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ARTICLE

BACK TO THE PARENT: HOLDING COMPANY LIABILITY FOR SUBSIDIARY BANKS—A DISCUSSION OF THE NET WORTH MAINTENANCE AGREEMENT, THE SOURCE OF STRENGTH DOCTRINE, AND THE PROMPT CORRECTIVE ACTION PROVISION

*Cassandra Jones Havard**

I. INTRODUCTION

The unprecedented number of bank¹ failures² in the past several years has spawned a crisis in the industry and fueled an extensive debate about how federal regulators can effectively make banks more responsible for guaranteeing the soundness of their operations. For the federal regulators most involved—the Federal Deposit Insurance Corporation (“FDIC”),³ Office of Thrift Supervision (“OTS”),⁴ and the Federal Reserve Board

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¹ The term “bank” refers both to federally insured commercial banks as well as savings and loan institutions (“thrifts”).

² For eight consecutive years, from 1985 to 1992, over 1000 banks and savings and loans failed across the United States. 1993 FDIC ANN. REP. at Table A; CONGRESSIONAL BUDGET OFFICE, RESOLVING THE THRIFT CRISIS 88 (1993) (Table C-2). The number of bank insolvencies hit a peak in 1989, when 306 banks were closed. Barbara A. Rehm, 42 *Banks Failed Last Year, Smallest Number Since 1982*, AM. BANKER, Jan. 5, 1994, at 3.

³ The FDIC administers two separate deposit insurance funds: the Bank Insurance Fund (“BIF”), which principally insures commercial banks, and the Savings Association Insurance Fund (“SAIF”), which principally insures savings and loans associations. Until 1993, member institutions funded the FDIC by paying flat-rate premiums. 12 U.S.C. § 1817(b) (1988), amended by 12 U.S.C. § 1817(b) (Supp. V 1993). Beginning with the first semiannual payment in 1993, the FDIC adopted a transitional risk-related deposit insurance assessment system in order to recapitalize the insurance funds. See 12 C.F.R. § 327 (1994).

⁴ As a part of the regulatory reforms of the Financial Institutions, Reform, Recovery and Enforcement Act (“FIRREA”), Pub. L. No. 101-73, 103 Stat. 183 (1989) (codified as amended in scattered sections of 12 U.S.C. (Supp. V 1993)), Congress abolished the Federal Home Loan Bank Board (“Bank Board”), see FIRREA § 401(a)(2), 103 Stat. at 354, and transferred its functions to the OTS within the Department of Treasury. See FIRREA

("FRB")⁵—Congress is directing the effort to enhance the banks' guarantees of self-policing. Congress's basic response to the crisis has been to heighten the minimum capital levels the banks must maintain to avoid direct corrective intervention by the federal regulatory agencies.⁶ In implementing this response, Congress also

§ 301, 103 Stat. at 278 (codified at 12 U.S.C. § 1462a (Supp. V 1993)). The Bank Board was both the regulator of savings and loan associations and the operating head of the savings and loan insurance fund, the Federal Savings and Loan Insurance Corporation ("FSLIC"), which FIRREA also abolished. See FIRREA § 401(a)(1), 103 Stat. at 354.

⁵ The FRB regulates bank holding companies and state-chartered banks that are members of the Federal Reserve system. 12 U.S.C. §§ 1841-50 (1988) (bank holding companies); 12 U.S.C. § 248(a) (1988) (state-chartered banks).

⁶ Although the failure of the nation's savings and loan institutions has been attributed to depression of the real estate industry, poorly timed deregulation, inadequate regulation, and economic depression, some commentators point towards the fraud and mismanagement of the savings and loan industry as a significant factor in advancing those failures. After an institution has been put into receivership, federal regulators may sue the directors and officers for failing to carry out their duties and responsibilities alleging gross negligence, breach of fiduciary duty, or self dealing. See Mark I. Rosen & John V. Thomas, *Directors' and Officers's Liability, in CIVIL AND CRIMINAL LIABILITY OF OFFICERS, DIRECTORS AND PROFESSIONALS: BANK AND THRIFT LITIGATION IN THE 1990's* 83 (PLI Com. L. & Prac. Course Handbook Series No. 565, 1991); see also GENERAL ACCOUNTING OFFICE, DEPOSIT INSURANCE: A STRATEGY FOR REFORM (1991) [hereinafter STRATEGY FOR REFORM] (Report to the Chairman, Committee on Finance and Urban Affairs, House of Representatives); Harris Weinstein, *Speech by OTS Chief Counsel Weinstein on Duties of Depository Institutions Fiduciaries*, 55 Banking Rep. (BNA) 510 (Sept. 24, 1990) (positing that directors and officers of institutions owe a fiduciary duty to depositors and the federal insurance fund). But see Joyce A. Hughes, *Law Firm Kaye, Scholer, Lincoln S&L and the OTS*, 7 NOTRE DAME J.L. ETHICS & PUB. POL'Y 177 (1993) (discussing the legal hurdles that OTS must clear before finding liability of a director or officer under FIRREA as an institution-affiliated party).

FIRREA sets out a standard of care for officers and directors of depository institutions. 12 U.S.C. § 1821(k) (Supp. V 1993). The statute defines officers and directors as "institution-affiliated parties." *Id.* § 1813(u). As an institution-affiliated party, an officer or director will be liable for gross negligence or "conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, as such terms are defined under applicable state law." *Id.* § 1821(k); cf. *FDIC v. Canfield*, 967 F.2d 443 (10th Cir. 1992) (interpreting FIRREA to permit a lawsuit against directors and officers of a failed savings and loan on a theory of simple negligence; the court's reasoning was based on FIRREA's deference to the state law's definition of gross negligence). Prior to FIRREA, an institution-affiliated party was protected from regulatory enforcement actions upon resignation. FIRREA extends liability retroactively to misconduct that is yet undiscovered. FIRREA § 905, 103 Stat. at 459 (codified at 12 U.S.C. § 1818(e) (Supp. V 1993)).

FIRREA also created a three-tier structure for violations of banking laws and regulations, and increased the amount of civil monetary penalties that the agencies may assess. See generally 12 U.S.C. § 1818(i)(2) (Supp. V 1993). Fines for a first-tier violation may be up to \$5000 per day, an increase from the \$1000 or \$100 per day under prior law. *Id.* § 1818(i)(2)(A). Second-tier violations have a civil money penalty of up to \$25,000 per day. *Id.* § 1818(i)(2)(B). Third-tier violations carry a penalty of \$1,000,000 per day for individuals and the lesser of \$1,000,000 per day or 1% of total assets per day for institutions. *Id.* § 1818(i)(2)(C)-(D).

has focused on the regulation of banks in a holding company⁷ structure.

Banks owned by a holding company always have presented a unique challenge to the federal regulators' efforts to assure minimal capital adequacy. Holding companies, by definition, shift assets among various subsidiaries in order to operate efficiently and to minimize loss. A bank holding company's decision on shifting assets among its banking subsidiaries can lead ultimately to a federally insured bank's insolvency.⁸ Yet, because of the corporate law doctrine of limited liability, the federal deposit insurance system—and potentially the taxpayers—bear, in major part, the insolvent, federally insured bank's losses.⁹

Thus, in the reform legislation of the Federal Deposit Insurance Corporation Improvement Act ("FDICIA"),¹⁰ Congress focused on parent or holding company responsibility for the maintenance of capital levels of subsidiary banks. Congress, by legislating the prompt corrective action provision,¹¹ reformed prior ineffective attempts aimed at regulating parental accountability through the regulatory tool of the parental guarantee.

The parental guarantee is a parent company's commitment that, if necessary, it will make a capital infusion into its banking subsidiary in order to maintain the subsidiary's minimum regulatory capital requirements. By requiring the guarantee of compliance with regulatory capital standards from the parent company,

⁷ A bank holding company is defined as a "company which has control over any bank or over any company that is or becomes a bank holding company . . . if the company directly or indirectly . . . owns, controls, or has power to vote 25 per centum . . . of any voting securities." 12 U.S.C. § 1841(a)(1)-(2) (1988); see Lissa L. Broome, *Redistributing Bank Insolvency Risks: Challenges to Limited Liability in the Bank Holding Company Structure*, 26 U.C. DAVIS L. REV. 935, 959 n.93 (1993) (noting that banks which are members of a holding company structure have more than 90% of all bank assets); see also Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 507 (1994).

⁸ See discussion *infra* part II.B.

⁹ The FDIC, as the insurer of depository institutions, may not have the resources in the insurance fund to finance the failures of depository institutions entirely on its own. However, since the federal government guarantees that the federal insurance fund will meet its obligations to depositors, taxpayers are ultimately liable. 12 U.S.C. § 1823 (Supp. V 1993).

¹⁰ Pub. L. No. 102-242, 105 Stat. 2236 (codified as amended in scattered sections of 12 U.S.C. (Supp. V 1993)). FDICIA created new capital standards for all federally insured depository institutions.

¹¹ 12 U.S.C. § 1831o(a)(2) (Supp. V 1993). Regulations for enforcing the provision were promulgated by the Department of Treasury, Federal Reserve System, and FDIC, and became effective on December 19, 1992. 12 C.F.R. §§ 6, 19, 565, 208, 263, 308 & 325 (1994).

Congress has shifted the banking subsidiary's financial risk taking away from the federal deposit insurance fund to the parent company.

This shift of financial risk is consistent with the congressional concern of strengthening the capital¹² adequacy of the nation's banks. At the core of the Financial Institutions Reform, Recovery and Enforcement Act ("FIRREA")¹³ and FDICIA are provisions addressing the capital adequacy of the nation's banks. The congressional focus on the capital levels is appropriate considering that low capital levels at many institutions contributed to the failure of those institutions and prompted the legislative reforms. After all, capital is a cushion against default.¹⁴ To shareholders, capital absorbs the bank's losses and thus, protects an investor's investment from the firm's insolvency. To creditors, capital represents a form of protection for repayment. To the federal deposit insurance fund, capital represents the amount by which the insurance fund will be shielded from losses should the institution become insolvent.

Under the reform legislation, Congress now has defined minimum capital standards¹⁵ for each institution that the federal bank-

¹² In the banking context, there are two relevant capital measures: the leverage limit, which relates an institution's capital to its total assets, and risk-based capital, which relates an institution's capital to its risk-adjusted assets. See 12 U.S.C. § 1831o(c)(1)(A) (Supp. V 1993).

¹³ Pub. L. No. 101-73, 103 Stat. 183 (1989) (codified as amended in scattered sections of 12 U.S.C. (Supp. V 1993)). FIRREA set new capital standards for thrifts. See 12 U.S.C. § 1464(t) (Supp. V 1993). Beginning in the mid-1980s, Congress raised the minimum capital standards for thrifts, to be phased in from 1986 to 1993. See 12 U.S.C. § 3907 (1988) (authorizing procedures for the enforcement of capital adequacy standards).

¹⁴ A bank with an adequate capital level produces several regulatory benefits. These include: 1) lower probability of bank failure; 2) reduced incentive to take excessive risks; 3) buffer against the insurance fund and the taxpayer; 4) reduced misallocation of credit; 5) avoidance of "credit crunches"; and 6) increased long-term competitiveness. See DEPARTMENT OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS II-1 to -4 (1991) [hereinafter MODERNIZING THE FINANCIAL SYSTEM]. For a discussion of a bank's capital structure, see Joseph J. Norton, *Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities*, 49 OHIO ST. L.J. 1299 (1989).

¹⁵ Section 38 identifies five capital-based categories for insured institutions. The statute defines them as follows:

1. Well capitalized: The institution "significantly exceeds the required minimum level for each relevant capital measure";
2. Adequately capitalized: The institution "meets the required minimum level for each relevant capital measure";
3. Undercapitalized: The institution "fails to meet the required minimum level for any relevant capital measure";
4. Significantly undercapitalized: The institution "is significantly below the required minimum level for any required capital measure"; and

ing regulatory agencies supervise.¹⁶ Those standards are also the basis for federal regulatory actions. The lack of capital adequacy is sufficient to trigger government intervention in financially troubled institutions. Capital-based regulations impose stringent regulatory controls, including dividend¹⁷ and growth restrictions¹⁸ and forced conservatorship.¹⁹ The capital-based regulations also remove from the regulatory agencies much of the discretion that the regulators once had in managing a capital-weakened institution.²⁰

Congress justified the capital adequacy reforms by referring to the protection that the federal deposit insurance fund provides to federally insured institutions and the "moral hazard"²¹ that its protection creates. By protecting depositors of less than \$100,000, the fund encourages bank managers—especially those of capital-weakened institutions—to make risky investments.²²

In addition to the nondiscretionary regulatory controls of the reform legislation, the prompt corrective action provision requires an undercapitalized²³ banking subsidiary to submit a capital restoration plan to its banking regulator. Within that plan, the parent company must guarantee that the banking subsidiary will meet regulatory capital requirements for four consecutive quarters.²⁴ By requiring the guarantee of compliance with regulatory capital

5. Critically undercapitalized: The institution fails to meet the leverage limit. 12 U.S.C. § 1831o(b)(1)(A)-(E) (Supp. V 1993).

¹⁶ FDICIA's legislative changes were partly the result of GAO and Department of the Treasury studies which determined that more stringent capital standards would alert regulators to the potential failure of troubled institutions. See GENERAL ACCOUNTING OFFICE, BANK SUPERVISION: PROMPT AND FORCEFUL REGULATORY ACTIONS NEEDED (1991) (Report to the Chairman, Subcommittee on Financial Institutions, Supervision, Regulations and Insurance Committee on Banking, Finance and Urban Affairs, House of Representatives); MODERNIZING THE FINANCIAL SYSTEM, *supra* note 14, at X-10 to -24.

¹⁷ FDICIA § 131(a) (codified at 12 U.S.C. § 1831o(d)(1)(A) (Supp. V 1993)).

¹⁸ *Id.* (codified at 12 U.S.C. § 1831o(e)(3)-(4) (Supp. V 1993)).

¹⁹ *Id.* § 133(a) (codified at 12 U.S.C. §§ 191, 203(a), 1464(d), 1821(c) (Supp. V 1993)).

²⁰ See discussion *infra* part IV.

²¹ Moral hazard refers to the disincentive that managers of an inadequately capitalized institutions have to operate in a risk-free manner. To restore a troubled bank to profitability, bank managers are tempted to engage in high-risk strategies, hoping for a high return. Should their efforts fail, the bank's losses are passed on to the insurance fund, which guarantees deposit accounts that do not exceed \$100,000. See William A. Lovett, *Moral Hazard, Bank Supervision and Risk-Based Capital Requirements*, 49 OHIO ST. L.J. 1365, 1381 (1989); see also Krishna G. Mantripragada, *Depositors as a Source of Market Discipline*, 9 YALE J. ON REG. 543, 548-49 (1992).

²² See Richard S. Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 ANN. REV. BANKING L. 317 (1993) (reviewing the history of the prompt corrective action provision).

²³ See discussion *supra* note 15.

²⁴ See 12 U.S.C. § 1831o(e)(2)(C)(ii)(I) (Supp. V 1993); see also 57 Fed. Reg. 44,866, 44,879 (1992).

standards from the parent company, the insurance fund shifts the banking subsidiary's financial risk taking to the parent company. In so doing, a parental guarantee effectively negates the corporate law doctrine of limited liability for bank holding companies and their federally insured subsidiaries. This statutory risk shifting from the insurance fund to the parent company raises serious questions about the propriety of the governmental protection of the federal deposit insurance fund at the expense of the time-honored doctrine of corporate separateness and limited liability.

Given the statutory goal of parental accountability, this Article focuses on a narrow issue: Whether parental guarantees are the most effective regulatory tool for shielding the federal deposit insurance fund from losses when insured banking subsidiaries that are members of a multibank holding company system are insolvent. This Article posits that a needed complement to parental guarantees is temporary substantive consolidation of a holding company's affiliated banks. This would require the parent company to combine the assets of its banking siblings to facilitate the reorganization of a financially troubled subsidiary. Temporary enterprise consolidation is a necessary regulatory tool because it provides an early form of intracorporate funding from any healthy banking subsidiary that has contributed to the weakened capital status of the financially troubled banking subsidiary.

Part II of this Article discusses inherent structural problems of the multibank holding company system. It shows how these unique situations become problematic when a banking subsidiary threatens failure. Part III discusses the traditional prereform parental guarantees—the FRB's source of strength condition and the OTS's net worth maintenance agreement. It concludes that both of these regulatory tools, which are essentially identical, have become disfavored by the regulatory agencies and the courts as enforcement methods. The source of strength condition is arguably beyond the statutory authority of the FRB. The implied net worth maintenance obligation often is unenforceable because it is overbroad and vague. Part IV briefly examines several of the inadequacies of the newest parental guarantee—the prompt corrective action provision. Part V serves as background for the use of temporary consolidation in the banking industry by discussing the FDIC's methods of resolving failed financial institutions; it explains how interaffiliate lending and captive funding may generate large loan losses and thereby increase the costs of failures within a multibank system. Part VI recommends an alternative to the prompt corrective

action provision: temporary consolidation of troubled or undercapitalized banking subsidiaries within a bank holding company system. This alternative addresses the public policy objective of protecting subsidiary banks and the insurance fund within the framework of the corporate law doctrine of limited liability.

II. THE BANK HOLDING COMPANY: INHERENT STRUCTURAL PROBLEMS

When a parent company owns more than one banking subsidiary, several operational factors unique to that structure complicate regulatory oversight. The doctrine of limited liability, the rules governing interaffiliate transfers, and the creation of banking conglomerates through the parent-subsidary structure each pose regulatory oversight issues for multibank holding companies. The discussion in Section A on the doctrine of limited liability questions whether, in the banking context, there should be an evaluation of the parent company's conduct or behavior in exercising control over a banking subsidiary when a banking subsidiary either becomes undercapitalized or fails.²⁵ There is reason for concern about the application of the doctrine in the banking context because the ultimate costs of a banking subsidiary's failure may be shifted to the federal deposit insurance fund. Section B, discussing the rules that allow transfers among affiliates in a multibank holding company system,²⁶ highlights the dilemma for the insurance fund when a financially troubled banking subsidiary threatens failure. That is, transfers among affiliates, may contribute to the failure of the financially troubled bank subsidiary. When the financial condition of the banking subsidiary holding the deposits deteriorates sufficiently to threaten its solvency, the healthy sibling banking subsidiary withdraws its deposits. The result is that the now-insolvent banking subsidiary must receive financial assistance from the insurance fund, to absorb the losses from the deposits withdrawn by the sibling bank.²⁷ Finally, Section C identifies the risks

²⁵ See 12 U.S.C. § 1831o(d)(1)(A) (Supp. V 1993); see also Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589 (1975) (arguing that the poor economic performance of a subsidiary always raises the issue of whether a parent company is actively participating in monitoring and controlling the affairs of the subsidiary and therefore should be held responsible for the subsidiary's failure).

²⁶ 12 U.S.C. § 371c (Supp. V 1993) regulates loans and purchases of assets between a bank and its affiliates, within proscribed limits. See discussion *infra* part II.B.

