not only by creating security for insured deposits, but also by developing integrity in the banking system itself.

At the heart of the policies to achieve these goals is the recognition that the existence of deposit insurance[145] creates a separation between the problems of

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144. *Cf.* Richard E. Flint, *Bankruptcy Policy: Toward a Moral Justification For Financial Rehabilitation of the Consumer Debtor*, 48 WASH. & LEE L. REV. 515, 531-43 (1991) (discussing the need for bankruptcy law to reflect the moral values inherent in society). Even conservative law and economic scholars recognize the fact that legal rights and obligations need to change and adapt over time to reflect the changes in relative economic values of competing uses of the factors of production. *See, e.g.*, POSNER, ECONOMIC, *supra* note 19, at 47.

145. Changes in the amount and extent of coverage for deposit insurance are suggested by the present administration. *See* TREASURY REPORT, *Conclusions and Recommendations*, *supra* note 14, at 33-43. Concern over the extent and scope of deposit insurance has been previously expressed. *See, e.g.*, KANE, *supra* note 15, at 155-56 (discussing the need to limit coverage in the area of brokered deposits); Scott, *Policy Choices*, *supra* note 4, at 31-32 (questioning the justification of coverage at the $100,000 level and the practice of permitting multiple accounts). For purposes of this article it is sufficient that there be some level of deposit insurance, that its terms and conditions are known, and that there is a government guarantee of all insured deposits.

deposit-account security and bank failure.[146] The existence of deposit insurance provides the initial solution to the macroeconomic problem of liquidity following bank failure by providing depositor confidence in the security of insured deposits. However, deposit insurance is not a remedy for the microeconomic problem of reducing individual bank risk-taking. In fact the very existence of deposit insurance creates a moral hazard that exacerbates individual bank risk and the possibility of bank failure.[147]

The policies dealing with the microeconomic illiquidity of individual banks must focus on creating an increased public confidence in the integrity of the structure of banking and its regulators. Thus, those policies need to create incentives to reduce the excessive risk-taking by individual banks and to develop a consistent and equitable solution for the treatment of all parties involved in a failure situation.

Healthy bank policies strive to reduce failure possibilities by counteracting the moral hazard problem inherent in deposit insurance, with reduction in the rewards that deposit insurance provides for excessive risk taking.[148] Thus, these policies seek to improve bank management, increase regulatory supervision, increase uninsured depositor exposure in the event of failure, and create consistent and equitable treatment of all parties in a failure situation. Public confidence in the integrity of the system can be maintained only if banks, depositors, and their regulators become accountable and accept responsibility for problems of credit risk. By addressing the problem facing banking law in terms of encouraging management and regulator responsibility prior to failure, and fairly dealing with creditors and debtors during failure resolution, the focus of the healthy bank paradigm becomes ethically value-based in contrast to the failed bank paradigm whose primary consideration is economic.

It needs to be remembered that in the final analysis banking policies are justified, when and if, they are effective in achieving the goals for which those policies were implemented. The demise of the failed bank paradigm has been a direct result of its inability to achieve public confidence in the integrity of the banking industry and its regulators, not the inability of its policies to prevent bank failures. This result was the inevitable byproduct of the paradigm's preoccupation with the costs of failure resolution driven by the political realities

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146. Economists have long recognized this separation. *See* Tussing, *supra* note 32, at 145 ("deposit insurance has largely separated the question of deposit-account security from that of bank failure").

147. *See supra* note 46 for a discussion of the concept of moral hazard.

148. *See* Keeley, *supra* note 16, at 1198 (concluding his empirical economic research by arguing that the "deposit insurance system must be reformed to reduce the rewards it provides for excessive risk taking").

of our country.[149] From the 1930's until recently, the proponents of failed bank policies led politicians and the public to perceive their success purely in terms of the sanctity and liquidity of the insurance fund; when the fund went bankrupt, so too did their credibility. Healthy bank policy seeks to regain that lost public confidence by stressing individual bank safety and integrity. It addresses head-on the microeconomic question of individual bank risk ex ante, and does not dabble in large aggregates that treat individual credit-risk issues as insignificant and unimportant for national policy. Its concern is creating solutions to the bank risk problem, not reacting to its results. To generate public confidence, the public must have faith in the system as evidenced by the lack of faith and subsequent demise of the failed bank paradigm.

Thus, implicit in the healthy bank paradigm is the awareness that liberal paternalism has failed to achieve its goal through failed bank policies, and that the time has come for bank management, depositors, and regulators to be held accountable and responsible for their actions. In a healthy bank paradigm the focus of regulatory action will be on reducing risk taking[150] through risk based insurance premiums,[151] modified market value accounting,[152] early intervention in appointing receivers prior to actual insolvency,[153] treatment of

149. *See generally* KANE, *supra* note 15, at 163-65 (discussing the political dilemma of reforming the deposit insurance system).

150. I realize that there is no consensus on whether the proposals of a healthy bank regulatory policy will be more effective in reducing the numbers of bank failures. *Compare* Garten, *Bank Failure*, *supra* note 15, at 1195 (boldly asserting that bank failure policy will be unable to create the proper incentives for better managed banks) *and* Garten, *Still Banking*, *supra* note 16, at 242 ("empirical studies of depositor behavior not only have failed to demonstrate that depositors will exert effective market discipline, but cannot explain why market discipline is not already working to constrain bank risk-taking") *with* Macey & Garrett, *supra* note 15, at 237-39 (concluding that empirical data establishes that market discipline is working now but that risk based premiums and changes in failure resolution techniques would work even better).

151. *See* TREASURY REPORT, *Conclusions and Recommendations*, *supra* note 14, at 43-45. The recommendation for change advocated by the administration was not new. Even before the crisis arose there were advocates for change in the structure of insurance rates whose voices apparently fell on deaf ears. *See, e.g.*, Scott & Mayer, *supra* note 15, at 890-92 (suggestion in 1971 that premium rates be tied in some manner to risk and capital structure).

152. *See* TREASURY REPORT, *Conclusions and Recommendations*, *supra* note 14, at 48-49. Once again this administration request for change had been advocated before the crisis. *See, e.g.*, KANE, *supra* note 15, at 148-51 (recommending in 1985 that book value accounting be replaced with a market-value accounting system). *Cf.* George J. Benston, *Accounting Numbers and Economic Values*, 27 ANTITRUST BULL. 161, 161-71 (1982) (noting that accounting values [book value] are concerned with recording data to meet the requirements of regulators while economic values [market value] measure net cash flows or values that need to be constantly reevaluated to meet changing circumstances and thus are a better indicator of actual financial condition).