²⁷ Regulators call this phenomenon "captive funding," an arrangement that concentrates the majority of a bank holding company's assets, usually deposits, in the largest bank or banks. See discussion *infra* part II.B.

for the deposit insurance fund when the exponential growth of banking subsidiaries within the holding company structure creates an entity that is "too big to fail." This doctrine provides greater protection for depositors in large institutions than it does for those who place their funds in smaller ones, preventing depositors of above \$100,000 from sustaining their proportion of the loss in an institution.²⁸

A. *The Doctrine of Limited Liability*

The doctrine of limited liability assures investors that their risk in a corporation will be limited to their investment. This means that should the corporation become insolvent, a single shareholder's losses are no greater than the capital contributions which the shareholder has made to the firm. This concept also means that when a corporation becomes insolvent, the cost of the failure of the corporation shifts to creditors and then eventually to society.²⁹ In the banking industry, the risk of failure may shift to the insurance fund.³⁰

The holding company structure, by definition, dictates a different organizational format for the management of the related corporations. The same holds true in banking and nonbanking parent-subsidiary relationships. Generally, although a subsidiary in a holding company structure will have its own management team, its policies and procedures are not routinely independent and separate from those of its parent.³¹ While the holding company may allow the subsidiary's management some discretion in its operational and organizational structure, it will closely monitor those

²⁸ See discussion *infra* accompanying note 63.

²⁹ Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 99-106 (1991) (arguing that instead of an incidence of incorporation granted by the state, limited liability should be available through private agreements made between the parties). Historically, shareholders of banks were responsible for a proportional share of the bank's losses upon the institution's insolvency. See Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31, 36-39 (1992).

³⁰ See *supra* note 21.

³¹ See discussion *infra* accompanying note 160 (concerning FirstRepublic Bancorporation); see also Kieran J. Fallon, Note, *Source of Strength or Source of Weakness?: A Critique of the "Source-of-Strength" Doctrine in Banking Reform*, 66 N.Y.U. L. REV. 1344, 1385 n.265 (1991) (noting that common areas of consolidated operation in the bank holding company context are "funds management, advertising, check processing, electronic funds transfer, corporate counsel, corporate planning, purchasing, personnel management and accounting").

choices.³² Similarly, to maximize its own profitability, the holding company may shift capital among its subsidiaries as the performance of the subsidiaries dictates. This exercise of control may not be greater in the banking context, but it may be more deleterious. Whenever a bank becomes financially weakened, the soundness of its operations is threatened.³³

What is distinguishable regarding banks operating in the holding company structure is the existence of the federal deposit insurance fund. This choice of corporate structure has significant consequences when the parent company uses the banking subsidiary to shift risks.³⁴ The insurance fund picks up the losses because each banking subsidiary in a multibank holding company structure is a separate corporate entity.³⁵ Recourse to the parent corporation or holding company is not possible.³⁶ While the parent company also owns stock in the banking subsidiary and exercises control of ownership, its liability is limited to its ownership interests in the banking subsidiary.³⁷ The application of limited liability

³² See Robert C. Clark, *The Regulation of Financial Holding Companies*, 92 HARV. L. REV. 787, 819-22 (1979); see generally Bernard F. Cataldo, *Limited Liability with One-Man Companies and Subsidiary Corporations*, 18 LAW & CONTEMP. PROBS. 473, 492-498 (1953); William O. Douglas & Carrol M. Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 YALE L.J. 193 (1929); Robert W. Hamilton, *The Corporate Entity*, 49 TEX. L. REV. 979, 991-93 (1973); Note, *Liability of a Corporation for the Acts of a Subsidiary or Affiliate*, 71 HARV. L. REV. 1122 (1958).

³³ See Clark, *supra* note 32, at 828-33 (discussing the possibility of fraud, bias, and self-dealing in intercompany transactions and the concomitant need for regulation). The parent company, for example, may decrease the banking subsidiary's capital level within appropriate regulatory limitations. Parental guarantees facilitate the movement of capital among subsidiaries, making the capital of the parent company available to the banking subsidiaries. As such, they protect the capital adequacy of the banking subsidiary while allowing the parent company to become more profitable by reallocating capital as needed. See discussion *infra* part II.B.

³⁴ See Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 109-13 (1985) (arguing that while limited liability facilitates the corporate form of organization, its social costs and benefits may not provide an incentive to stop the costs of a firm engaging in risky activities).

³⁵ A corporation may own stock issued by another corporation. See HARRY G. HENN & JOHN R. ALEXANDER, *LAW OF CORPORATIONS* § 183 (1983); see also Clark, *supra* note 32, at 795; PHILIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: PROCEDURAL PROBLEMS IN THE LAW OF PARENT AND SUBSIDIARY CORPORATIONS* (1983).

³⁶ Banks within a holding company structure have separate corporate identities and are not liable for the activities of other banks. 12 U.S.C. §§ 1841-1850 (1988). By contrast, branches are jointly responsible for the liabilities of each other. *Id.* § 36(d).

³⁷ Inherent in the ownership structure of a bank by a parent company is the conflict that exists between creditors and shareholders. Shareholders who choose to exercise control over a corporation may divert funds from the corporation to themselves. These same funds are assets that may be partially owned by creditors, or in this case of banks, depositors. This occurs even in the regulated environment of banking because of the rules allowing interaffiliate transfers. See discussion *infra* part II.B; see also Daniel R. Fischel et

in the banking industry may mean that the parent company shifts to the insurance fund the losses the parent would ordinarily shoulder.³⁸

A closer examination of the doctrine of limited liability and its supporting policy rationales in the context of the holding company requires a review of whether and how the parent company monitors and disciplines its subsidiaries.³⁹ Generally, a parent company is afforded the protection of limited liability vis-à-vis its subsidiary. Even when that subsidiary becomes insolvent and the parent company has exercised control, the parent company receives the protection of limited liability although it may have contributed to the subsidiary's insolvency.⁴⁰ But should the protection afforded by the limited liability principle be extended even when the parent's conduct contributed to the subsidiary's insolvency? The specific focus should be whether the parent company exercised legal control over its subsidiary's corporate behavior and the impact of that control on the member subsidiaries of the holding company structure.⁴¹

al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 314-16 (1987) (criticizing the current capital structure and the moral hazard of deposit insurance as inefficient in forcing investors to monitor and control bank losses.)

³⁸ See Ribstein, *supra* note 29, at 99-101.

³⁹ While recognizing that limited liability facilitates the separation of ownership and control, Professor Stone discusses the need for enterprise liability, which combines the rule of limited liability and agency in a manner that threatens corporate funds and assures accountability when there is an absence of passive ownership. Christopher D. Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 YALE L.J. 1, 8 (1980). The rationale for the rule of limited liability is that individual investors should be protected from the costs of a corporation's failure, although those costs will have to be borne by other parts of society. As Professor Stone explains, enterprise liability shifts the costs of corporate conduct away from society to the enterprise. This theory is based on the presumption that the members of the corporate enterprise operate it for their optimal advantage. *Id.* at 9.

⁴⁰ As with unrelated corporations, banking subsidiaries within a multibank holding company structure are allowed to transfer funds among themselves. See discussion of Section 23B of the Federal Reserve Act *infra* part II.B. When a single institution within the multibank holding company structure becomes financially troubled, the related corporations withdraw their funding and allow the financially troubled institution to fail. See *infra* notes 160-68 and accompanying text discussing FirstRepublic Bancorporation. The entities can behave as though they are separate economic units when one is about to fail, although before failure, they were behaving as a common corporate unit. See discussion of substantive consolidation *infra* part VI.

Parental guarantees make the doctrine of limited liability inapplicable in the context of a multibank holding company. As an incidence of ownership of a federally insured financial institution, the parent company accepts some responsibility for the debts of the subsidiary. See discussion *infra* part IV.

⁴¹ Because limited liability may carry a relatively low monitoring burden, creditors, in fact, may rely on shareholders' monitoring of the firm's risky investments to protect their residual interest. The creditors' interest in the firm's performance may depend on whether

When corporations are related, a review of their internal arrangements can correlate to the corporations' external affairs.⁴² To review the corporate behavior of the entire enterprise is to examine the close relationship between the parent company and its subsidiaries to assess internal and external effects.⁴³ Such a review begins with the assumption that a parent company that wholly owns a subsidiary is not a passive investor.⁴⁴ Instead, the parent company is a shareholder that actively assesses financial information about any one subsidiary in order to protect the entire corporate enterprise. As an active shareholder, the parent company should take measures to control speculative transactions. To allow an active shareholder the protection of limited liability means that the parent company retains for itself the benefits that result when the enterprise shifts its risks to the creditors. The parent company, although it exercises control over the conduct of its subsidiaries, may choose not to control the risky conduct of a subsidiary, allowing it to become financially weakened, or even insolvent. As a result, the parent company, as shareholder, may lose its investment in that subsidiary, and yet, the parent company has protected the assets of other subsidiaries.

Limited liability in the holding company context is inconsistent with the legal control that a parent company may exercise over

they have a secured status and the amount of risk reduction that they expect to maintain through monitoring. See Stone, *supra* note 39, at 68-70.

⁴² See *id.* at 72. The review of the internal relationships of related corporations is not limited to related corporations, but may also be necessary when a majority or dominant shareholder exercises control over a corporation. See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (discussing the fiduciary duty of care that a majority shareholder owes to the corporation).

⁴³ The manner in which the parent company exercises control over a subsidiary's operational and organizational structure is best evaluated in comparison to a similarly situated corporation that is not a member of a holding company structure. Only then can an accurate evaluation be made of whether the subsidiary's performance is different than it would have been without limited liability. See generally Christopher W. Frost, *Organizational Form, Misappropriation Risk, and the Substantive Consolidation of Corporate Group*, 44 HASTINGS L.J. 449 (1993); Mark L. Prager & Jonathan A. Backman, *Pursuing Alter-Ego Liability Against Nonbankrupt Third Parties: Structuring a Comprehensive Conceptual Framework*, 35 ST. LOUIS U. L.J. 657, 701-08 (1991) (discussing creditor remedies under an alter ego theory and arguing that limited liability should not be recognized when the corporate owners have ignored the "formalities and purposes of the corporation's separate legal existence" to their advantage).

⁴⁴ Shareholders who are passive investors do not monitor the performance of the corporation or take an active part in its management. See Ribstein, *supra* note 29, at 102-03; see also Susan E. Woodward, *Limited Liability in the Theory of the Firm*, in FOUNDATIONS OF CORPORATE LAW 72 (Roberta Romano ed., 1972).

its subsidiary.⁴⁵ Just as it is appropriate for a parent company to intervene to monitor and discipline its subsidiary, it is also appropriate to make the parent company liable when it performs this function in a manner that jeopardizes the financial soundness of the subsidiary. Parent companies may direct the movement of the assets and liabilities among affiliates in a way that is designed to minimize loss to the holding company.⁴⁶ In the banking context, a banking subsidiary's insolvency that is generated by the parent company's management is most likely to result in the insurance fund, rather than the parent, absorbing the insolvency. However, when the interest of the parent company as shareholder—who generates the risks—are measured against those of the public—who must finance the shareholder's risk—public policy weighs in favor of protecting the public and, in the banking context, the insurance fund.

Removing the protection of limited liability in the holding company context threatens the funds of the entire holding company structure. It also requires the parent company to be accountable for and to monitor internal corporate relationships. Ultimately, the parent company controls unwanted corporate conduct.⁴⁷ When this occurs in the context of a bank holding company, the federal deposit insurance fund benefits.⁴⁸

⁴⁵ See Stone, *supra* note 39, at 45-47, 73. In the banking context, the parent company's conduct may implicate its complicity in contributing to the subsidiary's poor performance when the parent company causes or allows the subsidiary to engage in misconduct. See discussion *infra* part VI.C.

⁴⁶ Parent company operations also present the possibility of fraudulent transfers. The parent company, because of its method and manner of operation, may allow transfers that increase the losses that would be borne by the insurance fund while decreasing losses to itself. This can occur in one of two ways. The parent company may transfer poorly performing assets that have inflated values to a troubled institution which ultimately receives financial assistance from the FDIC. Alternatively, the parent company may choose to sell or transfer good performing assets from a troubled institution for less than fair market value to a bank owned by the parent company. Although these transactions are prohibited, they are difficult to detect. See *infra* notes 49-51. A proposed remedy to avoid this problem is to require the full collateralization of interaffiliate transfers. See FEDERAL DEPOSIT INSURANCE CORPORATION, DEPOSIT INSURANCE FOR THE NINETIES, MEETING THE CHALLENGES 232 (Draft Report, Jan. 4, 1989) [hereinafter DEPOSIT INSURANCE FOR THE NINETIES]; see also discussion *infra* part II.B; discussion of moral hazard *supra* note 21.

⁴⁷ See Stone, *supra* note 39, at 59-61. When those who manage and those who invest capital are the same, management and shareholders monitor each other's performance.

⁴⁸ As discussed in Part VI, substantive consolidation is corporate bankruptcy's method of circumventing limited liability when there are related corporations.

In the banking context, ideally, the examination process provides a mechanism for the regulatory agency to monitor the parent company's conduct. Some commentators criticize the regulatory agencies, who they view as in a superior position for assessing information and monitoring activities, for not more closely controlling the conduct of parent compa-

B. *Interaffiliate Lending and Captive Funding*

The rules of interaffiliate lending also pose dangers when a banking subsidiary in a multibank holding company system threatens failure. Sections 23A⁴⁹ and 23B⁵⁰ of the Federal Reserve Act limit transactions among bank holding company affiliates. These rules prevent banking and nonbanking subsidiaries within a holding company system from experiencing overexposure to excessive risks and losses. The rules are fluid enough to recognize that the nature of holding company operations is to transfer assets freely among affiliates as dictated by market conditions.⁵¹

Section 23A limits the aggregate amount of all "covered"⁵² transactions between a bank and its affiliates to twenty percent of the bank's capital and surplus. The statute provides several exemp-

nies. These commentators argue that regulators are in a position to detect and abort some of the conduct that is disastrous to their banking subsidiaries. *See* discussion *infra* notes 140-46 (criticizing the newest parental guarantee, the prompt corrective action provision, as unnecessarily extending the protection of limited liability for parent companies when other mechanisms of control over the parent company's conduct are available and more effective).

There are a number of regulatory prohibitions that will minimize the type of risks to which a parent company may expose the bank subsidiary. For example, bank subsidiaries have minimal capital requirements set by regulation. Those business considerations which at times make inadequate capitalization profitable, e.g., the company can operate at a loss or "break even point" and thereby yield substantial tax advantages, are illegal for bank subsidiaries. Another advantage of the holding company structure is the commingling of funds and property among affiliated corporations. *See supra* text accompanying notes 15-20; *see also* Joseph H. Sommer, *The Subsidiary: Doctrine Without a Cause?*, 59 *FORDHAM L. REV.* 227, 234 (1990).

⁴⁹ Banking Act of 1933, ch. 89, § 23A, 48 Stat. 162, 183 (codified as amended at 12 U.S.C. § 371c (1988)).

⁵⁰ Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 102(a), 101 Stat. 552, 564 (codified at 12 U.S.C. § 371c-1 (1988)).

⁵¹ *See* Carl Felsenfeld, *The Bank Holding Company Act: Has It Lived Its Life?*, 38 *VILL. L. REV.* 1, 88-90 (1993).

⁵² "Covered" transactions include:

- (1) a loan or extension of credit by a bank to an affiliate;
- (2) a purchase by a bank of an investment in securities issued by an affiliate;
- (3) a purchase by a bank of assets from an affiliate, including assets subject to an agreement to repurchase;
- (4) the acceptance by a bank of securities issued by an affiliate as collateral or a loan or extension of credit by the bank to any person or company; and
- (5) the issuance by a bank of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate.

12 U.S.C. § 371c(b)(7)(A)-(E) (1988).

An "affiliate" is a company that controls or is under the common control of the bank and includes subsidiaries of banking holding companies as well as banking and nonbanking companies that are under common individual control. *Id.* § 371c(b)(1)(A).

The section also requires that all covered transactions between bank and affiliates are conducted on terms that are consistent with safe and sound banking practices. *Id.*

tions, three of which are important for banks operating in a multibank holding system. First, if the same bank holding company owns eighty percent of each subsidiary bank's stock, a sibling bank is exempt from the restrictions found in Section 23A.⁵³ Second, Section 23A exempts deposits made in an affiliated bank in the ordinary course of correspondent business.⁵⁴ Finally, it also exempts transactions secured by United States government obligations.⁵⁵ These exemptions promote efficiency in intercorporate transfers by allowing the bank holding company to operate to maximize profits by moving assets among subsidiaries as it deems necessary.⁵⁶

Notwithstanding the restrictions found in the Bank Holding Company Act, from which affiliated banking subsidiaries are exempt, there are no other controls that dictate the conduct of banking subsidiaries within a multibank holding company system. Traditionally, larger banking subsidiaries within the structure treat smaller banking subsidiaries as though they are branches within a single bank.⁵⁷ Regulators call this practice "captive funding."⁵⁸ Its practical effect is that the larger banking subsidiaries generate most of the loan business, but the funding for these loans comes from the smaller banking subsidiaries through interaffiliate lending.

These rules that regulate interaffiliate lending allow banking subsidiaries within the multibank holding company system to oper-

§ 371c(a)(4). There are stringent collateral requirements imposed on these transactions, requiring collateral of 100-130%. *Id.* § 371c(c)(1).

⁵³ These assets must be of a good quality and comply with safe and sound banking practices. *Id.* § 371c(c)(3), (a)(4).

⁵⁴ *Id.* § 371c(d)(2).

⁵⁵ *Id.* § 371c(d)(4); *see also* 12 C.F.R. § 201.108(b)(1)-(20) (1994) (listing qualifying obligations).

⁵⁶ Although Section 23B prescribes credit standards to be used in evaluating "covered" transactions between a bank and its affiliates, 12 U.S.C. § 371c-1(a)(1) (1988), they are not applicable if the transaction is one of those exempted under Section 23A. *Id.* § 371c-1(d)(3). More importantly, it excludes sibling banks from the definition of affiliates under the statute. *Id.* § 371c(b)(2). Section 23B, nonetheless, provides that the terms and circumstances, including credit standards, for a "covered" transaction must at least be as favorable as those prevailing at the time for comparable transactions with or involving nonaffiliated companies. *Id.* § 371c-1(a)(1)(A). If there are no comparable transactions, the transaction must be offered in good faith and at "arms-length." *Id.* § 371c-1(a)(1)(B). As discussed *infra* part V.B, most affiliate banks in a multibank holding company system take advantage of the Section 23A exemptions.

⁵⁷ *See supra* text accompanying note 36.

⁵⁸ This term was first used by then-Chairman L. William Seidman of the FDIC in proposing legislation to abate the problem of multibank holding company failures. *See* 134 CONG. REC. S11,440 (daily ed. Aug. 10, 1988) (statement of Sen. Proxmire); *see also* discussion *infra* part VI recommending temporary substantive consolidation as a means of resolving the problem of capital-weakened institutions.

ate as a single entity. It is this very scenario that contributed to the massive losses generated by the Texas bank centers, MCorp, FirstRepublic and TAB.⁵⁹ As in the operation of those systems, the smaller banking subsidiaries act as a funding source for another banking subsidiary, often denoted as the "lead" bank. The lead bank amasses its funds from most, if not all, of the smaller banking subsidiaries. The lead bank then uses these funds to make its financial commitments.⁶⁰

If a parent company uses interaffiliate lending to the fullest extent, the effect is that the lead bank may hold all of the liquid capital of the holding company's subsidiaries. The smaller banks become "deposit harvesters," gathering deposits of customers and depositing those monies into the lead bank. The lead bank becomes a "loan harvester," generating most of the new loans to customers based on its increased capital base.⁶¹ This type of interaffiliate lending or captive funding contributes to the larger bank's insolvency. A smaller banking subsidiary may have made loans to its larger affiliate without observing prudential lending practices. When these loan assets begin to deteriorate, the smaller banking subsidiaries withdraw their liquid assets. The lead bank suffers losses from nonperforming loans made to customers and shifts those losses to the FDIC. One basis on which a court may disregard corporate separateness is when a corporation draws upon the capital resources of a sibling or parent company because it is inadequately capitalized. Using assets to fund one banking subsidiary that belong to another and assets that are transferable on demand indicates that one or the other affiliate bank does not have sufficient capital to engage in the type of large scale lending that it may be conducting.⁶² Thus, captive funding is one way of showing

⁵⁹ See discussion *infra* part V.B.