153. *See* TREASURY REPORT, *Conclusions and Recommendations*, *supra* note 14, at 47-48. *See also* Scott, *Policy Choices*, *supra* note 4, at 917-21 (discussing early closure of banks as a way to deal with the risk problem). For a discussion of whether early closure rules violate certain constitutional principles see Curtis, *supra* note 17, at 375-84 (1990) (concluding that the early

uninsured depositors similar to general unsecured creditors,[154] and the elimination of the whole bank purchase and assumption transactions.[155] These policies along with the government's guarantee of deposit insurance, will insure public confidence not only in the security of their deposits but also in the integrity of the system and insure the liquidity of the money supply. Unlike the failed bank policies, the policies of the healthy bank paradigm will seek to achieve that goal through an awareness that depositors, banks, and regulators all have responsibilities and are accountable for their actions. Ineffective bank regulatory policy needs to move from economic paternalism to value-based responsibility.[156] Implicit in this shift is the recognition that the economic values inherent in failed bank policy must give way to the ethical values inherent in a system that demands responsibility and accountability.

In the event of failure, healthy bank policy relies upon the deposit guarantee to solve the plight of the insured depositor and avoid the potential macroeconomic effects of failure. It is here that the FDIC performs its statutory corporate role in protecting the major liability holders of the institution.[157] However, because healthy bank policy separates depositor security from resolution of bank failure, the actions of FDIC as receiver are independent of its actions in the corporate role. Thus, while the FDIC as receiver is performing its liquidation function, or engaging in a failure resolution technique, its goal is to preserve public confidence in the integrity of the banking system and its regulators. Under the *D'Oench* doctrine, the issue faced in the healthy bank paradigm is whether public confidence in the integrity of the system would be encouraged by protecting preliquidation entitlements. The article now turns

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intervention policies in savings and loan failure resolutions is not an unconstitutional taking).

154. As a result, uninsured depositors will be limited to the amount that they would have received in a liquidation, unless the FDIC decides to give them supplemental payments. *See supra* note 44.

155. *See infra* note 179 and accompanying text for a discussion of this proposal.

156. This shift in policies reflects a change in the underlying values sought to be preserved by the policies. The suggested implementation of a new scheme of regulation in the area of banking law is not unlike the shift in underlying values that led to a reversal in the orientation of bankruptcy policy. *See, e.g.*, Flint, *supra* note 144, at 29-40 (discussing the shift in focus of consumer bankruptcy legislation from the protection of creditors' rights to advocating the human dignity of the debtor).

157. *See, e.g.*, FRIEDMAN & SCHWARTZ, *supra* note 68, at 441 ("Federal deposit insurance attempts to solve the problem by removing the initial reason for runs – loss of confidence in the ability to convert deposits [bank liabilities] into currency."). The legislative history of deposit insurance makes it clear that the function of deposit insurance was liability oriented, separate and distinct from the recovery of assets in the failure resolution process. *See, e.g.*, H.R. REP. NO. 150, 73rd Cong., 1st Sess., 6 (1933) [report that accompanied the Banking Act of 1933 which created federal deposit insurance] ("[T]he public is afraid to deposit their money in the banks"). *See also* FDIC REPORT, *supra* note 8, *reprinted in* 1950 U.S.C.C.A.N. at 3766 (noting that the FDIC had brought "safety and liquidity of bank deposits").

to consideration of that issue.

A. A Commutative Justice Evaluation of D'Oench

D'Oench and its progeny are supposed equitable doctrines reflecting the balancing of the needs for an orderly system of bank liquidation with the demands of federal deposit insurance. Prior to *D'Oench* and the creation of the FDIC, bank liquidation had as its basic function the winding up of the financial affairs of an institution, the collection and liquidation of assets, and the making of distributions to creditors. Preliquidation state entitlements were generally upheld and the costs of individual bank failure were born by creditors, depositors, and shareholders.

The creation of deposit insurance interjected into this system of bank asset liquidation a macroeconomic federal interest to insure the stability of the money supply. Although the basic function of bank liquidation remained the same, the *D'Oench* Court perceived that this overriding federal interest could be achieved only through the preservation of the insurance fund. From this initial perception came the false belief that monetary stability was dependent upon the liquidity of the insurance fund. Even though the dollar amount of the fund is dependent in part upon the FDIC's ability to collect debts from obligors of failed banks, there was no direct indication in the legislative history that deposit insurance was intended to change the legal rights of debtors in bank asset liquidations.[158] Notwithstanding this fact, the *D'Oench* Court changed the manner and procedures of bank liquidation by eliminating preliquidation state entitlements. As a result, debtors under the *D'Oench* doctrine were left alone to subsidize the system of asset liquidation. Recent history has now established that a stable money supply can be achieved even when the insurance fund is nearing bankruptcy. Thus, any decision to return to preliquidation state entitlements in a *D'Oench* type situation is really dependent on whether such a move will increase public confidence in the integrity of the banking system. This is part and parcel of a larger question under a value-based system of whether *D'Oench* can be justified from a moral prospective.

There is no doubt that the *D'Oench* decision had certain economic and political justifications.[159] However, there has been no serious attempt to

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158. From the time of the creation of the FDIC in 1933 until the enactment of FIRREA, the FDIC while acting as receiver was to act "in conformity with the provisions of law relating to the liquidation of closed national banks, except as herein otherwise provided." 12 U.S.C. § 1821(d) (1980), *amended by* 12 U.S.C. § 1821(d) (1989).