⁶⁰ The financing sources that the smaller banking subsidiaries provide often vary in form. The smaller banking subsidiaries may deposit large amounts of liquid assets into the lead bank. This may include the smaller banking subsidiary's capital accounts, federal funds accounts, or certificates of deposits. Financing to the lead bank may also include smaller banking subsidiaries making unsecured loans to the lead bank. See DEPOSIT INSURANCE FOR THE NINETIES, *supra* note 46, at 227-33.

⁶¹ Federally insured banks that are members of the Federal Reserve system must comply with reserve requirements as set out in 12 U.S.C. § 461 (1988 & Supp. V 1993). This provision requires banks to maintain reserves against their deposits to meet the demands for withdrawals and avoid a sudden liquidity crisis. The lead bank is able to increase its credit function of making loans because the deposits from the smaller banks boost the lead bank's reserve requirement.

⁶² See HENN & ALEXANDER, *supra* note 35, § 148. When a sibling bank has relied upon interaffiliate funding, the FDIC must decide which financing alternative will best protect the interests of the deposit insurance fund. Often this results in protecting the

that individual subsidiaries within a multibank holding company system have disregarded their corporate form and therefore are not separate economic units. As discussed in Part VI, such a showing should be sufficient to persuade a court that because corporations did not operate as separate corporate entities, their financial problems should not be resolved by treating them as though they were separate entities.

C. Joint Failure Risks: "Too Big to Fail"

The final structural factor unique to the operation of a multibank holding company occurs when the holding company's size poses a systemic risk in the event of failure. The "too big to fail" doctrine means that uninsured depositors or creditors of a failed bank receive full payment when an institution fails.⁶³ The erosion of public confidence in the nation's economy justifies, at least in the regulators' minds, shoring up a failing banking subsidiary in a multibank holding company.⁶⁴

healthy sibling institution although that institution's lending practices have contributed to the weakened capital status of the failing institution. See discussion of FDIC failure resolution alternatives *infra* part V.A.

⁶³ This occurs because the FDIC often offers direct financial assistance to assist an open bank's merger with a healthy institution. Naturally, this facilitates the insolvent bank's remaining open and protects all depositors as well as results in fewer disruptions to banking services. Former FDIC Chairman William Seidman dubbed the policy "imprecise shorthand for 'too big to allow uninsured depositors to suffer losses.'" *Economic Implications of the "Too Big to Fail" Policy: Hearings Before the Economic Stabilization Subcomm. of the House Banking, Finance and Urban Affairs Comm.*, 102d Cong., 1st Sess. 70 (1991) [hereinafter "*Too Big to Fail*"] (testimony of L. William Seidman, Chairman, FDIC); see also John F. Bovenzi & Arthur J. Muton, *Resolution Costs of Bank Failures*, 1 FDIC BANKING REV. 1, 2 (1988). The protection occurs because the FDIC usually arranges a purchase and assumption transaction, which allows the acquiring bank to assume the assets and deposit liabilities of a failed bank. As a result of the acquiring bank accepting all of the deposits of the failed institution, both insured and uninsured, the transaction protects uninsured depositors. See discussion *infra* part IV; see also Fischel et al., *supra* note 37, at 313; Arthur E. Wilmarth, Jr., *Too Big To Fail, Too Few to Serve? The Potential Risks of Nationwide Banks*, 77 IOWA L. REV. 957, 994-95 (1992).

FDICIA limits the FDIC's authority to use the "too big to fail" policy. See 12 U.S.C. § 1823(c)(4)(A) (Supp. V 1993). Under FDICIA, the FDIC must meet a "least-cost" test before giving financial assistance. *Id.* Thus, a purchase and assumption transaction protecting uninsured depositors can be used only if it is the least costly compared to all other possible financial transactions. *Id.* § 1823(c)(E)(iii). If the FDIC, FRB, and the Secretary of the Treasury determine that the effects of the failure would cause serious "systemic risk," then the statute authorizes them to jointly agree to protect uninsured depositors or creditors. *Id.* § 1823(c)(E)(iii); see also Wilmarth, *supra*, at 996 nn.183-84.

⁶⁴ The failure of the Continental Illinois bank system provides an example of systemic risk failure. In 1984, Continental had extensive (over 1,000) correspondent bank accounts, which means that other banks held their accounts with Continental. Sixty-six of those correspondent banks had uninsured deposits exceeding 100% of capital and 113 had deposits equalling 50-100% of capital. Had the FDIC chosen not to protect Continental, that deci-

The integral role that banks provide in the payments system means that other financial markets signal distress when large financial institutions become insolvent.⁶⁵ The failure of large financial institutions undoubtedly undercuts the public confidence in the nation's system of banking, specifically, and its economy as a whole. These failures erode confidence when the public perceives that the regulators are not responsive to the problems of the institutions and markets. The magnitude of potential losses in the failure of large financial institutions are sudden and uncontrollable. Thus, "too big to fail" is in effect choosing to ignore established bank liquidation principles when certain banking organizations become insolvent because ignoring those principles is necessary to protect claimants and minimize disruptions.

When determining the most appropriate failure resolution method, the FDIC balances several policy objectives. These include minimizing the cost to the insurance fund, maintaining the stability of the financial system, encouraging market discipline, minimizing disruptions to the community, and providing consistent treatment to banks of all sizes. These policy objectives and the ability of the regulators to monitor and assess information regarding the performance of multibank holding companies place regulators in a position to take corrective action prior to a bank's insolvency. Taking corrective action could help to maintain the balance between public confidence and market discipline. Presently, however, regulators, recognizing the unique operational nature of banking subsidiaries in a multibank holding company, have moved to abort failure either by arranging mergers, recapitalizations, or managed reductions in size.⁶⁶ Applying substantive con-

sion would have significantly weakened the correspondent banks. See DEPOSIT INSURANCE FOR THE NINETIES, *supra* note 46, at 258-62.

Between 1986 and 1991, the FDIC determined that only four banks were "too big to fail" and protected all depositors. Those institutions were First National Bank & Trust Co, Oklahoma City, Oklahoma (1986); FirstRepublic Bank, Dallas, Texas (1988); MCorp, Houston, Texas (1989); and Bank of New England, Boston, Massachusetts (1991). The cost of protecting the uninsured depositors of these institutions was less than one billion dollars or about 3.5% of the FDIC's total insurance losses over this time period. See "Too Big to Fail," *supra* note 63, at 82-83 (testimony of L. William Seidman, Chairman, FDIC).

⁶⁵ The interrelationship of the country's payments system and the banking industry raises concerns about the systemic effect of a multibank holding company failure. The stability and integrity of the payments system operates as a check and balance on the financial viability of other financial institutions. When parties to a transaction are at risk, there is an effect on the flow of liquidity and credit at a financial institution. The financial market senses and reacts to perceived instabilities of financial institutions. See Wilmarth, *supra* note 63, at 997-1002.

⁶⁶ See Bovenzi & Mutton, *supra* note 63, at 2-3. Systemic risk also raises issues of economic inefficiency and equity. To the extent that institutions are reckless, abuse weak in-

solidation in the banking context is an alternative to prior ineffective attempts to make holding companies accountable through parental guarantees.

III. THE PRECURSORS: THE NET WORTH MAINTENANCE AGREEMENT AND THE SOURCE OF STRENGTH CONDITION

A. Background

Holding companies seeking to own thrift and banking subsidiaries are subject to approval of the formation, structure, and operation of the resulting entity by the appropriate regulatory agency.⁶⁷ The Bank Holding Company Act of 1956 ("BHCA") grants the FRB supervisory control over bank and nonbank subsidiaries.⁶⁸ The Savings and Loan Holding Company Amendments of 1967 ("SLHCA")⁶⁹ grants OTS, formerly the Federal Home Loan Bank Board ("Bank Board"), the same authority over companies acquiring control over and operating thrifts.

stitutions, or make mistakes whose consequences are borne by weak institutions, the economy absorbs the loss. See Wilmarth, *supra* note 63, at 986-90.

Similar concerns have not always been expressed by regulators when smaller institutions were at risk. Creditors of smaller failed institutions may not be protected from losses because the regulators evaluate the impact of the financial losses as minimal. Obviously, this raises issues of equity. Take, for example, New York City's Freedom National Bank, an institution founded by African Americans in the 1950s. Freedom National Bank had one branch in Brooklyn serving a large African American clientele of individuals and charitable organizations, many of whom had deposit accounts exceeding the \$100,000 coverage limit. It was not owned by a holding company. Although the FDIC ultimately used an "essentially" finding, recognizing that the protection of the uninsured deposit customers was essential to the interests of the insurance fund, the original financial package did not cover the uninsured claims because the FDIC did not consider the failure of Freedom National Bank to present a systemic risk. See *Failure of the Bank of New England: Hearings Before the House Banking, Finance and Urban Affairs Comm.*, 102d Cong., 1st Sess. 7 (1991) [hereinafter *Failure of the Bank of New England*] (testimony of L. William Seidman, Chairman, FDIC); Stephanie Strom, *FDIC Offers Aid Plan for Minority Owned Bank*, N.Y. TIMES, Jan. 13, 1991, at A20.

In January 1991, about two months after the failure of the Freedom National Bank, the Bank of New England, a multibank holding company system with subsidiary banks in Massachusetts, Maine, and Connecticut, and assets totaling \$22.9 billion, failed. The FDIC determined that the systemic risk of that failure required uninsured depositors to be protected. *Failure of the Bank of New England*, at 7.

⁶⁷ See generally Clark, *supra* note 32; Fischel et al., *supra* note 37.

⁶⁸ Bank Holding Company Act of 1956, ch. 240, 70 Stat. 133 (codified as amended at 12 U.S.C. § 1841-50 (1988)).

⁶⁹ Savings and Loan Holding Company Act Amendments of 1967, Pub. L. No. 90-255, 82 Stat. 5 (amending 12 U.S.C. § 1730a) (repealed 1989). With the adoption of FIRREA in 1989, Congress replaced § 1730a with new provisions regarding savings and loan holding companies. See 12 U.S.C. § 1467a (Supp. V 1993).

Each regulatory agency currently has regulations implementing parental guarantees.⁷⁰ As part of the approval process for acquiring a controlling interest in a thrift, regulators inquire into the "financial and managerial resources and future prospects of the [holding] company and [savings and loan association] involved."⁷¹ To carry out this statutory provision, the Bank Board and the FRB created a type of parental guarantee to protect banks and thrifts against potential abuse by parent companies.

For the FRB, the regulatory tool is the source of strength condition. For the Bank Board, it is the net worth maintenance agreement. Both regulatory tools have the same effect: They require the parent company to maintain the acquired subsidiary's net worth by infusing capital when the subsidiary fails to meet its minimum capital requirements. Thus, the bank and thrift regulators interpreted these statutory provisions as an extension of the government's authority to inquire into the financial resources and future prospects of corporations attempting to acquire federally insured institutions.⁷² After a brief discussion of the policy supporting each regu-

⁷⁰ The FRB and formerly the Bank Board, now OTS, evaluate the projected compliance of banks and thrifts with regulatory capital requirements. To protect the regulated subsidiary and to avoid ownership by unstable or weak holding companies that would not manage efficiently a banking subsidiary, both agencies have legislative delegation from Congress to evaluate a potential parent company's current and future financial ability to assist the bank or thrift in maintaining that capital standard. See 12 U.S.C. § 1467a(e)(2) (Supp. V 1993) (thrifts); 12 U.S.C. § 1842(c) (1988) (banks).

⁷¹ 12 U.S.C. § 1467a(e)(2) (Supp. V 1993); see also *id.* § 1842(c) (establishing similar criteria for bank acquisitions).

Under the regulatory scheme, OTS approval of the acquisition of companies acquiring their first federally insured institution is required unless it finds that "the financial and managerial resources and future prospects of the company and association involved to be such that acquisition would be detrimental to the association or [an] insurance risk to the corporation." *Id.* § 1467a(e)(1)(B); see also *Kaneb Servs., Inc. v. FSLIC*, 650 F.2d 78 (5th Cir. 1981) (affirming the FSLIC's imposition of a dividend restriction as a condition of purchasing two savings and loan associations). In addition to the acquisition approval of thrifts, the prior scheme gave the FSLIC authority to deal with insolvent thrifts "as it deems appropriate," 12 U.S.C. §§ 1729(b)(1)(A), 1729(c) (1988) (repealed 1989); to make contracts, *id.* § 1725(c)(3) (repealed 1989); and to issue cease and desist orders to enforce written agreements, *id.* § 1730(e)(1) (repealed 1989). These provisions of SLHCA are unambiguous statements that the regulators may use a compendium of supervisory powers as necessary to ensure the safety and soundness of financial institutions.

It is also well-established that the BHCA confers on the FRB broad supervisory powers. See *Board of Governors v. Dimension Fin. Corp.*, 474 U.S. 361, 365 (1986). This power includes the authority to establish minimum capital requirements for bank holding companies, 12 U.S.C. § 3907 (1988); to issue capital directives to bank holding companies, *id.*; to conduct financial examinations of bank holding companies and their subsidiaries, *id.* § 1844(c); and, to order bank holding companies to divest themselves of a nonbank subsidiary, *id.* § 1843(c).

⁷² The OTS and FRB have interpreted the statutes to permit net worth maintenance agreements and the source of strength condition. As administrative agencies charged with

latory tool, an evaluation follows of the merits of the claim that the source of strength condition is beyond the statutory authority of the FRB and that an implied net worth maintenance obligation (as opposed to an express one) is unenforceable because of vagueness. These claims have arisen because parent companies were not willing after acquisitions to make the cash infusions needed to maintain the capital requirements of subsidiary thrift and banking institutions. Given the vague statutory language authorizing the agencies' use of the specific regulatory tools, the opposition of parent companies to the use of these tools is legitimate.

1. *Net Worth Maintenance Agreements*

The financial crisis in the thrift industry during the 1970s and 1980s required thrift regulators to develop regulatory tools to avoid liquidating marginally capitalized thrifts.⁷³ Under the regulatory scheme in place at the time,⁷⁴ the Bank Board developed a policy requiring potential acquirors of FSLIC-insured institutions to execute a net worth maintenance agreement protecting the insurance fund from losses.

enforcing a statutory scheme, judicial review of the agency's construction is governed under the deference standard pronounced in the oft cited *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 842 (1984). The *Chevron* rule requires that a court reviewing an administrative agency's construction of a statute adopt the agency's construction unless "Congress has directly spoken to the precise question at issue." *Id.* at 842. In the absence of a specific legislative directive, the *Chevron* rule implies a congressional delegation to construe the statute. *Id.* at 843-44.

Chevron distinguishes between the level of judicial deference accorded to an administrative agency's interpretation depending upon whether the statutory construction is explicit or implicit. The reviewing court must apply the standard of "arbitrary, capricious, or manifestly contrary to the statute" when there is an explicit statutory gap for the agency to address. *Id.* at 844. The reviewing court's deference is limited to a "reasonable [agency] interpretation" when there is an implicit statutory gap delegated to the agency. *Id.* Whether there is either an explicit or implicit statutory gap, it is the agency's responsibility to create the necessary policy, rules, and regulations for a reviewing court to evaluate.

The *Chevron* analysis requires the reviewing court to make a two-step analysis. The reviewing court must determine whether Congress has "unambiguously expressed [its] intent" on the "precise question at issue." *Id.* at 843. To make this determination, the reviewing court may employ "traditional tools of statutory construction." *Id.* at 843 n.9. When congressional intent is unambiguously expressed, both the court and the agency are bound by that interpretation. In the second step, the court's role is limited to determining the reasonableness of the agency's interpretation. *Id.* As discussed *infra* in text at notes 108-22, courts have not viewed the FRB's interpretation of the source of strength doctrine as reasonable, but have accepted the use of a net worth maintenance agreement if imposed as a condition at the time of acquisition.

⁷³ In order to resolve the pending failures of insured institutions, acquirors and FSLIC entered into several different forms of financial and economic assistance. See DEPOSIT INSURANCE FOR THE NINETIES, *supra* note 46, at 161-85.

⁷⁴ 12 U.S.C. § 1730a (1988) (repealed 1989).

The Bank Board issued its first policy statement in 1984 explaining the need for net worth maintenance agreements.⁷⁵ The theory used to support early net worth maintenance agreements focused on parent company detriments and benefits.⁷⁶ The Bank Board's detriment theory was that a financially weakened parent company, to the detriment of its banking subsidiary, would strip the subsidiary of its capital, thereby causing insolvency and requiring an outlay of capital from the FSLIC.⁷⁷

The Bank Board based its benefit theory on two presumptions.⁷⁸ The first was that the parent company of a savings and loan association controlled the business practices of its insured subsidiaries.⁷⁹ The second was that the parent company, which may have been financially troubled itself, benefitted when FSLIC gave financial assistance to recapitalize a failing subsidiary.⁸⁰

Based on these presumptions, thrift regulators concluded that when the federally insured financial institution receives financial assistance from FSLIC, the parent company receives an indirect benefit. Thus, the cash infusion from FSLIC that enhances the thrift's capital base and promotes depositor confidence protects the parent company from financial weakness or instability. By requir-

⁷⁵ See 49 Fed. Reg. 41,237, 41,241 (1984) (to be codified at 12 C.F.R. §§ 543, 544, 552, 562, 571); see also Office of Regulatory Activities, Thrift Bull. No. 5, at 1, 2 (Oct. 19, 1988) [hereinafter Thrift Bull. No. 5] (requiring modified capital maintenance commitments for all acquisitions of FSLIC-insured institutions), rescinded by Office of Thrift Supervision, Thrift Bull. No. 5a, at 1 (Apr. 12, 1990) [hereinafter Thrift Bull. No. 5a].

⁷⁶ Regulatory Capital Maintenance Obligations of Acquirors of Insured Institutions, 53 Fed. Reg. 31,761 (1988) [hereinafter Capital Maintenance Obligations].

⁷⁷ There is empirical evidence that suggests that institutions with weakened capital usually become insolvent. See MODERNIZING THE FINANCIAL SYSTEM, *supra* note 14, at X-2. Not only do undercapitalized thrifts have a smaller "cushion" to absorb losses, but the managers of undercapitalized thrifts have greater incentives to take risks because of the moral hazard of deposit insurance. See H.R. REP. NO. 54(I), 101st Cong., 1st Sess. 298 (1989), reprinted in 1989 U.S.C.C.A.N. 86, 94 ("If capital levels are too low, managers may be willing to take excessive risks because of the perception that the FSLIC insurance fund will pay a substantial portion of the costs if the gamble fails."); H.R. REP. NO. 54(I), at 544, reprinted in 1989 U.S.C.C.A.N. at 336 ("Undercapitalized thrifts simply have no incentive not to take excessive risks with insured deposits.") (statement of Reps. Schumer, Morrison, Roukema, Gonzalez, Vento, McMillen, and Hoagland). Some commentators suggest that the absence of risk-based insurance premiums encourages excessive risk taking. See GEORGE J. BENSTON, AN ANALYSIS OF THE CAUSES OF THE SAVINGS AND LOAN ASSOCIATION FAILURES 174 (1986). But see Howell E. Jackson, *The Superior Performance of Savings and Loan Associations with Substantial Holding Companies*, 22 J. LEGAL STUD. 405 (1993) (using statistics to argue that savings and loan institutions owned by holding companies do not suffer a detriment because of parent company ownership and, indeed, usually perform better).