159. *See supra* notes 68-70 and accompanying text. The proposition that law is politically motivated or oriented is well recognized and accepted by certain legal philosophers. *See, e.g.*, RONALD DWORKIN, A MATTER OF PRINCIPLE 146 (1985) (stating that his conception of law is "deeply and thoroughly political"); Richard Posner, *Wealth Maximization Revisited*, 2 NOTRE DAME

examine the doctrine from a moral perspective. This oversight seems odd given the fact that by blindly following the doctrine of *stare decisis*, decisions have been rendered which do not fit any litmus test of fairness. The failure to analyze the doctrine in terms of its moral implications is reflective of the general distrust of value-based decision making in American legal philosophy of the recent past.[160] In order to begin to isolate and identify moral values, one must admit that there are normative underpinnings to the resolution of legal issues. Today with the increasing realization that law is not an autonomous discipline,[161] academicians are acknowledging there is a normative basis of law in a variety of areas.[162] Thus, the time has come to address *D'Oench* in

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J.L., ETHICS & PUB. POL'Y 85, 103 (1985) (stating that "[i]t must be emphasized that it is a *political* philosophy that I am expounding."). *Contra* Ernest J. Weinrib, *Legal Formalism: On the Immanent Rationality of Law*, 97 YALE L.J. 949, 951 (1988) (defending formalism as "an exploration of the sense in which law can, after all, be differentiated from politics").

160. For example, legal positivism contemplates only the form of law, confining itself to an investigation of law as it is, without regard to its justness or unjustness, thus attempting to free legal theory completely from all qualifications or value judgments of a political, social, or economic nature. *See, e.g.*, EDGAR BODENHEIMER, JURISPRUDENCE 285 (1940); H.L.A. Hart, *Legal Positiveness*, in 4 ENCYCLOPEDIA OF PHILOSOPHY 418, 419 (1967) (asserting that legal positivism's concern with law is "morally, politically, and evaluatively neutral"). *See also* POSNER, JURISPRUDENCE, *supra* note 6, at 348 (stating that "[a]s should be clear by now, I am skeptical that moral philosophy has much to offer law in the way of answers to specific legal questions or even in the way of general bearings"); Owen M. Fiss, *The Death of the Law?*, 72 CORNELL L. REV. 1, 14 (1986) (noting his dissatisfaction with the approaches of the Critical Legal Studies and Law and Economics philosophers for positing that public morality is untenable with the legal process). *Contra* Charles E. Rice, *Some Reasons for a Restoration of Natural Law Jurisprudence*, 24 WAKE FOREST L. REV. 539, 539 (1989) ("Legal positivism is unacceptable as a jurisprudential framework because it provides no inherent limits on the power of the state and no basis for determining what is just.").

161. *See, e.g.*, John B. Attanasio, *Everyman's Constitutional Law: A Theory of the Power of Judicial Review*, 72 GEO. L.J. 1665, 1716-23 (1984) [hereinafter Attanasio, *Everyman's Constitution*] (concluding that the Supreme Court's power of judicial review is not objectively determinable but rests on rational and nonrational elements); Richard Posner, *The Decline of Law as an Autonomous Discipline: 1962-1987*, 100 HARV. L. REV. 761, 766-77 (1987) (discussing various reasons to support his proposition that the law is no longer autonomous); Roberto M. Unger, *The Critical Legal Studies Movement*, 96 HARV. L. REV. 561, 568-76 (1983) (containing a critique of formalism and objectivism in the law). Professor Attanasio suggested that the critique of law by the Critical Legal Studies movement "has helped to dispel the illusion that law is largely value neutral." John B. Attanasio, *Foreward: The Impoverished States of Law and Morality*, 64 NOTRE DAME L. REV. 773, 775 (1989). He also rejected the Critical Legal Studies' notion that legal choice represents "arbitrary exercises of raw political power" and has asserted such choices are built on moral choices. *Id.* at 775-76. *See also* J. M. Finnis, *On "The Critical Legal Studies Movement"*, 30 AM. J. JURIS. 21, 42 (1985) (arguing that his explicit moral and political normative theory to law is sounder than that of CLS).

162. *See, e.g.*, Flint, *supra* note 144, at 17-29 (developing a moral justification as a foundation for an understanding of consumer bankruptcy); Karen Gross, *The Debtor as Modern Day Peon: A Problem of Unconstitutional Conditions*, 65 NOTRE DAME L. REV. 165, 200 (1990) ("discharge policy must be based upon non-instrumental (deontological) truths"); Robin P. Malloy, *Is Law and Economics Moral? – Humanistic Economics and a Classical Liberal Critique of Posner's Economic*

normative terms.

Even though it has been argued that there is no moral consensus in America,[163] there is clearly an awareness and realization of what constitutes basic fairness.[164] That is, although there may not be agreement on substantive moral issues, or for that matter there may not be a consensus on the underlying

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Analysis, 24 VAL. U. L. REV. 147, 154-60 (1990) (discussing the moral dimension of the study of law and economics).

163. *See, e.g.*, JAMES PATTERSON & PETER KIM, THE DAY AMERICA TOLD THE TRUTH 235 (1991) ("There is absolutely no moral consensus in this country -- as there was in the 1950s and 1960s."); Richard Posner, *Law and Economics Is Moral*, 24 VAL. U. L. REV. 163, 166 (1990) ("I regard moral philosophy as a weak field, a field in disarray, a field in which consensus is impossible to achieve in our society."). Some commentators have argued that this lack of consensus has resulted from the separation of religious beliefs from a theory of morality which has led to a secular morality that has no firm foundation. *See, e.g.*, JOHN LESLIE MACKIE, ETHICS -- INVENTING RIGHT AND WRONG 19 (1977) (noting that moral philosophy only addresses linguistic or conceptual questions, and that its failure to address questions in ontological terms leads to skepticism); George P. Fletcher, *The Meaning of Morality*, 64 NOTRE DAME L. REV. 805, 807 (1989) ("The problem with conventional morality is that neither custom nor consensus can deliver this extrinsic test for validating the conventional rules."); J. D. Goldsworthy, *God or Mackie? The Dilemma of Secular Moral Philosophy*, 30 AM. J. JURIS. 43, 77-78 (1985) (asserting the failure of moral philosophy to have its foundations in religious beliefs leave it barren); Arthur A. Leff, *Unspeakable Ethics, Unnatural Law*, 1979 DUKE L.J. 1229, 1249 (1979) (arguing that secular moral philosophy contains no real authority); Onora O'Neill, *Justice and the Virtues*, 34 AM. J. JURIS. 1, 1-6 (1989) (noting that the liberal account of morality is limiting and inadequate because it detaches justice from ethical values).

164. By the term basic fairness is meant that each individual person gets what they deserve. As used here the term "deserve" is meant to convey moral responsibility and obligations. *See, e.g.*, LLOYD E. WEINREB, NATURAL LAW AND JUSTICE 10 (1987). *See also* Attanasio, *Everyman's Constitution*, *supra* note 161, at 1699-70 ("Deep within human beings there is a need for moral certitude, a fundamental longing for affirmance of the rightness of our actions."). Patterson and Kim noted in their exhaustive survey of the moral fabric of the United States that Americans "want their kids to have basic values and a sense of right and wrong." PATTERSON & KIM, *supra* note 163, at 235-36. The concept of fairness is composed of a substantive and a procedural component. Substantive fairness involves concepts of corrective justice and accountability. United States v. Cannons Eng'g Corp., 899 F.2d 79, 87 (1st Cir. 1990) (discussing these elements of substantive fairness as the basis in evaluating settlements in environmental actions). *See also* FINNIS, *supra* note 36, at 261-64 (listing concepts of desert and proportionality in his discussion of one of the elements of practical reasonableness -- fairness). The breadth of a concept of substantive fairness rests primarily upon the common sense understanding of the community. *See, e.g.*, Catharine Wells, *Tort Law as Corrective Justice: A Pragmatic Justification for Jury Adjudication*, 88 MICH. L. REV. 2348, 2360 (1990) (discussing how tort adjudication identifies a common sense understanding of fairness). Even Judge Richard Posner asserted that a rule of law is unjust, if it is so contrary to dominant public opinion. POSNER, JURISPRUDENCE, *supra* note 6, at 334. Procedural fairness deals with "due process", i.e., the specific manner or method by which the result is reached. *See, e.g.*, Fuentes v. Shevin, 407 U.S. 67, 80 (1972) ("For more than a century the central meaning of procedural due process has been clear: 'Parties whose rights are to be affected are entitled to be heard; and in order that they may enjoy that right they must first be notified.'") (citations omitted).

foundations of morality -- religious or secular,[165] there is a basic agreement that law should work as an institutional arrangement in which public officials seek to elaborate and protect the values that the nation holds in common.[166]

D'Oench can be viewed as a pragmatic attempt to achieve ends of distributive justice at the expense of giving commutative justice to an individual debtor.[167] From this perspective *D'Oench* reflects the recognition of the more active role the government was to play in dealing with social and economic

165. *See, e.g.*, FINNIS, *supra* note 36, at 351 (establishing the basis for his moral approach to natural law on requirements of practical reasonableness without reference to religious beliefs); Fletcher, *supra* note 163, at 806-07 (noting that morality can be a code of norms crystallized as a matter of conventions, intuitive reasoning, or biblical authority); George W. Constable, *A Criticism of "Practical Principles, Moral Truths, and Ultimate Ends" by Grisez, Boyle, and Finnis*, 34 AM. J. JURIS. 19, 21-22 (1989) (arguing that religious beliefs can form the basis of a moral philosophy).

166. *See, e.g.*, POSNER, JURISPRUDENCE, *supra* note 6, at 454-70 (arguing for a pragmatic jurisprudence under which law reflects socially determined goals for shaping behavior to conform with society's values); Frank H. Easterbrook, *The Supreme Court 1983 Term-- Forward: The Court and the Economic System*, 98 HARV. L. REV. 4, 60 (1984) ("Judges' claim to authority rests on a plausible demonstration that they are faithfully executing decisions made by others."); Fiss, *supra* note 160, at 15 (asserting that "[w]e need public morality to have law, true, but even more, we need law to have a public morality"). *Cf.* Wells, *supra* note 164, at 2411 (arguing that a "pragmatic conception of corrective justice is based upon the idea that tort law enforces community standards of financial responsibility and just compensation").

167. The present system of failure resolution in conjunction with the *D'Oench* doctrine arbitrarily prefers the FDIC and uninsured depositors over possible innocent individuals purely for economic reasons. Although acknowledging that there are other values that could form the underlying basis for bank liquidation policies, the courts have uniformly rejected them, coercing the transfer of income from the debtor to the FDIC and its insurance fund to be redistributed to insured and uninsured depositors. *See, e.g.*, Langley v. FDIC, 484 U.S. 86, 94 (1987) ("the equities [that the borrower would have us invoke] are not the equities the statute [Section 1823(e)] regards as predominant"). In *Langley*, the Court held that it would not engraft an equitable exception upon the statute because such an exception would cause economic harm to the FDIC and the solvency of its fund. *Id.* at 94-95. Under a value-based approach one can view this subsidization as an attempt to secure distributive justice for society as a whole rather than commutative justice for the individual debtor. *See, e.g.*, FINNIS, *supra* note 36, at 180-84 (noting the difference in focus between the aggregate result [distributive justice] and the individual result [commutative justice]). In other words, commutative justice stresses the equities of the particular transaction, rather than the distributional entitlements of the parties, and thus concerns of commutative justice should be determined independently of any concerns for distributional results. *See generally* ARISTOTLE, *supra* note 30, at Book V .3-5. Aristotle argued that distributions were to be made according to merit, whereas commutative justice treated good men and bad men as equals and "the law looks only to the distinctive character of the injury, and treats the parties as equal, if one is in the wrong and the other is being wronged, and if one inflicted injury and the other has received it." *Id.* at Book V .4. In a nutshell, from an ethical point of view the *D'Oench* doctrine overemphasizes distributive justice concerns of protecting the insurance fund for the benefit of society as a whole, at the expense of resolving fairly the individual debtor's fate under principles of commutative justice. Such an approach is misguided for it presupposes the very fairness which in an ethical analysis should be at issue, and places a presumption in favor of an economic set of values over the value of fair dealing.

problems and thus, in the underlying distribution of wealth.[168] As a result governmental commitment to corrective justice took a rear seat as the New Dealers sought to establish a system of distributive justice through laws and regulations addressing specific ills. Thus, individual economic rights became subservient to the economic rights of the majority. However, when the individual rights trampled are those that society holds dear, and governmental decisions do not comport to a common sense understanding of community norms, time for change is necessary.[169] The application of the *D'Oench* doctrine to an innocent unsuspecting debtor does not meet the nation's concept of either substantive or procedural fairness.[170] Although the doctrine results in certainty for the FDIC in its role as a receiver, the intuitive judgment of a jury comprised of a debtor's peers would more likely equate with the nation's concept of fairness in a given context.[171] Intuitively, it is not fair to relegate the rights of an innocent debtor to the desert for the wrongdoings of others. It is time that legal decisions in *D'Oench* type cases reset the scales of justice to reflect the true balance between society's explicit normative concerns of commutative justice and the government's economic and political goals of distributive justice.[172]

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168. *See, e.g.*, Calvin Woodard, *Thoughts on the Interplay between Morality and Law in Modern Legal Thought*, 64 NOTRE DAME L. REV. 784, 800-01 (1989). Woodward summarized in Aristotelian terms the differences between modern and pre-twentieth century law as follows:

> For generations, our law, like that of most societies, was used almost exclusively as a means of corrective justice; in the modern era, however, and especially from the 1930's down through the 1970's, it has been used, in addition, as the means by which society pursued various forms of distributive justice.