⁷⁸ See Capital Maintenance Obligations, *supra* note 76, at 31,761.

⁷⁹ *Id.*

⁸⁰ *Id.*

ing a capital infusion from the parent company prior to the use of insurance funds, the Bank Board encouraged the parent company's prudential management of the insured institution.⁸¹

In 1988, the Bank Board issued a second policy statement, Thrift Bulletin 5.⁸² This second policy statement acknowledged that the requirement of a cash infusion might deter potential acquirors. The agency began looking for alternatives to the net worth maintenance agreement to enforce an acquirer's obligations to support its insured institution and to effectively protect the FSLIC.⁸³ Specifically, the Bank Board allowed acquirors of thrifts to negotiate a maximum amount of cash that they would be obligated to spend to maintain the thrift's capital.⁸⁴

After FIRREA, OTS, the Bank Board's successor, again modified its policy on parental guarantees in 1990 and 1991. Now, OTS requires an agreement from the parent company only when the thrift being acquired has failed to meet fully phased-in capital requirements. The agency inferred that this change was consistent with and followed from FIRREA's policy that savings and loan associations achieve FIRREA's capital levels as soon as possible, but no later than January 1, 1995.⁸⁵

⁸¹ *Id.*

⁸² Thrift Bull. No. 5, *supra* note 75.

⁸³ A clear down side of the early policy was that it discouraged potential acquirors. *Id.* The crisis in the savings and loan industry during the late 1980s and the specific need to attract acquirors for failing institutions accounts for the regulators' abandonment of early, open-ended net worth maintenance agreements as a condition to acquisition. Few individuals and corporations were interested in making an open-ended commitment as a condition of acquisition of a financial institution. The need to attract acquirors during the thrift crisis when the FSLIC was insolvent resulted in the change in policy in 1988 discontinuing the open-ended net worth maintenance agreement. In its stead, acquirors could negotiate with regulators for either a net worth maintenance agreement limited in amount and duration or a "pre-nuptial agreement" that gave the regulators control of the federally insured subsidiary if its capital position fell beneath the minimum capital requirements. *Id.*

⁸⁴ Under the 1988 policy, FSLIC redefined and limited the maximum amount of capital infusion required under the net worth maintenance agreement. The aggregate amount of the infusion—which could be required at a single time or in multiple infusions—would be limited or capped at a specified amount in the agreement. Also, the net worth maintenance agreement must be evidenced by a separate writing. *Id.*

⁸⁵ See Thrift Bull. No. 5a, *supra* note 75, at 1. OTS issued Thrift Bulletin No. 5a in April 1990, which set the maximum liability for an acquiror under a limited net worth maintenance agreement as the difference between the institution's capital immediately following the transaction and the institution's fully phased-in capital requirements as of the same date. *Id.* at 2; see Paul L. Lee, *Liability of Bank Holding Companies, Savings and Loan Holding Companies and Their Affiliates for Failed Bank and Thrift Subsidiaries*, in COUNSELLING CREDITORS OF BANK AND THRIFTS: DEALING WITH THE FDIC AND RTC (PLI Com. L. & Prac. Course Handbook Series No. A4-4323, 1991).

OTS modified its policy on net worth maintenance agreements again in 1991. See Office of Thrift Supervision, Thrift Bull. No. 38-3a (Nov. 19, 1991). The new policy in

2. *The Source of Strength Condition*

The FRB chose as its parental guarantee the source of strength condition. Using § 3(c) of the BHCA, the agency exercised its authority to impose the condition as a part of the approval process of a holding company's acquisition of a banking subsidiary.⁸⁶ Before the FRB issued its policy statements elaborating its views on the source of strength doctrine, a potential acquiror challenged the FRB's statutory authority to impose the condition. In *Board of Governors v. First Lincolnwood Corp.*,⁸⁷ the U.S. Supreme Court upheld the doctrine as an integral part of the FRB's exercise of its regulatory authority.⁸⁸

After the *Lincolnwood* decision, the FRB promulgated regulations on the source of strength condition. Those regulations

Thrift Bull. No. 38-3a requires either a capital maintenance agreement or a "pre-nuptial agreement" only if the acquired thrift has failed to meet its fully phased-in regulatory capital requirements. It also requires that persons or companies subject to capital maintenance obligations notify OTS before divesting control. See 12 C.F.R. § 567 (1994).

A limited capital net worth maintenance agreement expires after five years or when fully phased-in capital requirements exist for eight consecutive quarters. A prenuptial agreement becomes effective when the institution's capital declines below 2% of net assets. It gives an officer of OTS the right to vote the securities of the institution. This voting only occurs respecting certain actions (e.g., to remove and replace the board of directors of the institution), or to dispose of any or all of the securities of the institution owned by the acquiror in the event the institution's regulatory capital declines below a specified percentage of an institution's liabilities or assets. See Michael S. Helfer et al., *Net Worth Maintenance Actions*, in LITIGATING FOR AND AGAINST THE FDIC AND THE RTC 1993 (PLI Com. L. & Prac. Course Handbook Series No. A4-4429, 1993).

⁸⁶ The FRB based its authority on § 3(c) of the BHCA, 12 U.S.C. § 1842 (1988 & Supp. V 1993), and the Financial Institutions Supervisory Act ("FISA"), which governs "unsafe and unsound" banking practices. 12 U.S.C. § 1818 (1988).

⁸⁷ 439 U.S. 234 (1978). In *Lincolnwood*, four individual shareholders who controlled 86% of the voting stock of a bank applied to form a bank holding company. Their proposed transaction would have transferred all of the assets and liabilities of the bank to the holding company. The shareholders then would exchange their shares in the bank for shares in the holding company. The transaction's financing would require that the holding company assume \$3.7 million of debt that the shareholders had incurred previously to finance their interest in the bank; the holding company would then use dividends received on the bank stock to retire the acquisition debt over a 12-year period. To raise additional capital, the shareholders contemplated that the holding company would undertake a \$1.5 million note issue, using the proceeds to finance the holding company's purchase of newly issued stock. *Id.* at 237-38.

⁸⁸ In the *Lincolnwood* decision, the FRB denied an application to form a bank holding company because the holding company could not serve as a source of strength to the subsidiary bank, even though the formation of the holding company did not cause or exacerbate any financial problems. The Supreme Court upheld the source of strength doctrine based on the specific statutory language directing the FRB to consider a bank holding company's financial and managerial resources. The legislative history of the BHCA and later amendments thereto demonstrated that Congress conferred broad discretion on the agency to ensure bank safety and the financial soundness of the banking system. *Id.* at 248-49.

made failure to comply with the source of strength condition the basis for an enforcement action. In 1984, the FRB amended Regulation Y to include, specifically, the statutory language of § 1842(c).⁸⁹ Three years later, the FRB issued a policy statement indicating that a violation of Regulation Y would be grounds for an enforcement violation.⁹⁰

B. Enforcement

1. FDIC or RTC

Acquirors of federally insured thrifts did not challenge the Bank Board's authority to condition the approval of thrift holding company applications on the acquiror's execution of a net worth maintenance agreement at the time of the approval of the acquisition. It was only when the regulatory agencies began enforcing these agreements that acquirors mounted objections to their valid-

⁸⁹ Regulation Y allows bank holding companies to acquire certain nonbank companies provided that they offer services that are so closely related to banking as to be an "incident" to banking. 12 C.F.R. § 225 (1994). The policy concern is that the holding company's ownership of nonbanking subsidiaries will adversely affect its ownership of banking subsidiaries.

The amendment to Regulation Y stated: "[A] bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner." Revision of Regulation Y, 49 Fed. Reg. 794, 820 (1984) (to be codified at 12 C.F.R. § 225.4(a)(1)); see also Julius L. Loeser, *Bank Holding Company Regulation: The Federal Reserve Board's Recent Revision of Regulation Y*, 101 BANKING L.J. 525 (1984); Fallon, *supra* note 31; James F. Groth, Comment, *Can Regulators Force Bank Holding Companies to Bail Out Their Failing Subsidiaries? An Analysis of the Federal Reserve Board's Source-of-Strength Doctrine*, 86 Nw. U. L. REV. 112 (1991).

⁹⁰ The 1987 Policy Statement provided, in part, that "[a] bank holding company's failure to meet its obligation to serve as a source of strength to its subsidiary bank(s), including an unwillingness to provide appropriate assistance to a troubled or failing bank will generally . . . result in . . . enforcement action." 52 Fed. Reg. 15,707, 15,708 (1987). The FRB explained the need for this statement by saying that it had "become aware of situations where a bank [had] been threatened with failure notwithstanding the availability of resources to its parent holding company." *Id.* at 15,707. Like the Bank Board, the FRB cited as rationales for the doctrine the benefit that the holding company receives from its ownership of banking subsidiaries, the need to promote public confidence in the safety and soundness of the nation's banks, and the reduced risk to the insurance fund. *Id.*

Consistent with its revised policy statement, which explained that the FRB would pursue enforcement "particularly if appropriate resources are on hand or are available to the bank holding company on a reasonable basis," *id.* at 15,708, the FRB chose not to enforce its source of strength regulation against Hawkeye Bancorporation, an Iowa multibank holding company. Although the FRB initially ordered the holding company to inject \$1.2 million into a failing subsidiary, it dismissed the charges prior to the beginning of a scheduled administrative hearing. The FRB's rationale for the dismissal was based apparently on the severe financial condition of the bank holding company, which was unable to fulfill its obligations to its creditors. See Lisabeth Weiner, *Fed Drops Case Against Hawkeye*, AM. BANKER, May 4, 1987, at 11; Fallon, *supra* note 31, at 1369.

ity.⁹¹ The FDIC or the Resolution Trust Corporation ("RTC")⁹² have sought to enforce net worth maintenance agreements by arguing that the acquirors entered into a contract with the Bank Board to maintain the thrift's net worth at the levels required by the insurance regulations.⁹³ The FDIC and RTC proceeded under a contract theory because, as the receiver or conservator of a troubled or failed thrift, the agencies may pursue common law claims on behalf of the thrift. They do not have the authority to pursue regulatory enforcement actions against the insolvent thrifts.⁹⁴ To the extent that the FDIC or RTC can successfully prove that the acquiror

⁹¹ Estimates reveal that several hundred net worth maintenance agreements exist that arguably could be enforced by the agencies. See Rosemary Stewart, *Enforcement of Capital Maintenance Pacts Strained by Failure, Uncertainty, Unfairness*, AM. BANKER, Mar. 19, 1991, at 4.

⁹² The RTC is the government agency created by FIRREA to receive and dispose of the assets of failed thrifts. See 12 U.S.C. § 1441a(b) (Supp. V 1993).

⁹³ The applicable regulation was 12 C.F.R. § 563.13 (1989).

⁹⁴ Section 401(f) of FIRREA is a "savings provision" which provides that the abolishment of the FSLIC does not affect the validity of FSLIC's rights under any section of Title IV of the National Housing Act. Pub. L. No. 101-73, § 401(f), 103 Stat. 183, 354 (1989) (reprinted in 12 U.S.C. § 1437 note (Supp. V 1993)); see also § 401(g)(1), 103 Stat. at 356-57 (similar "savings provision" relating to FHLBB). Thus, the OTS, FDIC, or RTC may succeed FSLIC as a party-in-interest in enforcing these agreements. OTS takes the position that when FSLIC was abolished, FIRREA transferred its regulatory and enforcement authority over federally insured thrifts to OTS as well as FSLIC's net worth maintenance regulations. See 12 U.S.C. § 1464(t)(1)(D) (requiring OTS to promulgate regulations by November 7, 1989 prescribing uniformly applicable capital standards for all savings associations). The new capital regulations, found in 12 C.F.R. § 567 (1994), replaced the former net worth maintenance regulations found at 12 C.F.R. § 563.13 (1989). See Regulatory Capital, 54 Fed Reg. 46,845, 46,847 (1989) (to be codified at 12 C.F.R. pts. 561, 563, & 567).

OTS has chosen to enforce net worth maintenance agreements only when they have a document so labeled. The agency then proceeds under 12 U.S.C. § 1818(b)(1) (Supp. V 1993) to enforce the net worth maintenance agreement, which provides in part:

If . . . the agency has reasonable cause to believe that the depository institution or any institution-affiliated party . . . is violating or has violated, or the agency has reasonable cause to believe that the depository institution or any institution-affiliated party is about to violate, a law, rule, or regulation, or any condition imposed in writing by the agency in connection with the granting of any application or other request by the depository institution or any written agreement entered into with the agency, the agency may issue and serve upon the depository institution or such party a notice of charges in respect thereof. . . . [T]he agency may issue and serve upon the depository institution or the institution-affiliated party an order to cease and desist from any such violation or practice. Such order may, by provisions which may be mandatory or otherwise, require the depository institution or its institution-affiliated parties to cease and desist from the same, and, further, to take affirmative action to correct the conditions resulting from any such violation or practice.

Id. (emphasis added).

The OTS, the FRB, the Comptroller of the Currency, and the FDIC administer this provision.

owed an obligation to the Bank Board, the FDIC or RTC can increase the assets of the thrift's estate available to its creditors.⁹⁵

In these cases, the FDIC or RTC argued that the thrift is a third party beneficiary to an enforceable contract between the Bank Board and the thrift's acquirors, thus making the FDIC or RTC the successor-in-interest.⁹⁶ The regulatory agencies faced two impediments in asserting this claim. First, the success of the third party beneficiary claim depended on the existence of an enforceable contract. Second, the FDIC or RTC had to demonstrate that they were the intended beneficiary of such an agreement.⁹⁷

The least complicated case for the enforcement of a net worth maintenance obligation is when the acquirors and FSLIC entered into a separate agreement or express net worth maintenance obligation.⁹⁸ In the absence of such an agreement, the agencies have relied on various other documents executed at the time of the acquisition to prove the existence of an implied contract.⁹⁹

⁹⁵ 12 U.S.C. § 1821(d)(2)(A)(1) (Supp. V 1993) (providing that the FDIC, as conservator or receiver, succeeds to all rights, titles, powers, and privileges of the insured depository institution); *id.* § 1441a(b)(4)(A) (similar provision applying to RTC).

⁹⁶ The opinions of the three federal courts that have considered this issue form the basis for the discussion that follows. *In re Conner Corp.*, 127 B.R. 775 (E.D.N.C. 1991), *aff'g In re Conner Corp.*, No. 87-01697-M04, 1990 Bankr. LEXIS 1751 (Bankr. E.D.N.C. June 20, 1990); *RTC v. Tetco, Inc.*, 758 F. Supp. 1159 (W.D. Tex. 1990); *FSLIC v. Savers, Inc.*, No. LR-C-89-529, 1989 U.S. Dist. LEXIS 16591 (E.D. Ark. Dec. 13, 1989).

⁹⁷ This second contention may not be as difficult as the first for the agencies to be successful on because at least one court has found that if indeed a contractual obligation exists, it is for the benefit of the insurance fund. The *Savers* court recognized that as between Savers, Inc. (the acquiror) and FSLIC, Savers Federal (the acquired institution) was the intended third-party beneficiary, making the insurance fund the successor in interest. The court, however, denied the regulators' efforts to enforce the contract claim saying that it would appear to be based on an absence of a private right of action, pursuant to 12 C.F.R. § 563.13 to enforce the obligation. *Savers*, 1989 U.S. Dist. LEXIS 16591, at *2-*3.

⁹⁸ Those cases in which the court has enforced an obligation based on the existence of an agreement so labeled include: *Guaranty Fin. Servs., Inc. v. Ryan*, 928 F.2d 994 (11th Cir. 1991); *Flagship Fed. Sav. Bank v. Wall*, 748 F. Supp. 742 (S.D. Cal. 1990); *Century Fed. Sav. Bank v. United States*, 745 F. Supp. 1363 (N.D. Ill. 1990).

⁹⁹ In the typical acquisition, the acquiror, after extensive negotiations with FSLIC, entered into an "assistance agreement." The resulting agreement set forth FSLIC's promised monetary contributions and other contractual responsibilities. The potential acquiror and FSLIC, within statutory and policy constraints, could agree upon various forms of assistance including cash contributions, interest bearing capital rates, indemnification against potential related claims by third parties, guarantees against losses from specific assets acquired, and greater minimum yields on low and nonearning assets. See *DEPOSIT INSURANCE FOR THE NINETIES*, *supra* note 46, at 180-85. The typical agreement also contained an "integration clause" incorporating any contemporaneous regulations, stipulations, or letters between the Bank Board and the acquirors. These contemporaneous letters, resolutions, and stipulations of the Bank Board contain the only express references to the acquiror's maintenance of the subsidiary's net worth. See, e.g., *In re Conner Corp.*, 127 B.R. at 779-80; *Tetco*, 758 F. Supp. at 1162-63; *Savers*, 1989 U.S. Dist. LEXIS 16591 at *1.

There are two documents that the agencies most often rely upon to establish the existence of an enforceable contract. One is the resolution passed by the Bank Board at the time of the acquisition; the other is the commitment letter sent from the acquiror to the regulatory agency agreeing to comply with the insurance regulations. The FDIC and RTC point to language in both documents stating that the institution's net worth is to be maintained "at an amount equal to the higher of five percent of the total liabilities or the amount required by § 563.13 of the Insurance Regulations,"¹⁰⁰ as a statement of the specific obligation.¹⁰¹

The FDIC and RTC's reliance on these documents to establish a contract is misplaced given that the Bank Board executed the documents in its regulatory capacity.¹⁰² In order for the regulatory

¹⁰⁰ The language in the agreement is a verbatim quote of the insurance regulations in place at the time. See 12 C.F.R. § 563.13 (1987).

¹⁰¹ The acquirors argue that the documents are overly vague and too indefinite to be enforceable as contracts because they neither specify the amount of the obligation nor its duration. See *In re Conner Corp.*, 1990 Bankr. LEXIS 1751 at *10 (concluding that Conner "was simply complying with the regulatory requirements"); *Tetco*, 758 F. Supp. at 1163 (finding no "independent contractual obligations"); *Savers*, 1989 U.S. Dist. LEXIS 16591 at *2 (finding "no contract at all"). These same courts noted the absence of documentation to prove the existence of an agreement and found that mutual assent was lacking. See, e.g., *In re Conner Corp.*, 1990 Bankr. LEXIS 1751 at *9 (finding no meeting of the minds); *Tetco*, 758 F. Supp. at 1162-63 (noting that the record surrounding the application procedures was unclear). Courts also disposed of the cases by finding that the federal receiver did not qualify as a third party beneficiary under applicable contract law. See, e.g., *In re Conner Corp.*, 1990 Bankr. LEXIS 1751 at *12-*13; cf. *Savers*, 1989 U.S. Dist. LEXIS 16591 at *3 (reaching a similar result under Arkansas law); *Securities Fed. Sav. v. OTS*, 747 F. Supp. 656 (N.D. Fla. 1990) (finding that an intent to contract existed because the parties entered into extensive negotiations regarding the infusion of capital into the thrift to avoid the appointment of a receiver).