Id at 799.

169. *See* FINNIS, *supra* note 36, at 184 (noting that laws adopted by those in authority may be distributively just, but the lawful and regular administration of the law is a matter of commutative justice owed to all those who have ascertainable rights, powers, immunities, or duties under it.). According to Finnis, laws must balance the obligations of both principles of justice to reach an equitable result. *Id.* He concluded his discussion of this point by noting that to give undue preference to one or the other would be wrong. *Id.* at 127.

170. *See supra* note 164 for a discussion of procedural and substantive fairness.

171. *See, e.g.*, Wells, *supra* note 164, at 2360 (noting that courts and juries on a case by case basis rely upon their respective intuitive judgements of the "common sense understandings of community norms" to find fairness in tort adjudication). *See generally* Owen M. Fiss, *The Supreme Court, 1978 Term – Foreword: The Forms of Justice*, 93 HARV. L. REV. 1, 14, 41 (1979) (noting that the adjudicative method is a process on a moral plane which reveals or elaborates public values).

172. *See, e.g.*, Weinrib, *supra* note 159, at 989 ("Distributive justice implies that a political authority must define and particularize the scope or criterion of a scheme of distribution."). Weinrib viewed corrective justice as an immediate bilateral interaction between the parties and thus, devoid of politics. *Id.* at 992. Weinrib asserted that Aristotle's conception of corrective justice might be interpreted as requiring courts to ignore distributional considerations. Lloyd L. Weinreb, *Toward a Moral Theory of Negligence Law*, 2 LAW & PHIL. 37, 38-39 (1983). *See also* Ulen Cooter, *The Best Right Laws: Value Foundations of the Economic Analysis of Law*, 64 NOTRE DAME L. REV. 817, 836-37 (1989) (discussing the fact that under policies seeking to achieve economic efficiency the values of liberty and equality may not necessary also be attained).

There is no pragmatic reason to treat a debtor of a failed financial institution any different from a similarly situated debtor in a liquidating bankruptcy context.[173] That is not to say that the Bankruptcy Code should be engrafted into the healthy bank paradigm. But the disparate treatment serves to emphasize the need for consistency and fairness to achieve public confidence in the procedures underlying the failure resolution process.

The concerns of deposit insurance relate exclusively to the issues of depositor security and prevention of macroeconomic crises. As a result, the focal point of failure resolution techniques, including the treatment of a *D'Oench* type debtor, is on the impact such policies or actions will have on the public confidence in the integrity of the system. Thus, unless there is a valid policy goal that would be compromised, questions concerning liquidation or other disposition of assets of failed or failing financial institutions should be decided as if the failure had not occurred. Under such an approach there is no justification to apply an estoppel in situations where the borrower has not violated a legal obligation, nor perpetrated a fraud under the laws of the state in which the action arises.[174]

The healthy bank paradigm liquidation law does not create or eliminate rights; it seeks to insure that preliquidation state entitlements are vindicated.[175]

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173. *See supra* note 90 for a discussion of the treatment of general unsecured creditors in a liquidating bankruptcy.

174. *See, e.g.*, FINNIS, *supra* note 36, at 181 ("[T]he scheme for securing commutative justice seeks to compensate *only* those who were injured by the act of one who failed to live up to his duties (in commutative justice) of care and respect for the well-being of others, and who is thereby required to make reparations.").

175. This assertion is somewhat analogous to the position taken by Thomas Jackson in the area of bankruptcy. Jackson stated that bankruptcy law is designed to ameliorate the common pool problem central to collective debt collection. THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 21 (1986). He argued that "[b]ankruptcy law cannot both give new groups rights and continue effectively to solve a common pool problem." *Id.* at 26. Fashioning distinctive bankruptcy rules creating rights not recognized in nonbankruptcy situations, would create incentives by those advantaged by a new bankruptcy rule to use the process to the possible detriment of others. *Id.* Thus, he concluded that if a nonbankruptcy rule was undesirable, it should be overturned in general, not just in a bankruptcy context. *Id.* at 26-27. "At bottom, bankruptcy is justified in overriding nonbankruptcy rights *because* those rights interfere" with the primary goal of bankruptcy as a superior debt collection mechanism. *Id.* at 26.

In the area of deposit insurance the goal is to create an atmosphere that generates public confidence in the integrity of the system and a stable money supply. Preliquidation entitlements [i.e., defenses to debt collection] are to be allowed as long as they do not interfere with the achievement of that goal. As an individual debtor has no control over the risks and conduct of a bank, and the recognition of his defense has no bearing on the stability of the money supply, there is no justifiable reason to make him bear the loss. The recognition of state law defenses during the receivership adds consistency and fairness to the liquidation process thus, enhancing public confidence in the system. If for any reason the assertion of a particular defense is deemed undesirable, Congress should override that particular state defense across the board. Another factor

Under such policies the economic costs of failure resolution may increase, but that loss will be spread over the entire banking system. On the plus side, however, such a system is morally justified and will instill public confidence in the manner and procedure of bank liquidation.[176] Moreover, this approach is consistent with the accepted practice of allocating losses arising from credit risk upon the system as a whole.[177]

V. Application of a Value-Based Approach to Bank Asset Liquidation

This article posits that *D'Oench* suffers from many deficiencies. The legal underpinnings of *D'Oench* are weak; it is ethically inconsistent with the nation's sense of fair-play; it is an integral part of the failed bank policies which have proven to be totally ineffective in achieving their stated goal of preserving the insurance fund from depletion; and, finally, *D'Oench* is not a part of the healthy bank paradigm. It is clearly time for change. Section 1823(e) should be repealed; *D'Oench* and its progeny should be overruled. In their place state laws and regulations and an impartial fact finder will be used to determine the respective rights among the litigants on a case by case basis.

The inherent economic cost issue associated with bank "closing and transfer

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that militates in favor of permitting state law defenses in bank liquidation under the healthy bank paradigm, is that the validity of defenses will encourage more responsibility and accountability on the part of regulators. The existence of *D'Oench* can create incentives for receivership solely to enhance the assets of an institution which participated in alleged improper conduct which was not detected early by federal regulators. By permitting state law defenses, federal regulators will have more incentive to adequately examine bank assets during their routine examinations leading to less risk-taking and possibly less failure.

176. Thus, under the healthy bank paradigm there is a presumption that federal power should not be used in the area of failed bank asset liquidation or transfer to trump state law entitlements. This may result in disparate treatment of the FDIC as it seeks to recover on loans of failed institutions in various states with differing laws relating to a similar defense or claim. On the other hand the debtor will receive uniform treatment in his dealings with local banks regardless of their solvency. This result will reinforce public confidence in the integrity of failed bank procedures. In any event the lack of uniformity from the perspective of the FDIC is no different from that which the government or other creditors face under the constitutionally required "uniform" bankruptcy system [U.S. CONST. art I, § 8, cl. 4] which generally permits a debtor to select his own respective state's exemption law. *See* 11 U.S.C. § 522(b) (1989) (giving the debtor a choice of his own state's exemptions or the uniform federal exemptions, if his state has not opted-out of the federal scheme). *See also* Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 188 (1902) (noting that the uniformity referred to in the Constitution is geographical not personal); *In re* Sullivan, 680 F.2d 1131, 1137 (7th Cir.), *cert. denied*, 459 U.S. 992 (1982) (upholding the validity of the opt-out provision against challenge that it violates the constitutional command of uniformity).

177. *See* Miller & Meacham, *supra* note 129, at 636 (asserting that there is no readily ascertainable difference between the diminishing value of assets acquired by the FDIC arising from economic factors or legal defenses).

or payment of deposit liabilities" needs to be divorced and separated from the remaining bank liquidation functions. Thus, once a decision is made by the Comptroller of the Currency that an institution needs to be closed, the FDIC must first address the preservation and security of insured demand deposits. In doing so it will make an "estimated least cost" choice among its various failed bank resolution techniques relying upon the stated values on the books of the institution in an attempt to maximize the economic return from the transaction.[178]

Once the decision is made and the deposit liabilities are safely protected by another institution or paid off, the FDIC's focus will turn to normal liquidation activities including collection efforts on the remaining assets or those assets which are returned by acquiring institutions.[179] In these collection efforts and in the collection efforts by successor financial institutions any and all state law defenses and claims will be permitted. This approach will increase the costs of failure resolution to the extent that valid state law defenses reduce the amount that the FDIC projected it would collect from the assets of failed institutions, and by any amount that the FDIC will have to indemnify successor financial

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178. Of course under the healthy bank paradigm, with a scheme of market value accounting, the values on the books will be closer to actual realizable values.

179. Under the general principles of commutative justice inherent in the healthy bank paradigm, it would not be fair to expect a successor financial institution to bear losses from either credit risks undertaken by the failed institution or valid state law defenses which would reduce its expected realizable asset value of purchased assets. Thus, under a healthy bank paradigm the whole bank purchase and assumption transaction would be replaced so that the acquiring institution would purchase only selected assets with the right to return others. *See supra* notes 17 and 138 for a more detailed discussion of purchase and assumption transactions. However, consistent with the principles of commutative justice, nothing in the healthy bank paradigm would prevent the FDIC and the acquiring institution from contractually allocating between themselves any of the risks of loss. But as a general result, those losses would be born by the FDIC to be spread among the industry and the nation as a whole. The FDIC would also be prohibited from giving any priority to uninsured depositors, and they would bear the same risks as general unsecured creditors. Certain other advocates for reform have suggested a return to the modified payoff. *See generally* Elizabeth H. Garret, Comment, *The Modified Payoff of Failed Banks: A Settlement Practice to Inject Market Discipline into the Commercial Banking System*, 73 VA. L. REV. 1349 (1987) (arguing that use of the modified payoff injects market discipline into the banking industry). Under a modified payoff the insured depositors receive full payment from the FDIC, or such deposits are sold to an acquiring institution which assumes their liability, and partial payments are made to uninsured depositors based upon the FDIC's estimate of recovery from the proceeds of liquidation. *See* TREASURY REPORT, *supra* note 14, at I-32. If a higher recovery from the assets than had been estimated is recovered, additional payments are then made to the uninsured depositors. *Id.* Following the Continental Bank failure where all uninsured depositors were protected under an open assistance plan, the FDIC stopped using the modified payoff because "it was thought to be unfair to apply a more stringent routine in the failure of small banks." *Id.* In the *Continental* case only $3 billion of the $33 billion in liabilities were insured at the time of the open assistance transaction. *Id.* at III-29. In this author's opinion, the modified payoff is unacceptable because uninsured depositors should not be given any preferences.

institutions that collect less than the stated value of the assets purchased as a result of these defenses. However, because the focus of the healthy bank paradigm is on better managed banks, more effective supervision of bank activities, and efforts to reduce the inherent risk in the banking business, the number of failures and the amount of "secret" agreements which reduce the net assets realizable upon failure, should be substantially reduced. In any event it is time to depart from the fixation on the importance of the liquidity of the insurance fund and instead make pragmatic ethical decisions based on fairness. The risk of "secret agreements" will then be spread among the participants and the public at large, rather than resting solely on the innocent borrower.

The repeal of Section 1823(e) and overruling of *D'Oench* and its progeny will return normalcy and predictability to bank failure resolution. Additionally, it will generate public confidence in the integrity of the system by instilling both procedural and substantive fairness in the resolution of disputes. This article will now briefly examine the facts of three well-known cases involving the application of the *D'Oench* doctrine and compare their respective results with the conclusions which would have been reached in those cases under the value-based analysis developed in this article.