Even if the agreements are not enforceable as contracts, they are the type of regulatory agreements that the Bank Board could require as part of its enforcement action. See *In re Conner Corp.*, 127 B.R. at 779-80 (distinguishing for contract law purposes net worth maintenance obligations imposed pursuant to holding company applications from commitments negotiated in settlement of enforcement actions).

¹⁰² In the "goodwill" cases, the agencies have argued that these same documents do *not* constitute a contract. In certain circumstances, FSLIC granted a goodwill forbearance, which permitted the acquirors to include goodwill, an intangible asset, in the calculation of capital for the purpose of satisfying the institution's regulatory capital requirements. Under the forbearance, an acquiror could amortize goodwill usually for a period of between 25 to 40 years. The agency also agreed to forbear from imposing sanctions if the institution failed to meet its capital requirements under Generally Accepted Accounting Principles ("GAAP"). FIRREA phased out the use of goodwill to satisfy the minimum capital requirements for savings institutions. See 12 U.S.C. § 1464(t)(3)(A) (Supp. V 1993). The acquirors then instituted court actions claiming that FIRREA and its implementing regulations constituted a breach of contract. Although some acquirors had specific documents to show the existence of such an agreement (e.g., FSLIC Assistance Agreements, Forbearance Letters, and Conversion Agreements), many argued that a *de facto* forbearance existed because the transaction was based on GAAP. Essentially, the

orders to represent a contract, there must have been a commercial transaction between the Bank Board and the acquirors. However, the commercial transaction was between the acquiror and the thrift. The Bank Board's role was solely as regulator—to evaluate the holding company's internal and external financial status to ensure that the holding company's ownership would not affect the thrift adversely and to enforce the agreement if necessary. To argue that the provisions of the resolutions are contractually binding on the parent company would mean that the regulatory agency has assumed contractual obligations simply by exercising its regulatory authority.¹⁰³

Federal regulations govern the Bank Board's approval or rejection of acquisition applications. Therefore, when the Bank Board reviews an acquisition application, the regulations constrain the Bank Board's actions. It is artificial to view the terms of these documents relating to the acquisition—the acquisition agreement, the Bank Board resolution, the commitment letter—together or separately as implying contractual terms. The documents do no more than state the governing regulations, making them a regulatory agreement that can be enforced by the appropriate agency,

acquirors argued that the forbearance was more than a statement of regulatory intent regarding accounting treatment. The FDIC and OTS adopted the position that the regulatory statement was not an agreement because it was not executed by both parties, did not contain mutual promises, and was not supported by consideration. *See Transohio Sav. Bank v. OTS*, 967 F.2d 598 (D.C. Cir. 1992); *Carteret Sav. Bank, FA v. OTS*, 963 F.2d 567 (3d Cir. 1992); *Far West Fed. Sav. Bank v. OTS*, 951 F.2d 1093 (9th Cir. 1991); *Guaranty Fin. Servs., Inc. v. Ryan*, 928 F.2d 994 (11th Cir. 1991); *Franklin Fed. Sav. Bank v. OTS*, 927 F.2d 1332 (6th Cir.), *cert. denied*, 112 S.Ct. 370 (1991); *cf. Olympic Fed. Sav. & Loan v. OTS*, 903 F.2d 837 (D.C. Cir. 1990) (finding that there could be no implied in fact contract without express statutory authority which was lacking in FIRREA).

¹⁰³ The commitment letters, which are the acquiror's acknowledgment that the Bank Board's supervisory process binds it, are superfluous. By submitting an application to the Bank Board for approval, the acquiror became subject to the Bank Board's supervisory authority. 12 U.S.C. § 1730a (1988) (repealed 1989). The letters do no more than serve as further acknowledgement that the acquiror, like its subsidiary, is subject to the Bank Board's supervisory powers. *But see Northeast Bancorp v. Board of Governors*, 849 F.2d 1499, 1501 n.1 (D.C. Cir. 1988) (“[T]hese letters . . . are clearly a binding portion of the Board's action on Northeast's application, conditions imposed as part of the Board's duty to consider bank holding company applications under 12 U.S.C. § 1842(c).”) The requirement that the acquirors enter into a net worth maintenance agreement was no more than the acquiror's compliance with the existing regulatory policy. The acquiror, because it was subject to the agency's jurisdiction, was also subject to whatever terms the Bank Board in its regulatory capacity determined were necessary to impose. As the *Savers* court stated: “[A] ‘contract’ to do what one is already required by law to do is really no contract at all.” *Savers*, 1989 U.S. Dist. LEXIS 16591 at *3.

but not a contract that can be enforced by either party in case of a breach.¹⁰⁴

2. FRB

In *MCorp Financial, Inc. v. Board of Governors (MCorp)*,¹⁰⁵ the Fifth Circuit Court of Appeals invalidated the FRB's authority to enforce the source of strength condition against a holding company as unsafe and unsound banking practices. MCorp, a multibank holding company, challenged the authority of the FRB to require it to make capital infusions into its failing subsidiary banks after an acquisition.¹⁰⁶

Federal court review of the FRB's authority to impose the source of strength condition after acquisition occurred for the first time in 1988. MCorp, a multibillion dollar bank holding company that owned twenty-five subsidiary banks in Texas, began experiencing financial difficulties that threatened the subsidiary banks. The parent company had substantial assets which led the FRB to issue a temporary cease and desist order directing MCorp to use all of its assets to provide capital support to its subsidiary banks in need of additional capital.¹⁰⁷ When MCorp failed to comply with the FRB order, the Office of the Comptroller of the Currency ("OCC")¹⁰⁸ declared twenty of MCorp's twenty-five subsidiaries insolvent and closed them. The FRB then initiated an administrative action (a source of strength proceeding) against MCorp claiming that it had failed to give financial support to the five remaining subsidiary

¹⁰⁴ See Alfred C. Aman, Jr., *Bargaining for Justice: An Examination of the Use and Limits of Conditions by the Federal Reserve Board*, 74 IOWA L. REV. 837, 879-98 (1989). Professor Aman argues that administrative agencies use conditions to expand their supervisory powers in areas where the reach of their enforcement powers under the law is unclear. Under this theory, the net worth maintenance agreement is a nonnegotiable term to which the acquiror may either consent or refuse consent under likely penalty of the agency's denial of approval of the acquisition.

¹⁰⁵ 900 F.2d 852 (5th Cir. 1990), *rev'd on jurisdictional grounds*, 502 U.S. 32 (1991).

¹⁰⁶ That policy statement mandated that after approval of the acquisition application, a parent company must agree to use its available managerial and financial resources for the benefit of its failing subsidiary banks. See 52 Fed. Reg. 15,707, 15,708 (1987).

¹⁰⁷ The FRB also issued two other temporary cease-and-desist orders charging that the parent company was engaged in unsafe and unsound banking practices that jeopardized the financial condition of the 25 subsidiary banks. The first order forbid MCorp from declaring or paying any dividends without the prior approval of the Board. The second order forbid MCorp from dissipating any of its nonbank assets without the prior approval of the Board. *MCorp*, 502 U.S. at 34.

¹⁰⁸ The OCC is the chartering agency for national banks. In this capacity, it makes the decision to close a national bank on a finding of insolvency. 12 U.S.C. § 191 (Supp. V 1993).

banks. Within a short time, MCorp filed for voluntary bankruptcy.¹⁰⁹

The federal district court enjoined the FRB from continuing its administrative source of strength proceeding on the ground that the bankruptcy code's automatic stay provision barred the FRB's actions.¹¹⁰ This decision prohibited the FRB from pursuing its "source of strength" proceedings against MCorp and the FRB appealed this decision to the Fifth Circuit Court of Appeals.

On appeal, the Fifth Circuit Court of Appeals partially reversed, holding that judicial review provisions of 12 U.S.C. § 1818 deprived the district court of jurisdiction until the FRB completed the administrative proceedings.¹¹¹ The Fifth Circuit evaluated two grounds of the FRB's alleged authority: (1) unsafe and unsound banking practices,¹¹² and (2) Regulation Y.¹¹³ After evaluating both grounds, the Fifth Circuit concluded that the FRB exceeded its authority when it adopted the source of strength policy statement. Specifically, the court found Regulation Y would require the parent company to waste its corporate assets and the FRB did not have the authority to require that.¹¹⁴

An "unsafe and unsound practice," as defined by this court, would be any action or lack of action that is "contrary to generally accepted standards of prudent operation."¹¹⁵ The court concluded that capital injections on the scale the FRB would require would in turn require MCorp to disregard its own separate corporate status.¹¹⁶ Thus, the court determined that MCorp's refusal to transfer funds to its troubled subsidiaries was not an "unsafe and unsound

¹⁰⁹ MCorp filed a motion for a preliminary injunction against the OTS. The district court ruled that the bankruptcy court had primary jurisdiction over the parent company. *In re MCorp*, 101 B.R. 483 (S.D. Tex. 1989), *rev'd in part and vacated in part sub nom. MCorp Fin., Inc. v. Board of Governors (MCorp)*, 900 F.2d 852 (5th Cir. 1990), *rev'd on jurisdictional grounds*, 502 U.S. 32 (1991).

¹¹⁰ The district court granted MCorp's motion for a preliminary injunction against the Federal Reserve Board. The court reasoned that the bankruptcy court, and not the Federal Reserve Board, must have primary jurisdiction over the company's actions because at that time the company was to have an effective plan of restructuring under the bankruptcy laws. *MCorp*, 101 B.R. at 485-88.

¹¹¹ *MCorp*, 900 F.2d at 854-57.

¹¹² *Id.* at 862-64.

¹¹³ *Id.* at 860-62.

¹¹⁴ *Id.* at 863.

¹¹⁵ *Id.* (quoting *Gulf Fed. Sav. & Loan Ass'n v. FHLBB*, 651 F.2d 259, 264 (5th Cir. 1981), *cert. denied* 458 U.S. 1121 (1982)).

¹¹⁶ *Id.*

practice” because it would, among other things, amount to a wasting of MCorp’s assets violating its duty to its shareholders.¹¹⁷

Under Regulation Y, the court denied the FRB’s assertion that it had authority to take supervisory action to require a holding company to make financial assistance to a troubled subsidiary.¹¹⁸ The court ruled that the FRB has supervisory control over bank holding companies and bank subsidiaries as well as the power to approve the acquisition of banks by a holding company, but the FRB “does not [have] the authority to consider the financial and managerial soundness of subsidiary banks” after issuing an approval of an acquisition to a holding company.¹¹⁹ Thus, the court found that the FRB had exceeded its statutory authority by promulgating and enforcing its source of strength doctrine, as set forth in Regulation Y and the 1987 Policy Statement.¹²⁰

The Fifth Circuit, in a footnote, indicated its approval of net worth maintenance agreements as an appropriate means of implementing the source of strength policy statement.¹²¹ Thus, the court was indicating that the FRB’s source of strength requirement might be acceptable if, like the net worth maintenance agreement, the requirement is imposed as a condition to acquisition rather than simply an arbitrary imposition applied at some subsequent point of difficulty.¹²²

3. *Present Status of the Source of Strength Condition and the Net Worth Maintenance Agreement*

Each of the regulatory agencies—the FRB, OTS, FDIC, and RTC—has experienced difficulty enforcing parental guarantees.

¹¹⁷ *Id.*

¹¹⁸ The Fifth Circuit also expressly rejected the FRB’s interpretation under a *Chevron* analysis. *Id.* at 862-64. The court specifically found that no statute authorized the FRB to require a bank holding company to make capital infusions into its subsidiary banks. *Id.* at 863; see also Cass R. Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405, 444-61 (1989). Professor Sunstein argues that a *Chevron* analysis does not apply to an administrative agency’s determination of its own jurisdiction.

¹¹⁹ *MCorp*, 900 F.2d at 861.

¹²⁰ *Id.* at 864.

¹²¹ *Id.* at 862 n.5.

¹²² The FRB appealed to the Supreme Court. See 502 U.S. at 32. In its review, the Court did not reach the merits of the applicability of the source of strength condition. Instead, it found that the appellate court did not have jurisdiction to consider the merits of the parent company’s claim. Citing the statutory scheme found in 12 U.S.C. § 1818(i) (1988), the Court held that the FRB administrative proceeding was not final, thereby precluding review of either the regulation or its application. *MCorp*, 502 U.S. at 42-45. For a recent court’s view of the FRB’s authority to regulate the activities of a holding company’s subsidiary banks, see *Citicorp v. Board of Governors*, 936 F.2d 66, 73-76 (2d Cir. 1991).

The FRB and the Bank Board have relied on identical statutory language to create similar parental guarantees. The FRB and OTS have been unsuccessful in defending court challenges to the enforceability of parental guarantees.¹²³

For the FRB, when the source of strength condition or net worth maintenance agreement can be imposed on the parent company, such as MCorp, is an issue of notice and of whether the statute provides sufficient basis for the FRB to require the holding company to violate its duty to shareholders without more notice. To the extent that the holding company should be subjected to continuous scrutiny of its financial viability by the FRB, the regulatory scheme, in addition to the statutory language, should so specify. Quite simply, the regulations and the statute should explicitly require the holding company to make these infusions. Sufficient notice would require no more than imposing the condition on the acquirors at the time of the acquisition. Without imposing this condition prior to requiring the capital infusion, a court reviewing the FRB's actions, and adopting the reasoning of the Fifth Circuit, might find that a fiduciary duty to shareholders and corporate separateness would be violated when prior to the FRB's issuing an administrative order, a holding company has not agreed specifically to make additional capital infusions.¹²⁴

The Bank Board's use of a net worth maintenance agreement seems to resolve the notice issue in that the agency's regulatory scheme makes clear that continuing assessment of the holding company's viability will occur.¹²⁵ However, this still may not make the agreements enforceable. Courts have been reluctant to find im-

¹²³ The OTS has successfully enforced obligations that are express, usually in separately labeled agreements. See *supra* note 117.

¹²⁴ The FRB continues to evaluate applications of holding companies for the acquisition of a bank under the source of strength doctrine. The FRB has rejected application wholly or in part on the basis of the source of strength doctrine. See *FNBA Holding Co.*, 75 Fed. Res. Bull. 711 (1989) (application to become an holding company denied because plan to acquire a bank was financially unsound given the bank's current debt obligation to its present holding company); *St. Croix Valley Bancshares, Inc.*, 75 Fed. Res. Bull. 575 (1989) (holding company's application to purchase another holding company rejected because projections about future performance were overly optimistic and would affect holding company's future ability to raise capital); *Croesus Partners I, Inc.*, 72 Fed. Res. Bull. 45, 46 (1986) (application to become a bank holding company rejected because applicant "would not have sufficient financial flexibility to serve as a source of financial strength to its subsidiary banks in the future").

¹²⁵ The 1988 Policy statement represented a dramatic change in FSLIC's regulatory policy. The Bank Board required the acquiror to enter into a net worth maintenance agreement as a condition of acquisition only if the institution being acquired failed to meet fully phased-in capital requirements at the time of the acquisition. See *Thrift Bull. No. 5*, *supra* note 75.

plied contracts and have found that absent a document labeled "net worth maintenance agreement," there is no enforceable contract between the Bank Board and the acquiring holding company. Courts would perhaps be more willing to find an implied obligation if the regulatory scheme made the obligation a specific condition of acquisition rather than an arbitrary condition imposed when a subsidiary is experiencing a financial crisis.¹²⁶

Even when the Bank Board made it clear at the time of acquisition that capital infusions may be required as a condition for approval, holding companies challenged the condition on the grounds that it exceeded the statutory authority of the Bank Board. The Bank Board and OTS's estoppel defenses against these claims have been rejected by those courts that have heard them. *See, e.g.,* *Wachtel v. OTS*, 982 F.2d 581, 586 (D.C. Cir. 1993) (holding company and shareholders were not equitably estopped from challenging the order of the OTS on the theory that the savings bank had received regulatory approval only after agreeing to net worth conditions); *see also In re Conner Corporation*, 127 B.R. 775 (E.D.N.C. 1991) (agreement by debtor-holding company to maintain net worth of savings bank at the level required by deposit insurance regulation does not constitute an enforceable contract between the debtor and the FHLBB); *RTC v. Tetco, Inc.*, 758 F. Supp. 1159 (W.D. Tex. 1990) (net worth maintenance stipulation included in the FHLBB's resolution approving the holding company's application for deposit insurance is not a contract condition and no private right of action exists to enforce the regulatory condition under SLHCA or Change in Control Act).

¹²⁶ OTS has been successful in bringing administrative actions against acquirors in order to enforce net worth maintenance agreements of now insolvent thrifts. *See In re Akin*, OTS Order No. 90-4009 (Dec. 24, 1990), *aff'd*, 950 F.2d 1180, 1181 (5th Cir. 1992) (OTS enforcement proceeding against an individual shareholder who had agreed in writing to a capital maintenance commitment in order to forestall an earlier enforcement action against a different thrift in which the shareholder had a controlling interest; OTS ordered individual shareholder to make payment of \$19.6 million); *In re Wachtel*, OTS Order No. AP 91-88 (Nov. 20, 1991), *petition for review granted*, 982 F.2d 581, 582 (D.C. Cir. 1993) (OTS enforcement proceeding against several defendants, including a holding company, that had acceded to a capital maintenance obligation imposed as a condition to the Bank Board's initial approval of the company's acquisition of its thrift subsidiary in 1977; OTS ordered the defendants to make payments of \$5.3 million into federal receivership); *see also In re Firstcorp, Inc.*, OTS Order No. AP 92-125, 1992 LEXIS 107, at *32 (Nov. 20, 1992) (ordering a \$45 million payment under a capital maintenance commitment).

These enforcement proceedings are based on 12 U.S.C. § 1818(b)(1) (Supp. V 1993), which allows OTS to initiate a cease and desist proceeding to enforce a written condition or agreement. *See Kaneb Servs., Inc. v. FSLIC*, 650 F.2d 78, 82-83 (5th Cir. 1981) (FSLIC's authority to impose a dividend restriction as a condition of approval for the acquisition of a savings and loan subsidiary by a holding company upheld under the broad authority of FSLIC to regulate acquisitions by the holding company).

To support the order to cease and desist, the OTS must show that, because of the acquiror's failure to perform according to either the written agreement or condition to maintain the subsidiary's net worth, the acquiror has been unjustly enriched or has shown a reckless disregard for its legal obligations. OTS's remedy allows the agency to require the institution or the party to cease and desist, make restitution, or engage in "affirmative action." Affirmative action may include giving OTS the power to: restrict the growth of the institution; dispose of any loan or asset involved; rescind agreements or contracts; employ qualified officers or employees; or take such other action as the banking agency determines to be appropriate. 12 U.S.C. § 1818(b)(6) (Supp. V 1993).

IV. THE PROMPT CORRECTIVE ACTION PROVISION

Unlike the net worth maintenance agreement or the source of strength condition, the prompt corrective action provision imposes a capital maintenance obligation¹²⁷ on all parent companies and specifies when the parental guarantee becomes effective, as well as the amount of the financial commitment.¹²⁸ It is intended to remedy the weaknesses of the net worth maintenance agreement and the source of strength condition by creating an obligation that is easily enforced.

Section 38(e) of FDICIA sets forth the financial circumstances under which a parent holding company must provide a capital infusion into its bank subsidiary.¹²⁹ The basic premise of the regulatory scheme is that a low level of capital serves as neutral evidence that an institution is financially troubled. Thus, under the new statutory

¹²⁷ FDICIA uses the term "capital restoration plan." See 12 U.S.C. § 1831o(b)(2)(C) (Supp. V 1993). Under FDICIA, when regulators classify a bank as undercapitalized, several discretionary and mandatory corrective intervention actions take place. These corrective interventions increase in severity as the institution's undercapitalization becomes more critical. *Id.* § 1831o(f)-(i).

¹²⁸ All federally insured banks must be categorized according to their capital level as determined by the relevant capital measures. See *supra* note 15.

An undercapitalized institution must submit a capital restoration plan to its primary federal regulator in a timely manner. See 12 U.S.C. § 1831o(e)(2)(A) (Supp. V 1993). The plan must explain in detail how the institution will rebuild capital, specifying year-to-year target levels for capital growth. See *id.* § 1831o(e)(2)(B). The plan must be based on realistic assumptions, describe activities that are likely to succeed, and not expose the institution to appreciably increased risk. The plan must also describe the types and levels of activities in which the institution will engage and contain such other information as regulators require. See *id.* § 1831o(e)(2)(C)(i).

¹²⁹ The parent company is identified under the statute as the "company having control of the institution." *Id.* § 1831o(e)(2)(C). As a condition for obtaining the regulator's approval of the recapitalization plan, each company having control of an undercapitalized institution must: (1) guarantee that the undercapitalized institution will comply with its recapitalization plan until it has been adequately capitalized on average during each of four consecutive calendar quarters; and (2) provide appropriate assurances of performance. See *id.* § 1831o(e)(2)(C)(ii).

The statute limits the amount of the parent company's liability on its guarantee to the lesser of: (1) 5% of the depository institution's total assets at the time it becomes undercapitalized, or (b) the amount necessary to bring the institution into compliance with all capital standards. See *id.* § 1831o(e)(2)(E)(i); see also 12 C.F.R. § 325.104(h)(1)(i)(B) (1994).

If there are two or more parent companies, their aggregate liability is similarly limited to the lesser of 5% of the troubled institution's assets or the compliance total. 12 U.S.C. § 1831o(e)(2)(E)(i) (Supp. V 1994). Only companies having control of an undercapitalized insured depository institution are required to issue the guarantee and to be liable on a capital restoration plan; other affiliates are not required to guarantee the plan. See *id.* § 1831o(e)(2)(E)(ii).

To ensure a sufficient guarantee, the parent company must also provide "appropriate assurances of performance." *Id.* § 1831o(e)(2)(C)(ii).

provision, capital serves as an indicator that early intervention is needed to resolve the problems of troubled institutions with minimal loss to the insurance fund.¹³⁰

Another articulated premise supporting this statutory provision is that control shareholders, such as parent companies, have a greater equity share in the institution and, therefore, have more of an interest than the typical shareholder in monitoring the activities of the management.¹³¹ When an institution's capital level is low, management is more likely to take risks with the institution's deposits in order to make a profit.¹³² Congress and the FDIC have recognized that a subsidiary bank's parent company and its shareholders that receive financial assistance from the insurance fund are unintended but significant beneficiaries of that financial assistance.¹³³

The prompt corrective action provision has two different goals. First, there is the cash infusion, which is an initial effort to stabilize a solvent, but troubled bank subsidiary. The cash assistance required from the parent company is an early effort to restructure and recapitalize the troubled institution without the financial assistance of the FDIC.¹³⁴ Whether the recapitalization will succeed is uncertain at the time of the infusion.¹³⁵ When the cash infusion is needed, existing shareholders' interests already are

¹³⁰ Under the statute, an undercapitalized institution must submit within 45 days a capital restoration plan and the regulatory agency must review that plan within 60 days. 12 U.S.C. § 1831o(e)(2)(D)(i)-(ii) (Supp. V 1993); see also Richard S. Carnell, *Prompt Corrective Action Under the FDIC Improvement Act of 1991*, in LITIGATING FOR AND AGAINST THE FDIC AND THE RTC (PLI Com. L. & Prac. Course Handbook Series No. 625, 1992); Nina Cortell, *Aspects of Financial Institutions Exposure*, in RESPONSIBILITY OF THE CORPORATE PARENT FOR THE ACTIVITIES OF A SUBSIDIARY BANKS (PLI Com. L. & Prac. Course Handbook Series No. 706, 1990).

¹³¹ The problem of moral hazard of deposit insurance increases the opportunities for managers and owners of a financial institution to engage in risky activity because the losses created by the risky behavior will be absorbed by the deposit insurance fund. See *supra* note 21. The statute prevents an institution from paying dividends or management fees that cause the institution to become undercapitalized as a result of the distribution. See 12 U.S.C. § 1831o(d)(1)(A) (Supp. V 1993). As the Senate Report explains, this provision "protects the insurance fund by preventing institutions from depleting their capital for the benefit of their shareholders." See S. REP. NO. 167, 102d Cong., 1st Sess. 35 (1991).

¹³² See MODERNIZING THE FINANCIAL SYSTEM, *supra* note 14, at X-1 to -5 (drawing a corollary between low supervisory ratings and banks that eventually fail).

¹³³ Low capital levels increase incentives for banks to act recklessly, not prudently, because owners have nothing to lose and everything to win by gambling with insured deposits. See S. REP. NO. 167, 102d Cong., 1st Sess. 32-33 (1991). The capital infusion provision is designed to induce the parent company to decide promptly whether to recapitalize the institution, sell it, or stand behind it until it recovers. *Id.* at 35.

¹³⁴ See MODERNIZING THE FINANCIAL SYSTEM, *supra* note 14, at X-1.

¹³⁵ See discussion of *TAB Holding, Inc.*, *infra* notes 169-75 and accompanying text.

diluted.¹³⁶ Optimally, the infusion may provide a chance to restructure and salvage some value for creditors and perhaps shareholders. If stabilization does not occur, the parent company can try to arrange a more permanent solution with the FDIC.¹³⁷

The second goal of the provision is to allow the parent company to make an early, quick decision about its future plans for the financially troubled subsidiary. If the parent company decides that it does not want the subsidiary to remain financially viable, the parent company may choose not to guarantee the subsidiary's compliance with its capital restoration plan.¹³⁸ This allows the parent company to voluntarily liquidate the bank or seek its closure.

FDICIA sets the obligation of the parent company to make a cash infusion into its subsidiary as the least amount needed to bring the depository institution into compliance with all capital standards as of the time it fails to comply with its capital restoration plan, or five percent of the institution's assets at the time it became undercapitalized.¹³⁹

On several key issues, the statutory language and the implementing regulations are unclear. These issues of vagueness concern the obligations of the parent company as well as the protections that should be afforded an institution that is found to be capital deficient. These are areas ripe for administrative overreach if not addressed. One of the goals of the FDIC is to take away the banking regulators' discretion when a financial institution becomes financially troubled. However, the vagueness of the statute and regulations may give regulators the kind of discretion that results in harsh enforcement. This will result in disadvantaging the

¹³⁶ The cash infusion from the parent company presents the opposite effect of the condition of moral hazard—shareholders risk their funds in the hopes that the institution will return to profitability.

¹³⁷ This is the most viable alternative for the FDIC because it may either reduce costs or result in a "costless" solution. See MODERNIZING THE FINANCIAL SYSTEM, *supra* note 14, at X-21 to -22. Under the FDIC's traditional resolution alternatives, creditors may receive reimbursement from the insurance fund. See discussion of the FDIC's resolution alternatives *infra* part V.

¹³⁸ 12 U.S.C. § 1831o(e)(2)(C)(ii) (Supp. V 1993). If the parent company fails to guarantee its subsidiary bank's capital plan, it places the bank subsidiary in noncompliance with the minimum capital requirements.

¹³⁹ The statute requires that the parent company infuse the amount necessary to bring the institution into capital compliance "as of the time the institution fails to comply with [its capital restoration plan.]" *Id.* § 1831o(e)(2)(E)(i)(II) (Supp. V 1993). Strategically, the parent company may choose not to guarantee the bank subsidiary's plan so as to limit the amount of its liability. The parental guarantee is limited to the amount necessary to bring the institution into compliance at the time that the subsidiary bank fails to comply with the capital restoration plan. *Id.*

regulated entities—the parent company and the troubled financial institution.¹⁴⁰

The statutory language is vague on several significant issues of parental liability. For example, the statutory language is unclear as to whether a parent company is only required to make a single capital infusion.¹⁴¹ The statute might require the parent company's obligation to continue indefinitely. Consider an undercapitalized financial institution that submits an acceptable capital restoration plan to the regulatory agency and is adequately recapitalized with the assistance of cash infusions from the parent company for the required four consecutive quarters. Three quarters later, in quarter seven, the financial institution becomes undercapitalized again. The regulations seem to require the institution to submit another capital restoration plan, and for the parent company to guarantee again the institution's performance with the plan for four consecutive quarters.¹⁴²

Similarly, an issue that needs clarity is the responsibility of a parent company when multiple subsidiary banks need financial assistance. Without establishing options for the parent company, the regulations once again give the regulators much discretion in framing a remedy to address this dilemma. This type of discretion may result in an appropriate remedy, and yet, one that was not contemplated under the statutory scheme.¹⁴³

The institution that is declared undercapitalized by the agency should also be afforded more protection from administrative abuse. There is currently no procedure in the regulations that pro-

¹⁴⁰ See Lawrence G. Baxter, *Administrative and Judicial Review of Prompt Corrective Action Decisions by Federal Banking Regulators*, 7 ADMIN. L.J. 505, 567-73 (1993). Professor Baxter identifies several areas in which enforcing the prompt corrective action provision is unclear and therefore may conflict with other established enforcement procedures. He argues that a lack of clarity in these areas may lead to administrative overreach by the enforcing agencies. The troublesome areas of vagueness include the appointment of a receiver, lack of judicial review for the capital classifications, and existing safety and soundness regulations.

¹⁴¹ This issue of continuous liability no doubt raises issues of whether the board of directors of the holding company is exercising its "independent business judgment." See Leonard Bierman & Donald R. Fraiser, *The "Source of Strength" Doctrine: Formulating the Future of America's Financial Markets*, 12 ANN. REV. BANKING L. 269, 281-84 (1993) (recommending the repeal of the prompt corrective action provision and replacing it with alternative reforms of the deposit insurance system, interstate banking, market value accounting, and "early" bank closure).

¹⁴² This scenario could continue *ad infinitum*. However, assuming that the parent company is committed to restoring the subsidiary to financial viability, it may be able to enter into a contractual agreement with the appropriate regulatory agency to establish reasonable limits on continuous liability. *Id.* at 278.

¹⁴³ See Aman, *supra* note 104, at 883.

vides for administrative review of the determination of undercapitalization. More importantly, there is no requirement that the agency create a substantial record from which that determination can be made. This lack of review means that regulators, following the congressional mandate for quick intervention, may unfairly take control of an institution. Without an administrative review process in place, if the regulatory agency makes an error, the institution loses irreparably.¹⁴⁴ Finally, all institutions subject to the prompt corrective action benefit if there is uniformity among the various regulatory agencies authorized to enforce this provision.¹⁴⁵

Under the statutory scheme, the parent company is not subject to any liability should the institution become insolvent without having received cash infusions from the parent. The absence of this key provision makes the statute an ineffective remedy for resolving the problem of undercapitalized institutions. Undoubtedly, the congressional intention in establishing an early intervention remedy like prompt corrective action was to allow the parent company to make an early decision about whether it would stand behind a banking subsidiary or allow it to fail.¹⁴⁶ However, this is an ineffective and unfair solution in those situations in which a parent company may have exercised control over the subsidiary in such a way that it has become undercapitalized. When it can be shown, by applying the tests establishing economic identity discussed in Part VI that a parent company has manipulated an un-

¹⁴⁴ When the chartering agency appoints a conservator or receiver, the courts have long recognized that the agencies must act swiftly to avoid further dissipation of assets and to minimize the public's perception of harm in the financial industry. See, e.g., *Telegraph Sav. & Loan Ass'n v. FSLIC*, 564 F. Supp. 862, 873 (N.D. Ill. 1981), *aff'd sub. nom.* *Telegraph Sav. & Loan Ass'n v. Schilling*, 703 F.2d 1019 (7th Cir.), *cert. denied*, 464 U.S. 992 (1983). However, in those situations, there is an opportunity for the court to review the agency's decision. The institution may file a challenge to the appointment in federal district court resulting in judicial review of the agency's factual findings supporting that decision. See 12 U.S.C. § 203(b)(1) (Supp. V 1993) (allowing national banks to challenge appointment of conservator within 20 days); *id.* § 1821(c)(7) (allowing federally insured state banks to challenge appointment of conservator or receiver within 30 days); *id.* § 1464(d)(2)(B) (allowing federally insured thrifts to challenge appointment of conservator or receiver within 30 days); see also *Baxter*, *supra* note 140, at 563-65. This after-the-fact determination justifies the expedient action of the regulators and satisfies the institution's due process concern. See *Fahey v. Mallonee*, 332 U.S. 245, 253-54 (1947); *Haralson v. FHLBB*, 837 F.2d 1123, 1126 (D.C. Cir. 1988) ([T]he fact that judicial review is available only after the fact does not . . . render that judicial review constitutionally inadequate.)

¹⁴⁵ The statute gives enforcement authority to "[e]ach appropriate Federal banking agency." 12 U.S.C. § 1831o(a)(2) (Supp. V 1993); see also *Jamie C. Mann & Barbara J. Ellis*, *Developments in Banking Law: 1992*, 12 ANN. REV. BANKING L. 1 (1992) (discussing the need for concerted efforts among the regulatory agencies to ensure fairness in administration of regulations and procedures).

¹⁴⁶ See *supra* note 137.

dercapitalized banking subsidiary's capital position in such a manner that a healthy banking subsidiary benefits, the parent company should be held accountable. The only way to make the parent company accountable is to take away its discretion to make a capital infusion when the institution becomes undercapitalized under the prompt corrective action standards. Consolidation of the undercapitalized and healthy banking subsidiaries is a better alternative than the capital infusion mandated by the prompt corrective action provision to address the problem of parent company control and to protect the resources of the insurance fund.

V. THE RESOLUTION OF FINANCIALLY TROUBLED FINANCIAL INSTITUTIONS

Parental guarantees, because they are mandated by statute, become an essential element of the FDIC's use of its regulatory enforcement powers to resolve troubled financial institutions. Although banks within a multibank holding company are allowed to transfer funds among themselves,¹⁴⁷ it is the FDIC that must pay for the losses when, as single units, the institutions fail.¹⁴⁸ The strategy of resolving the financial problems of banks in a multibank holding company presents a peculiar problem: How to observe the formalities of limited liability even though the entities conduct business as though they are a common corporate unit. The impact of interaffiliate lending and captive funding both affect the alternatives that the FDIC must choose from in resolving the problem of providing financial assistance within a multibank holding system. This Part discusses the traditional ways in which the FDIC has provided financial institution packages to multibank holding company systems and how those packages have created unavoidable losses to the insurance fund.

A. *Resolution Alternatives*

The FDIC has a menu of five alternatives from which to choose when an institution threatens failure. The FDIC may arrange: (1) a purchase and assumption transaction; (2) open bank assistance; (3) a deposit pay-off; (4) an insured deposit transfer; or (5) establish a bridge bank. The purchase and assumption transaction and open

¹⁴⁷ 12 U.S.C. § 371c-1(a) (Supp. V 1993). The rules governing interaffiliate transactions permit some transactions without the prior approval of the regulatory agencies. See discussion *supra* part II.C.

¹⁴⁸ See DEPOSIT INSURANCE FOR THE NINETIES, *supra* note 46, at 227-29 (describing the difficulties associated with problem banks in multibank holding companies).

bank assistance are usually the most efficient and least costly alternatives.¹⁴⁹

1. *The Purchase and Assumption Transaction*

In a purchase and assumption transaction, some or all of a failed bank's assets are transferred to an acquiring institution. The acquiring institution enters into a bidding process with the FDIC. The acquirer, in effect, merges with the insolvent bank and assumes all of the deposits and general creditor claims. The acquirer also receives all of the performing assets of the failed bank. The FDIC makes an offsetting cash payment and also holds all of the nonperforming assets to liquidate them.¹⁵⁰

2. *Open Bank Assistance*

In an open bank assistance transaction, the FDIC makes a cash advance or a "loan" to the financial institution.¹⁵¹ In order to receive the assistance, the executive management, directors, shareholders, and subordinated debt holders of the holding company must have suffered a financial impact comparable to what would have occurred if the bank had actually closed. This means that a bank holding company, and that holding company's creditors, should receive no more than they would be entitled to if the failed bank's assets were liquidated in a deposit pay-off. Open bank assistance is similar to a purchase and assumption transaction, with one major difference—the open bank assistance occurs before the failing bank is technically insolvent. Depositors and general creditors are protected against loss. Additionally, as in a purchase and assumption transaction, management is usually replaced, bank stockholders lose their investment, and if a holding company is involved, creditors are not protected by the FDIC.¹⁵²

¹⁴⁹ The FDIC is required by statute to choose the least costly alternative. See 12 U.S.C. § 1823(c)(4)(A) (Supp. V 1993). Prior to passage of FDICIA in 1991, regulators were free to ignore that restriction if "the continued operation of [a defaulting bank] . . . [was] essential to provide adequate banking services in the community." 12 U.S.C. § 1823(c)(4)(A) (Supp. II 1990) (repealed 1991) (emphasis added). A finding of "essentiality" was required only if the costs of assisting a bank exceeded the cost of closing or liquidating it. *Id.* § 1823(c)(4)(A)(ii).

¹⁵⁰ See MODERNIZING THE FINANCIAL SYSTEM, *supra* note 14, at I-30 to -31.

¹⁵¹ The FDIC is authorized to provide open bank assistance "in its sole discretion and upon such terms and conditions as . . . [it] may prescribe." 12 U.S.C. § 1823(c)(1) (1988 & Supp. V 1994); see also MODERNIZING THE FINANCIAL SYSTEM, *supra* note 14, at I-34.

¹⁵² The terms and conditions for open bank assistance were established in the FDIC's 1983 policy statement. 48 Fed. Reg. 38,669 (1983). It provided that the FDIC "generally will not approve any proposal requesting assistance . . . unless . . . [t]he financial impact on executive management, directors, shareholders and subordinated debt holders is compara-

3. Deposit Pay-Off

The only way that affiliated banks in a multibank holding system can share in the losses is to handle the insolvent bank's failure as a deposit pay-off or an insured deposit transfer. These approaches are generally more disruptive and costlier.¹⁵³160

In a deposit pay-off, the failed institution is declared insolvent and a receiver is appointed. All insured deposits are paid off. Uninsured depositors do not receive the full amount of their deposits and become general creditors of the receivership estate. The FDIC also becomes a general creditor for the amount advanced to pay off insured depositors.¹⁵⁴ A deposit pay-off limits the FDIC's losses

ble to what would have occurred if the bank had actually closed." *Id.* at 38,670. This policy implements the FDIC's statutory duty to maintain stability in the banking system and to preserve the Insurance Fund. *See* 12 U.S.C. § 1823(c)(1)(C); *id.* § 1823(c)(2)(B)(iii); *id.* § 1823(c)(4)(A) (Supp. V 1993).