In *Federal Deposit Insurance Corporation v. McClanahan,*[180] McClanahan was a farmer who had briefly served on the board of directors of a local Texas bank. During his time on the board, Orrin Shaid purchased the bank in the name of his then-current paramour. Later, after resigning from the board, McClanahan sought to obtain a loan from this bank to purchase a tractor. Shaid, representing himself as the bank's owner, persuaded McClanahan to sign a blank note with the understanding that the terms and conditions would be filled in later after his loan had been approved.[181] Subsequently, upon being informed by Shaid that the loan had not been approved, McClanahan obtained a loan from another financial institution to purchase the tractor. He never asked the first bank or any of its officers for the return of his blank executed note. Furthermore, unknown to McClanahan, Shaid had filled in terms of the note and had taken the loan proceeds for himself.

Following the initial bank's insolvency, the FDIC, as receiver, brought suit against McClanahan seeking to recover on the note. McClanahan asserted the affirmative defenses of fraud in the inducement and failure of consideration. Following a bench trial in federal court, the judge concluded that McClanahan's

180. FDIC v. McClanahan, 795 F.2d 512 (5th Cir. 1986). The facts of the case recited in the text are taken from this opinion. *Id.* at 513-14.

181. The appellate court felt that this action was probably negligence on the part of McClanahan as he apparently knew that Shaid had previously been convicted of bank fraud. *Id.* at 513.

defenses were good, and entered judgment in his favor.[182] The Fifth Circuit, relying on *D'Oench*, reversed the district court's judgment, holding that McClanahan's defenses were barred by the rule of estoppel announced in *D'Oench* in that he lent himself to a scheme to mislead the banking authorities.[183] The court then remanded the case to the district court for entry of an appropriate judgement in favor of the FDIC.

In *Federal Deposit Insurance Corporation v. Wood*,[184] a promissory note in the amount of $12,000 with interest at fifteen percent per annum was executed at a Michigan bank by Peter Stone and Carole Barnett and guaranteed by Richard Wood. The note was not paid when it became due. Later, the bank was placed under FDIC receivership, which entered into a "clean-bank" purchase and assumption transaction with another Michigan bank. In order to consummate the purchase and assumption transaction, the FDIC in its corporate capacity purchased from itself, as receiver, the failed bank's unacceptable assets including the note guaranteed by Wood. The FDIC then filed suit to collect the note and the defendants asserted that the note was usurious under Michigan law.[185] Following a jury trial, a verdict was returned finding for the FDIC on its claim, but also finding that the loan had not been made for business purposes. Thus, the trial court entered judgment for the FDIC on only the

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182. The trial judge rejected the FDIC's *D'Oench* argument, noting that McClanahan was not a knowing participant in the alleged scheme. *Id.* at 514.

183. *Id.* at 517. The court asserted that McClanahan rather than the FDIC, or the innocent depositors or creditors of the failed bank, should bear the consequences of his unfortunate involvement with Shaid. *Id.* at 516. Although such an assertion has some linguistic merit, the court was well aware that the innocent depositors were well protected by deposit insurance. It is ironic that a doctrine whose fountainhead was equity, was applied to reach such inequitable results. The results in cases such as *McClanahan* reflect a perversion of the equitable principles upon which *D'Oench* was supposedly based. *See, e.g.*, Hymanson, Note, *supra* note 7, at 318-19 (1988) ("[C]ourts have lost sight of the equitable roots of both the *D'Oench, Duhme* doctrine and of insolvency law in general, and have expanded greatly the protection afforded the bank insurer."). *Cf. In re* Sanderfoot, 899 F.2d 598, 606 (7th Cir. 1990) (Posner, J., dissenting), *rev'd sub nom.* Farrey v. Sanderfoot, 111 S. Ct. 1825 (1991) (asserting that the Court's decision to void a lien granted by a divorce court to an ex-spouse as part of its division of property, in order to preserve an exemption for the other spouse under 11 U.S.C. § 522(f) (1980) is a perversion of the bankruptcy laws).

184. FDIC v. Wood, 758 F.2d 156 (6th Cir.), *cert. denied*, 474 U.S. 944 (1985). The facts as stated in the text are taken from this opinion. *Id.* at 157.

185. Under the law of the state of Michigan, "a loan made by a bank to an individual at an interest rate of more than seven percent is usurious unless there is a sworn statement specifying the type of business and the business purpose." *Id.* at 161 (reference to specific Michigan statute omitted). In this case the loan was for fifteen percent and no sworn statement was in the bank's files. *Id.*

principal amount of the note.[186] Later, the trial court granted a judgment notwithstanding the verdict for the FDIC awarding it both principal and interest. The court held that since the FDIC enjoyed a status similar to that of a holder in due course, it was not subject to the defense of usury under Michigan law.[187] The Sixth Circuit affirmed.[188] The court noted that although Section 1823(e) did not authorize holder in due course status for the FDIC, under federal common law the FDIC enjoyed that status when it acquired assets through a purchase and assumption transaction.[189] Thus, the court held that if the FDIC had no actual knowledge of the usury defense prior to the consummation of the transaction, it acquired the note free of all personal defenses.[190] Notwithstanding the fact that the note was usurious on its face, the court concluded that there was no evidence that the FDIC had actual knowledge of the usurious character of the note and thus, it had taken the note free of that defense.[191]

In *Langley v. Federal Deposit Insurance Corporation*[192] the Supreme Court held that Section 1823(e) barred the defense of fraud in the inducement even when the FDIC had actual knowledge of the defense.[193] In *Langley*, W.T. and Maryanne Langley had borrowed money from a FDIC insured Louisiana bank to purchase property owned by the insured bank. Later when the note went into default, the bank instituted suit in state court to collect on the note. The Langleys removed the case to federal court to be consolidated with their other suit for damages against the bank.

By way of defense to the bank's suit, the Langleys alleged that certain oral promises had been made to them by the bank, including a representation that they would have no personal liability on the note. Furthermore, they alleged that the bank had misrepresented the acreage being purchased as well as the

186. The jury's finding that the note was not made for business purposes made the note usurious. However, under Michigan law, that finding only barred collection of the interest not the underlying debt. *Id.* at 158 (citing MICH. COMP. LAWS ANN. § 438.32 (West 1978)).

187. FDIC v. Wood, 758 F.2d at 158 (citing MICH. COMP. LAWS ANN. § 438.5 (West 1978) (providing that a holder in due course is immune from the defense of usury).

188. *Id.* at 162.

189. *Id.* at 159.

190. *Id.* at 160-61.