The FDIC revised its policy statement in late 1986 to reflect what then-Chairman William Seidman referred to as the "increasing supply of failed and failing banks . . . [which are] failures of units in multibank holding companies and one-bank holding companies, large and small." *See* L. William Seidman, *Perspectives on Open Bank Assistance*, Address Before the Government Relations Committee, Association of Bank Holding Companies (Sept. 17, 1986), in *THE THRIFT INDUSTRY RESTRUCTURED: THE NEW REGULATORS AND OPPORTUNITIES FOR THE FUTURE* 181, 184 (PLI Com. L. & Prac. Course Handbook Series No. 508, 1989). That revision stated that "except where there are compelling reasons to the contrary . . . [t]he financial effect on common shareholders and holders of material amounts of subordinated debt and/or preferred stock of the failing bank must approximate the effect which would have occurred had the assisted bank failed." 51 Fed. Reg. 44,122, 44,122-23 (1986). It also made clear that in order to preserve the insurance fund and where an assisted bank is a subsidiary, an assistance proposal should be structured such that the impact on directors, management, shareholders and creditors of the holding company approximates what would be expected had the assisted subsidiary bank failed . . . and . . . available resources from the holding company and its other banks and/or nonbank subsidiaries are used to make significant contribution toward minimizing the financial exposure of the FDIC.

Id. at 44,123.

¹⁵³ Neither of these alternative approaches would fully compensate the affiliate lender. Besides, the FDIC usually rejects both of these because neither of them presents a least cost alternative, which the agency is statutorily mandated to follow. *See* 12 U.S.C. § 1823(c)(4) (Supp. V 1993); *see also* DEPOSIT INSURANCE FOR THE NINETIES, *supra* note 46, at 228.

In a revised policy statement issued in 1988, the FDIC specifically addressed and called for "common shareholders and holders of material amounts of subordinated debt and/or preferred stock of the failing bank [to] approximate the financial effect which would have occurred had the assisted bank failed." 51 Fed. Reg. 44,122, 44,123 (1986).

Then-FDIC Chairman William Seidman identified the crux of the problem. When federal financial assistance is provided in what he termed "holding company situations . . . there is an obligation on the part of the whole of the organization to the health of each affiliate. The failure of one bank within a holding company could well lead to the failure of other banks in the organization. The problem should not be viewed on a stand-alone basis." Seidman, *supra* note 152, at 184.

¹⁵⁴ *See* MODERNIZING THE FINANCIAL SYSTEM, *supra* note 14, at I-32.

because its exposure is to insured depositors only. Deposit pay-offs tend to promote depositor discipline because large, uninsured depositors are not fully compensated when the bank fails.¹⁵⁵ They are more disruptive to the local economy because the FDIC freezes the uninsured funds while it recovers the receivership amounts.¹⁵⁶

4. *Insured Deposit Transfer*

An insured deposit pay-off is a modification of the deposit pay-off alternative. The failed institution is declared insolvent and the FDIC is appointed as receiver. The potential acquiring institution submits a bid to the FDIC for the purchase of insured deposits and certain assets. The insolvent and healthy institutions then merge. To ease the disruptiveness of a straight deposit pay-off, the FDIC makes a conservative estimate of the receivership recoveries and issues a cash advance to the acquirors. The acquiror, acting as an agent of the FDIC, makes immediate payments to the uninsured depositors. The acquiring institution does not automatically assume the deposit accounts. Instead, the depositors have a specified time within which to notify the acquiror that they wish to retain their accounts with the acquirors.

5. *Bridge Bank*

Beginning in 1987, the FDIC began using a transitional transaction, a "bridge bank,"¹⁵⁷ to stabilize the operations of an insolvent institution. A bridge bank is a temporary institution that assumes the assets and some of the liabilities of the failed institution through a purchase and assumption agreement. The FDIC then arranges for a permanent acquisition by a healthy institution.

The bridge bank has several significant advantages. First, for the public, it is less disruptive to the community because the bridge bank, after assuming the failed bank's obligations, is able to reopen immediately. For the insurance fund, it is a way to control the costs of the institution's failure. This is because uninsured depositors, nondeposit creditors, holding company creditors, and shareholders

¹⁵⁵ This alternative for deposit accounts is chosen when potential acquirors are unwilling to pay a premium sufficient to pass the FDIC's cost test and therefore the agency does not use a purchase and assumption transaction. *Id.*

¹⁵⁶ *Id.*

¹⁵⁷ 12 U.S.C. § 1821(n) (Supp. V 1993).

are not compensated from the insurance fund, but instead lose their investment.¹⁵⁸

B. *The Texas Paradigms: FirstRepublic and TAB*

When a multibank holding system threatens failure, the FDIC is concerned about the erosion of public confidence. Although the regulators evaluate the alternatives for failure resolution of any financial institution based upon the potential adverse impact on the economy, they choose a resolution that is perceived as less disruptive although those alternatives may fully compensate affiliated subsidiaries and creditors.¹⁵⁹

The rescue methods used by the FDIC to resolve the failures of the subsidiary banks of Texas American Bancshares and First RepublicBank Corporation, multibank systems located in Texas, are illustrative of the legal issues that the FDIC faces in structuring a transaction that separates the obligations owed to affiliated parties who may have contributed to the institution's insolvency.

Texas is the chosen example because the state's banks operate under a system of unit banking. Due to state imposed restrictions on branch banking in Texas, the banking industry is organized as holding company structures with separately incorporated banking subsidiaries. Although these situations will occur only in states that have similar restrictions on branch banking, they are germane because they highlight the flaws in the regulatory scheme that sanction misconduct by the controlling parent company. As discussed below, uninsured creditors sued the FDIC, challenging the financial assistance package that did not fully compensate them. In these situations, the permissive regulatory system allowed the managers of the institutions to amass massive losses without sufficient safeguards to protect the federal deposit insurance fund.

1. *First Republic*

The First RepublicBank Corporation ("FRBC") and First United Bancorporation, Inc. were bank holding companies that owned a system of 41 banks located primarily throughout the state of Texas. They also owned various nonbank subsidiaries. FRBC controlled and operated its network of subsidiary banks as if it were a single bank with branches.¹⁶⁰ The subsidiary bank in Dallas

¹⁵⁸ See MODERNIZING THE FINANCIAL SYSTEM, *supra* note 14, at I-33.

¹⁵⁹ See *supra* text accompanying notes 59-62.

¹⁶⁰ FRBC and its wholly-owned subsidiary, IFRB, acknowledged that they ran the affiliated corporations and the bank subsidiaries as one banking system. In aggregate, the

was the lead bank in the FRBC system. This meant that the other subsidiary banks raised deposits, and advanced them to the Dallas bank, which had huge lending activity.¹⁶¹

In late January 1988, FRBC publicly announced that \$3.9 billion, or one percent, of the loans in the FRBC system were nonperforming and that it had suffered a fourth quarter loss of \$347 million, bringing its 1987 losses to a total of \$656 million. The situation continued to deteriorate until depositor concerns about the condition of FRBC led to a massive withdrawal of deposits.¹⁶²

FRBC requested financial assistance from the FDIC in March 1988.¹⁶³ Massive federal borrowing proved insufficient to solve the problem, and publicity about the FRBC System's distressed financial condition only exacerbated withdrawals. By July 1988, the FRBC system was again in dire financial straits and on the verge of collapse. The OCC declared FRBC subsidiary banks insolvent, and appointed the FDIC receiver of the failed subsidiary banks.¹⁶⁴ The FDIC provided \$1 billion in financial assistance to Dallas and Houston banks. The FDIC requested that the holding company and the subsidiary banks enter into a contract to guarantee that the loans would be repaid.¹⁶⁵ FRBC and IFRB filed voluntary petitions under Chapter 11.¹⁶⁶ The FDIC then filed proofs of claim against the parent companies based on the \$1 billion guarantee.

The creditors of FRBC filed a lawsuit against the FDIC challenging the assistance package.¹⁶⁷ Specifically, the creditors alleged

FRBC system had over \$28 billion in assets and accounted for 20% of the commercial lending in Texas through some 125,000 borrowers with over \$90 billion in unfunded loan commitments. The FRBC system also had 25,000 trust department customers for which it administered \$50 billion in assets, 2.2 million deposit accounts, and over 1,000 correspondent bank relationships throughout the country. Brief for FDIC at 3-4, *Senior Unsecured Creditors' Comm. of First RepublicBank Corp. v. FDIC*, 749 F. Supp. 758 (N.D. Tex. 1990) (No. CA-3-88-2871-D).

¹⁶¹ By March 1989, the unsecured debt which the Dallas Bank owed its sister banks had increased to over \$6 billion. *Id.* at 4.

¹⁶² The Dallas bank alone lost \$599 million of deposits in a five-day period and the FRBC System lost more than \$1.8 billion in deposits during the first weeks of 1988. By March 1988, the FRBC System was on the verge of financial collapse. *Id.*

¹⁶³ At the time of that request, FRBC had tapped its emergency \$2 billion line of credit from a group of banks, thus exhausting its private sector sources of liquidity. To repay these loans and cover the continuing depositor runs, the Dallas bank borrowed \$2.6 billion at the "discount window" of the Federal Reserve Bank of Dallas. *Id.* at 5.

¹⁶⁴ A purchase and assumption transaction was later arranged with NCNB Corporation. See *Senior Unsecured Creditors' Comm. of First RepublicBank Corp. v. FDIC*, 749 F.2d 758, 762 (N.D. Tex. 1990).

¹⁶⁵ Brief for FDIC at 5-7.

¹⁶⁶ *Id.* at 10.

¹⁶⁷ *Id.* at 11.

that the FDIC did not have the authority to condition the \$1 billion assistance package to the Dallas and Houston banks on a guarantee from the holding company and the subsidiary banks. They also argued that the FDIC did not have the authority to subordinate the intrasystem loans to the claims of depositors and general creditors of the FRBC. Although the FDIC argued that § 13(c) gave it broad discretion and maximum flexibility to determine the terms of a financial assistance package, in February 1991, the agency settled that lawsuit with the creditors.¹⁶⁸

2. TAB

Texas American Bancshares, Inc. ("TAB Holding") owned a system of twenty-four banks located throughout the state of Texas and several nonbank subsidiaries. The lead subsidiary bank was TAB/Fort Worth, which had forty-six percent of the total assets of the TAB subsidiary banks as of December 31, 1988. TAB/Fort Worth maintained obligations in the form of federal funds, certificates of deposits, and other deposit obligations to other TAB subsidiary banks.¹⁶⁹

In October 1988, after the failure of an initial restructuring plan in which TAB Holding and its subsidiaries participated, the FDIC began soliciting bids for a purchase and assumption agreement. In July 1988, the FDIC arranged for a purchase and assumption transaction that resulted in the full payment of claims of all nonsubordinated general creditors of TAB/Fort Worth, except those obligations made to creditors who were TAB Holding subsidiaries.¹⁷⁰

The TAB subsidiaries successfully challenged the FDIC assistance package.¹⁷¹ The district court rejected the FDIC's argument that the decision to treat the TAB affiliated creditors differently

¹⁶⁸ The FDIC settled the litigation with the creditors by paying \$121.8 million. See Steve Klinkerman, *FDIC Pays to Settle Texas Suit*, AM. BANKER, Feb. 14, 1990, at 10.

¹⁶⁹ From its subsidiary banks, TAB/Fort Worth had purchased over \$675 million in the form of Fed funds, \$120 million in the form of certificates of deposits, and over \$54 million in the form of demand deposits from subsidiary and nonaffiliated banks. See *Texas Am. Bancshares, Inc. v. Clarke*, 740 F. Supp. 1243, 1245-47 (N.D. Tex. 1990), *rev'd*, 954 F.2d 329 (5th Cir. 1992).

¹⁷⁰ *Id.* at 1245. In the liquidation of TAB/Fort Worth, the FDIC decided that the TAB subsidiaries receive no more than 67% of the face amount of the TAB/Fort Worth liabilities owed to each TAB subsidiary bank. The TAB subsidiary banks were later declared insolvent, but the OCC admitted afterward that had the obligations of TAB/Fort Worth to the TAB subsidiaries been paid in full, the OCC would not have declared any of the TAB subsidiaries insolvent. *Id.* at 1246-47.

¹⁷¹ *Id.* at 1254.

from other nonaffiliated creditors was designed to "further its statutory mission to preserve competence in the banking system while protecting the Insurance Fund"; and that providing "enhanced payments" to the TAB banks would 'reward' TAB Holding," under whose poor management the TAB banking group failed.¹⁷² The district court held that nothing under the National Bank Act gave the FDIC the power to "manipulat[e] the recovery of affiliated banks on the obligations owed to them in order to make those banks insolvent as well."¹⁷³ In fact, the court inferred that the FDIC should have filed civil or criminal lawsuits against the management of the TAB system if it believed that there was wrongdoing, instead of penalizing the related entities who were creditors of the failed banks and ultimately the parent holding company which lost its entire investment.¹⁷⁴

The challenge by unsecured creditors and affiliated subsidiaries to the FDIC's choice of resolution alternatives in a multibank holding company system indicates that the agency may be unsuccessful in its efforts to exercise a solution that will defray its costs. Although a resolution alternative may appear to be more equitable to nonaffiliated parties, the courts may not uphold the agency's use of discretion under section 13(c) in structuring a resolution alternative. The courts unwillingness to treat the claims of affiliated entities differently underscores the need to provide a substantial record of findings to assist the court in determining that in fact affiliated parties who do not receive full payment for their claims from the receivership estate are being treated fairly.¹⁷⁵

VI. AMALGAMATING PARENTAL GUARANTEES

A solution for resolving problem banks in a multibank holding company system is an amalgam of the existing parental guaran-

¹⁷² *Id.* at 1247. The FDIC based its argument on *Woodbridge Plaza v. Bank of Irvine*, 815 F.2d 538, 541-42 (9th Cir. 1987) and *First Empire Bank v. FDIC*, 572 F.2d 1361, 1370-71 (9th Cir.), *cert. denied*, 439 U.S. 919 (1978). It argued that the *pro rata* distribution rules of the Federal Banking Act, 12 U.S.C. §§ 91, 194 (1988), required that unsecured creditors only be paid an amount equivalent to what they would have received had the insolvent bank been liquidated. Although the district court did not accept the FDIC's argument, *Texas Am. Bancshares*, 740 F. Supp. at 1245-47, the FDIC was successful on the appellate level. *Texas Am. Bancshares v. Clarke*, 954 F.2d 329, 335-36 (5th Cir. 1992).

¹⁷³ *Texas Am. Bancshares*, 740 F. Supp. at 1253.

¹⁷⁴ *Id.* at 1254. FIRREA requires the FDIC to pay any creditor of a failed bank an amount equal to that which the claimant would have received if the FDIC had liquidated the institution. 12 U.S.C. § 1823(c)(4)(E)(iii) (Supp. V 1993). Arguably, this provision should have applied in the Texas American Bancshares litigation at the district court level.

¹⁷⁵ See discussion *infra* part VI.C.

tees.¹⁷⁶ Regulators should continue to require an acquisition evaluation at the time of acquisition of the financial and managerial resources of a holding company to ensure that the parent company seeking to acquire the bank subsidiary maintain its capital adequacy.¹⁷⁷ The prompt corrective action provision, which requires that the banking subsidiary submit a capital restoration plan when an institution becomes capital deficient, is an appropriate alternative to a limited net worth maintenance agreement or a source of strength condition.¹⁷⁸ In addition to the capital infusion required under a capital restoration plan, regulators should have the discretion to require that holding company banks consolidate, if banking subsidiaries have functioned as an economic unit prior to their weakened capital status.¹⁷⁹

A. *Prefailure Enterprise Consolidation*

Giving regulators the discretion to require the consolidation¹⁸⁰ of banking subsidiaries within a holding company structure upon the trigger of the prompt corrective action plan is an effective means of obtaining financial assistance for troubled bank subsidiaries. It encourages early reorganization of the enterprise in an effort to stem, perhaps, a temporary financial crisis. The limited purpose of consolidation is to secure intercorporate financing for bank subsidiaries that are becoming insolvent. It is a more effective mechanism for controlling corporate conduct prior to insolvency than the prompt corrective action provision alone because enterprise consolidation acts as an internal device to control corporate conduct. Given a rule of unlimited liability, several aspects of

¹⁷⁶ As will be discussed below, the present solutions do not balance the interests of the insurance fund to avoid losses by having to pay the claims of affiliated shareholders and creditors of the troubled institution in need of FDIC assistance. See discussion *infra* at part VI.

¹⁷⁷ As discussed *supra* part III, this is to ensure that the parent company will not leverage the subsidiary's assets in order to acquire the banking subsidiary.

¹⁷⁸ Although this provision is flawed, its enactment by Congress vitiates the argument that the source of strength condition is beyond the statutory authority of the regulatory agencies. It also demonstrates that the net worth maintenance agreement as an implied obligation is vague and indeterminate. See discussion *supra* part III.

¹⁷⁹ In September 1994, Congress passed legislation authorizing interstate banking. See Riegle-Neal Interstate Banking and Branching Efficiency Act, Pub. L. No. 103-328, 108 Stat. 2338 (1994) (codified in scattered sections of 12 U.S.C. (1994)). There is a concern that this legislation will lead to more voluntary bank consolidations as the American banking industry tries to remain competitive. See Wilmarth, *supra* note 63, at 978-82; Clyde Mitchell, *Legislation Affecting Interstate Banking*, N.Y.L.J., Sept. 21, 1994, at 3.

¹⁸⁰ The term "consolidation" refers to substantive consolidation of the assets of banking subsidiaries rather than procedural consolidation of the bankruptcy proceedings of bankrupt affiliates.

a shareholder's conduct vis-à-vis the assessment of the corporation's financial matters would change. First, a shareholder must actively assess financial information about the corporation to protect him- or herself against the risks of the business enterprise. This means that the shareholder, in addition to monitoring, must take active measures to control speculative transactions. It also means that there must exist some efficient means of assessing, and recovering from, individual shareholders their proportional share of the corporation's debt.¹⁸¹

Prefailure consolidation recognizes the wholeness of the separate economic units of the holding company in a manner similar to enterprise liability.¹⁸² Like enterprise liability, it negates the notion that corporate separateness is necessarily and sufficiently evidenced by separate corporate charters. Rather, as with the concept of enterprise liability, a close evaluation of the relationship between the parent and the subsidiary is necessary to determine if the parent is an active or passive investor.¹⁸³

¹⁸¹ See Stone, *supra* note 39, at 73-74. Creditors of a corporation routinely contract around potential parent company control by requiring that the parent and affiliated corporations guarantee a subsidiary's debt. This type of intersubsidiary liability substitutes for the creditor's task of monitoring the subsidiary's operations. It guarantees that the creditor will be advantaged by the parent company's corporate conduct. It also shifts the risks away from creditor to the entire business enterprise. See Easterbrook & Fischel, *supra* note 34, at 103-09; see also Peter A. Alces, *The Efficacy of Guaranty Contracts in Sophisticated Commercial Transactions*, 61 N.C. L. REV. 655 (1983); Scott F. Norberg, *Avoidability of Intercorporate Guarantees Under Section 548(a)(2) and 544(b) of the Bankruptcy Code*, 64 N.C. L. REV. 1099 (1986) (discussing the use of intercorporate guarantees as a means of eliminating risks of a lender); Robert J. Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware*, 125 U. PA. L. REV. 235, 236 n.2, 263-64 (1976) (arguing that enterprise liability or joint and several liability among entities in the corporate group is an alternative to intercorporate guarantees).