191. FDIC v. Wood, 758 F.2d 156, 162 (6th Cir.), *cert. denied*, 474 U.S. 944 (1985). The court noted that following a purchase and assumption transaction there is a rebuttable presumption that the FDIC did not have knowledge of any defenses. *Id.* at 161. The court held that the defendants' assertion that knowledge was apparent from the face of the bank's files was not enough to overcome this presumption. *Id.* at 162. It should be noted that there was no evidence that any of the defendants sought to deceive anyone nor that any of the defendants committed any misrepresentation or fraudulent act.

192. 484 U.S. 86, 93 (1987).

193. *Id.* at 88-89. The facts recited in the text are taken from this opinion.

number of mineral acres on the tract. While the suits were pending, the bank failed, and the FDIC Corporation acquired the Langleys' note following a purchase and assumption transaction. The trial court granted a summary judgment for the FDIC finding that Section 1823(e) barred all alleged defenses.[194] That opinion was affirmed by the Fifth Circuit.[195] Affirming the lower court, Mr. Justice Scalia defined the term "agreement" in Section 1823(e) very broadly to include all of the conditions of performance which were a part of the original bargain.[196] Given this broad interpretation the Court then held that the bank's fraudulent misrepresentations were agreements under the statute, and as they were not documented as statutorily required they could not form the basis of defenses to the action.[197] Even the actual knowledge of the FDIC of the alleged defenses discovered during an examination prior to receivership were not relevant to the statute's application.[198]

These three cases are illustrative of fairness concerns raised by the present expansive nature of *D'Oench* and its progeny. A value-based approach to the same cases would likely yield different results. First, in *McClanahan*, the judgment of the trial court would stand because the defenses of failure of consideration or fraud in the inducement were valid state law defenses and were satisfactorily proven. In *Wood*, judgment would be entered on the jury's verdict granting the FDIC recovery of the principle amount of the note, but denying it recovery of interest pursuant to Michigan law. Finally, in *Langley*, the case would have to be tried to a jury to determine whether the Langleys' defenses could be established. If so, the *Langley* defendants would defeat recovery on the notes.[199] In each case the pragmatic value-based approach is to permit the collective values as recognized in the local community through validly enacted statutes and the intuitive fairness evaluation of the finder of facts resolve these problems as if no FDIC intervention had occurred. Substantive state law rights are to be vindicated by a jury of defendant's peers.

As we have seen in the above explanation of a value-based approach to asset liquidation, the ultimate cost to the FDIC of failure resolution may be

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194. Planters Trust & Sav. Bank v. Langley, 615 F. Supp. 749 (W.D. La. 1985), *aff'd sub nom.* Langley v. FDIC, 792 F.2d 541 (5th Cir. 1986), *aff'd*, 484 U.S. 86 (1987).

195. FDIC v. Langley, 792 F.2d 541, 546 (5th Cir. 1986), *aff'd*, 484 U.S. 86 (1987).

196. Langley v. FDIC, 484 U.S. at 91. Thus, the failure of the bank to perform a promise that was a condition of the Langleys' performance would be an agreement which would have to comply with the statutory requirements.

197. *Id.* at 93.

198. *Id.* at 89, 93. The Court in effect used Section 1823(e) to make the FDIC a holder in due course. *See* Hymanson, Note, *supra* note 7, at 309.

199. LA. CIV. CODE ANN. arts. 1948, 1953-1954 (West 1987) (establishing that fraud may vitiate consent). *See also* First Fed. Sav. & Loan Ass'n v. Twin City Sav. Bank, 868 F.2d 725 (5th Cir. 1989).

greater than if *D'Oench* and its progeny prevail.[200] However, the results reached are fairer and will lead to restored public confidence in the procedural and substantive integrity of the banking system by treating individuals after failure, the same as if the failure had not occurred. Thus, defenses normally available under state law would not be extinguished by the appointment of the FDIC as receiver following insolvency, but would continue through the insolvency proceeding subject to proper pleading, proof, and burden of persuasion as in any trial proceeding.

VI. CONCLUSION

In the nearly fifty years since Justice Douglas placed the albatross of bank failure upon the neck of the unwary innocent borrower, the entire system of banking regulation has come under valid criticism for its increasing social costs and its failure to promote public confidence in the basic integrity of the system. Although the system of deposit insurance has successfully deterred macroeconomic crises and achieved a stable money supply, it has encouraged excessive risk taking by banks and has resulted in bank failures.

The economic preoccupation of bank failure policies with the preservation of the liquidity of the insurance fund in order to resolve the increasing numbers of failures has led to a policy debacle. Instead of facing and attempting to resolve the microeconomic problems of individual bank risk, the failed bank paradigm has continued to focus on ex post "least cost" failure resolution while its sacred insurance fund has expired in the strangle hold of bankruptcy. The *D'Oench* doctrine, an integral part of this failed bank paradigm, has placed economic values on a pedestal, effectively trumping ethical values of common decency and fair play in a seemingly never ending struggle to preserve the insurance fund.

As this country strives to refocus its efforts toward promoting healthier banks by attacking the problem of credit risk head-on, the time has come to let this albatross and the policies of the failed bank paradigm drop away.[201] Too

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200. Each of these cases involved a situation where the alleged defense would have had the effect of reducing the net asset recovery by the FDIC. A more troublesome problem exists in the situation where the borrower asserts an affirmative claim against the insolvent institution. However, as shown above, FIRREA limits recovery even in those cases to the amount the claimant would have recovered in the event of liquidation. *See supra* note 44.

201. Many years ago Samuel Taylor Coleridge poetically described the release from the burdens and sins of life as follows:

> The self-same moment I could pray;
> And from my neck so free
> The Albatross fell off, and sank
> Like lead into the sea.

long have bank borrowers borne the sins of banking failure into the wilderness of their own financial reversals. Too long has the FDIC been able to shift the cost of its failures to the innocent. The concept of commutative justice reflects the inherent awareness that each participant in a transaction is responsible and accountable for his own actions, and that such actions are to be judged in light of principles of fairness representing the collective values of the community in which one lives. The time has come for the scapegoat debtor to come before the altar with bank regulators and bank officials and be sacrificed and held accountable exclusively for his own sins and failure, not the sins and failures of the credit system and its regulators as a whole.

SAMUEL T. COLERIDGE, *The Rime of the Ancient Mariner*, *in* 1 THE COMPLETE POETICAL WORKS OF SAMUEL TAYLOR COLERIDGE 186, 198 (Oxford Press 1912).