¹⁸² See discussion in text *supra* note 29. The enterprise liability theory begins with the notion that the parent corporation that owns 100% of the stock of its subsidiary is not a passive investor.

Inherent in the subsidiary structure is the notion that the subsidiary operates for the benefit of the parent. This means that subsidiaries may not operate in a profit-maximizing manner. The parent may choose to strip the subsidiary of its productive assets, transfer those assets into other parts of the enterprise, and leave the subsidiary's creditors to absorb the losses. Whether the parent company has chosen to engage in asset stripping or is transferring assets for economic efficiency is not easily detectable. Because this type of decision making cannot be controlled, the parent's conduct cannot be easily monitored. This also means that monitoring the subsidiary is riskier. See Stone, *supra* note 39, at 11.

Creditors, presumably, are superior to shareholders as risk monitors in at least three ways: assessing or protecting against the risk of insolvency, accepting the risk, and reducing the cost of bankruptcy. See Ribstein, *supra* note 29, at 101-06.

¹⁸³ See PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: TORT, CONTRACT, AND OTHER COMMON LAW PROBLEMS IN THE SUBSTANTIVE LAW OF PARENT AND SUBSIDIARY CORPORATIONS* § 2.01 (1987); Landers, *supra* note 25, at 592-93.

Prefailure consolidation parallels the theory of substantive consolidation which is common in bankruptcy law.¹⁸⁴ The basic premise of substantive consolidation is that the power of the bankruptcy court extends to all of the affiliates of the corporate enterprise. Enterprises that formerly were separate corporate bodies may be subjected to the bankruptcy court's power to prevent unjust or fraudulent attempts to shield assets that otherwise would be vulnerable to creditor's claims. Substantive consolidation allows the property of solvent affiliates of a bankrupt debtor to be reached to pay the bankrupt's liabilities. It combines the assets and liabilities of the affiliated parties in order to invalidate interentity claims and effect a more equitable distribution of property among creditors.¹⁸⁵ The theory does not disregard corporate separateness. Instead, its application depends on whether the affiliates prior to the debtor's bankruptcy behaved as a single economic unit, although formally they were independent entities.¹⁸⁶ Bankruptcy courts cautiously use the substantive consolidation power, which is an equitable principle and not specifically authorized under the Bankruptcy Reform Act of 1978 ("Bankruptcy Code").¹⁸⁷

The clear advantage of substantive consolidation of banking subsidiaries within a multibank holding company system is that it is a preinsolvency concentration of financial resources that can forestall immediate resort to the insurance fund, if not foreclose the need for such resort altogether. The effect is that the enterprise provides its own financial assistance or a cash advance to the troubled, failing institution. The use of regulatory powers to impose substantive consolidation allows the regulators the flexibility to deal with the threatened failure, while also preserving some value for not only the troubled subsidiary, but also for the entire enterprise.

¹⁸⁴ Banks and savings and loan associations are not subject to the Bankruptcy Code. See 11 U.S.C. § 109(b)(2)(d) ("Who may be a debtor").

¹⁸⁵ See *In re Baker & Getty Fin. Servs.*, 78 B.R. 139, 141 (Bankr. N.D. Ohio 1987); *In re Manzy Land & Cattle Co.*, 17 B.R. 332, 337 (Bankr. D.S.D. 1987).

¹⁸⁶ Substantive consolidation of a corporate group allows the bankruptcy court to consolidate the assets and liabilities of different group members. From this single pool of assets, all creditors of the group are paid and the entire enterprise can be recreated. See *generally* Frost, *supra* note 43; Prager & Backman, *supra* note 43, at 701-09.

¹⁸⁷ Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at 11 U.S.C. §§ 101-1330 (1988 & Supp. V 1993)). "Consolidation, as distinguished from joint administration, is neither authorized nor prohibited by this rule since the propriety of consolidation depends on substantive considerations and affects the substantive rights of the creditors of the different estates." FED. R. BANKR. P. 1015 advisory committee's note; see also 8 COLLIER ON BANKRUPTCY ¶ 1015.01, at 1015-2 to -3 (15th ed. 1988).

This power¹⁸⁸ to assert control over healthy bank subsidiaries in the holding company system is appropriate because the solvency of some of the healthy holding company subsidiaries may be dependent on the holding company operating other subsidiaries in an unsafe and unsound manner.¹⁸⁹ This assertion of control over the solvent subsidiaries may serve to protect the soundness of the enterprise as a whole. The core aim of the action is to preserve the value of the enterprise from further dissipation of its assets.¹⁹⁰ To empower regulators to consolidate the troubled and healthy banking subsidiaries would give regulators a greater level of supervisory power over multibank holding company systems.

B. *The Current Law on Substantive Consolidation*

The tendency of the parent company to pool the assets of related subsidiaries in order to maximize the parent company's profitability justifies the bankruptcy policy of substantive

¹⁸⁸ A specific regulatory structure governs the liquidation of insolvent depository institutions. Similar to the bankruptcy code provision, the regulatory scheme has a predetermined priority of claims. The claims of depositors have priority over those of owners; some claims are paid in full, while others are denied. See 12 U.S.C. § 194 (1988) (distribution of assets of failed national banks); 12 C.F.R. § 389.11 (1994) (distribution priority rules for savings associations).

The same regulatory scheme governs the supervision and closure of troubled or failed financial institutions. Under the grounds for the appointment of a receiver, the OCC or OTS may close an institution if there has been a "substantial dissipation of assets or earnings." 12 U.S.C. § 1821(c)(5) (Supp. V 1993). This may mean that the institution is operating in a capital-deficient status with less than the required minimum level of capital. Under the grounds for the appointment of a conservator, the OCC and OTS have specific authority to appoint a conservator to manage an institution on the basis of insufficient capital. *Id.* § 203(b)(1) (national banks); *id.* § 1464(d)(2)(B) (thrifts).

Under a consolidation theory, the owners of the institution would temporarily lose control to the regulators. The subsidiary's charter would be suspended for such time as it takes to facilitate the reorganization of the enterprise. At the end of that period, the subsidiary may apply to the chartering authority to have the charter reinstated. See 12 U.S.C. §§ 21-27 (1988 & Supp. V 1993).

¹⁸⁹ FIRREA's statutory provision authorizing "cross-guarantee" power gives the FDIC similar power over solvent banks and thrifts whenever it incurs a loss from insolvent banks and thrifts within the same holding company system. See 12 U.S.C. § 1815(e) (Supp. V 1993). The restrictions may apply when the regulatory agency can show that, based on noncapital supervisory criteria, safety and soundness supervisory concerns exist. *Id.*

¹⁹⁰ Consolidation raises the problem that the government takeover of the institution might diminish its value and result in losses to the shareholders. *But see* U.S. v. Gaubert, 111 S. Ct. 1267 (1991) (rejecting a shareholder's claim that federal operation of an insolvent savings and loan was negligent because Federal Torts Claims Act's discretionary function exception immunized the operational or management actions of federal regulators). Note that just as with a sale or liquidation, the consolidation of an institution may yield some residual value that the owner is entitled to recover. See Christopher T. Curtis, *The Takings Clause and Regulatory Takeovers of Banks and Thrifts*, 27 HARV. J. ON LEGIS. 367, 381 (1990).

consolidation.¹⁹¹ The case law on substantive consolidation is not clear, however, on which factors make the policy applicable to a given circumstance nor on the underlying principles that support the use of the theory.

Courts examining the use of substantive consolidation in bankruptcy proceedings frequently have applied analogous corporate law doctrines. The doctrine of piercing the corporate veil has been the basis for several court decisions.¹⁹² Commentators have criticized this approach because it fails to assess the reality of the corporate group's functioning.¹⁹³ An approach more analogous to substantive consolidation that recognizes the existence of the economic relationship of the related entities is equitable subordination.¹⁹⁴

¹⁹¹ See Landers, *supra* note 25, at 632.

¹⁹² In *Fish v. East*, 114 F.2d 177 (10th Cir. 1940), the court adopted a "piercing the corporate veil" analysis to determine whether a parent and its subsidiary should be treated as a single entity. The court identified the relevant factors as:

- (1) The parent corporation owns all or a majority of the capital stock of the subsidiary;
- (2) The parent and subsidiary corporations have common directors or officers;
- (3) The parent corporation finances the subsidiary;
- (4) The parent company subscribes to all of the capital stock of the subsidiary or otherwise causes its incorporation;
- (5) The subsidiary has grossly inadequate capital;
- (6) The parent company pays the salaries or expenses or losses of the subsidiary;
- (7) The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation;
- (8) . . . "[T]he subsidiary" is referred to as [a subsidiary] or as a department or a division [of the parent corporation];
- (9) The directors and executives of the subsidiary do not act independently in the interest but take direction from the parent corporation; and
- (10) The formal legal requirements of the subsidiary as a separate and independent corporation are not observed.

Id. at 191.

¹⁹³ See Landers, *supra* note 25, at 633-34. Professor Landers notes also that the approach is of limited value since most courts avoid piercing the corporate veil due to the doctrine of limited liability. See also J. Stephen Gilbert, *Substantive Consolidation in Bankruptcy: A Primer*, 43 VAND. L. REV. 207, 218 (1990) (criticizing the analogy to piercing the corporate veil in substantive consolidation cases because substantive consolidation does not involve the doctrine of limited liability which holds shareholders responsible for the debts of the corporation).

¹⁹⁴ Equitable subordination focuses on the creditors who are competing for receipt of the pooled assets. Substantive consolidation, like equitable subordination, is a preferable approach when related entities have comingled assets because it requires that the claims of affiliated entities be given a lesser priority status for full repayment. See generally Helen D. Chaitman, *The Equitable Subordination of Bank Claims*, 39 BUS. LAW 1561 (1984).

Courts use substantive consolidation cautiously because they are concerned with whether it is equitable to creditors. Specifically, the concern is whether creditors who do business with a single corporation are aware that their repayment will come from the enterprise as a whole, which necessarily means that less assets are available for distribution. The cases in which the courts have allowed substantive consolidation fall generally into one of four categories.¹⁹⁵ The courts have allowed substantive consolidation when there was evidence of the comingling of assets;¹⁹⁶ when firms had inadequate capital;¹⁹⁷ when related corporations used unified advertising;¹⁹⁸ and when related corporations used each other's funds or property as cross-guarantees, or for payment of financial obligations.¹⁹⁹

Two cases, *Chemical Bank New York Trust Co. v. Kheel*²⁰⁰ and *In re Flora Mir Candy Corp.*,²⁰¹ are noteworthy for identifying when substantive consolidation should occur. Although the *Kheel*²⁰² court allowed substantive consolidation and the court in

¹⁹⁵ See Landers, *supra* note 25.

¹⁹⁶ See *Stone v. Eacho*, 127 F.2d 284 (4th Cir.), *cert. denied*, 317 U.S. 635 (1942). The officers of a Virginia corporation and a Delaware corporation were the same. The Virginia corporation did not have any independent corporate activity—no money was paid into its treasury and no contracts were executed on its behalf—and its corporate records, which contained transcriptions from the books of the Delaware corporation, were kept in Delaware. *Id.* at 286.

In *Soverio v. Franklin Nat'l Bank*, 328 F.2d 446, 447 (2d Cir. 1964), the court approved the use of substantive consolidation where the bankrupt corporation and its affiliates were in the same line of business, and the bankrupt corporation provided all of the financing to the affiliate and signed a majority of the affiliates' leases. All of the affiliates of the corporate enterprise had the same two shareholders and directors. The affiliates did not have working capital, corporate minutes, or separate bank account balances large enough to pay local obligations such as rent and utilities. They were listed as assets of the bankrupt corporation and, on stationary and advertising, referred to as branches.

¹⁹⁷ In these cases, the courts could show that one corporation relied completely on a related corporation for the payment of operational expenses. See *In re Assoc. Gas & Elec. Co.*, 149 F.2d 996, 1002, 1005 (2d Cir.), *cert. denied*, 326 U.S. 736 (1945); *Stone*, 127 F.2d at 284.

¹⁹⁸ See *Soverio*, 328 F.2d at 446; *Trustees Sys. Co. v. Payne*, 65 F.2d 103, 105 (3d Cir. 1933).

¹⁹⁹ See *Consolidated Rock Prods. v. DuBois*, 312 U.S. 510 (1941); *Fish*, 114 F.2d at 117; *Barr & Creelman Mill & Plumbing Supply Co. v. Zoller*, 109 F.2d 924, 927 (2d Cir. 1940); *In re Eilers Music House*, 270 F. 915 (9th Cir.), *cert. denied*, 257 U.S. 646 (1921).

²⁰⁰ 369 F.2d 845 (2d Cir. 1966).

²⁰¹ 432 F.2d 1060 (2d Cir. 1970).

²⁰² The court found profit maximization in *Kheel* because eight shipping companies that one individual owned or controlled disregarded their corporate separateness. The corporations shifted funds, made intercorporate loans, regularly paid each other's obligations, and made withdrawals and payments from and to corporate accounts without sufficient record-keeping. *Kheel*, 369 F.2d at 846. The court also found consolidation reasonable because of the effort and expense of reconstructing the financial records of the debtor corporations.

*Flora Mir*²⁰³ did not, both cases identified disregard of corporate separateness and the equitable interest of creditors who relied upon payment from a single creditor rather than from the whole enterprise as the most significant factors supporting a court's decision making.²⁰⁴ In these two cases, the court's evaluation turns to whether the related corporations functioned as a single economic unit.²⁰⁵ Specifically, the court is trying to determine whether the affiliates have an incentive to maximize profits for the entire corporate enterprise without regard to the affiliates's own profitability.²⁰⁶

Bankruptcy courts tend to allow substantive consolidation only if there is a disregard for separateness or the affairs of the affiliates are hopelessly entangled.²⁰⁷ This stringent standard could be lessened somewhat in the banking context without violating the

Creditors were not able to make a feasible determination, allowance, or classification of claims as needed to assert claims under the plan of liquidation. *Id.* at 847.

²⁰³ In *Flora Mir*, the court emphasized the reliance interest of the creditors opposing substantive consolidation. This case involved one parent company and twelve subsidiaries and affiliates that had filed individual plans of reorganization. *Flora Mir*, the parent company acquired Meadors six years after Meadors had issued debentures. When the debenture holders brought an action in state court against two *Flora Mir* companies and Meadors for fraud, the related corporations moved for consolidation. The court refused to consolidate Meadors with the other debtors, finding that these creditors had not relied on the credit of any consolidated group. The creditors would also be unfairly prejudiced because consolidation would eliminate a misappropriation of assets claim that Meador might have against *Flora Mir*. *Flora Mir*, 432 F.2d at 1062-63.

²⁰⁴ See *Kheel*, 369 F.2d at 1062-63; *Flora Mir*, 432 F.2d at 847.

²⁰⁵ The *Kheel* court allowed consolidation because the administration of the estate would be unduly burdened with the cost of disentangling the financial records of affiliated corporations and because consolidation facilitated the plan of reorganization. *Kheel*, 369 F.2d at 847. The standard, however, is strict because the court requires a showing that the disentanglement of records threatens the realization of any net assets. Parties urging consolidation have attempted *Kheel's* entanglement argument but have not met its strict standard. See *Flora Mir*, 432 F.2d at 1060; *In re Augie/Restivo Baking Co.*, 860 F.2d 515, 518 (2d Cir. 1988); *In re Gulfco*, 593 F.2d 921, 925 (10th Cir. 1979).

Judge Friendly, in a concurring opinion, recognized that the impossibility of an accurate assessment of the financial condition of the debtor corporations might warrant consolidation. He expressed a preference, however, for allowing consolidation only after a reasonable effort has been made to identify the creditor's reliance interest and protect it. *Kheel*, 369 F.2d at 848.

²⁰⁶ Professor Landers argues that the profit maximization test is more accurate in determining the relationship between affiliate corporations than the traditional tests that the courts use, such as whether corporate formalities were observed, because what is most significant is whether the corporations operate as a single unit. He contends that most creditors are aware of the existence of a common operation within the holding company structure, thereby making the reliance argument inapplicable. See Landers, *supra* note 25, at 600-05.

²⁰⁷ See William H. Thornton, *The Continuing Presumption Against Substantive Consolidation*, 105 *BANKING L.J.* 448, 451 (1988) (pointing out that the theory of limited liability underlies courts' reluctance to use substantive consolidation).

equitable considerations that underly the use of substantive consolidation. If bank holding companies are manipulating the multibank system by concentrating risky loans in one or two banks, substantive consolidation acts as a control on the parent company conduct. This makes disregard of corporate separateness the most important factor for determining whether substantive consolidation should be applied. Thus, the appropriate focus becomes the relationship of the banking subsidiary to its owners and not the creditors' reliance.²⁰⁸

The FDIC serves two distinct purposes, both of which are consistent with using substantive consolidation in this context. First, Congress has charged the FDIC, as well as the other federal regulators, with protecting the integrity of the nation's banking system. Second, FDIC provides deposit insurance for member institutions thus providing depositor confidence. Both of these public purposes should be balanced against the interests of the parent company, healthy banking subsidiaries, and creditors. Imposing substantive consolidation discourages the parent company from shifting the risks of failure to the FDIC in a way that balances the harm to these other interests.

The doctrine of limited liability should not protect the parent company who operated the subsidiary without regard to corporate formalities. Neither should limited liability protect the healthy subsidiary that participates in a plan that results in weakening another subsidiary.²⁰⁹ To impose liability, it should be shown that the healthy subsidiary contributed to the condition that caused the weakened subsidiary in ways other than common ownership. This relationship is sufficient to make the healthy subsidiary responsible for the troubled subsidiary's liabilities. If this application of substantive consolidation were to become a part of the statutory scheme, healthy banking subsidiaries would operate with the ex-

²⁰⁸ Although creditors of the healthy subsidiary are likely to oppose substantive consolidation more vigorously than those of the troubled banking subsidiary, consolidation may work to satisfy the equitable claims of both groups of creditors. If, as Professor Landers argues, creditors do not have a reliance interest because they are aware of the operating relationships of the related corporations, it is only fair that those same creditors not benefit due to a plan of consolidation. See Landers, *supra* note 25, at 630-32. Moreover, the FDIC is a potential creditor when it steps in as receiver to marshal the assets of the failed banking subsidiary. The agency, therefore, is entitled also to some protection because its financial assistance to the failed institution may involve taxpayers' monies.

²⁰⁹ To control the practice of isolating bad or risky loans in one banking subsidiary, a healthy banking subsidiary may be subject to government regulation. The FDIC must be able to show a direct relationship between the assessed liability and the healthy subsidiary. The assessed liability satisfies the proportional liability that the healthy subsidiary has already incurred through its participation with the weakened subsidiary.

pectation that if they chose to engage in excessive affiliate lending practices, which resulted in captive funding, then they may not remain in possession of their assets and they might be held accountable for a proportion of the debt that resulted from participation in this profit-maximizing scheme. Conversely, healthy subsidiaries would also be on notice that if they avoid these types of practices, they will not be in danger of regulatory imposed consolidation²¹⁰

Finally, substantive consolidation remedies the potential for injustice to the taxpayers. This injustice results when the FDIC must use the limited resources of the insurance fund for the benefit of banking subsidiaries while the parents are shielded by limited liability simply because of their separate legal existence. Taxpayers should not be held responsible for paying for the means that the parent company has employed to use the corporate structure to its advantage.

C. *Defining the Economic Relationship*

In the context of a multibank holding company, substantive consolidation is consistent with the regulatory scheme of liquidation of failed financial institutions because it requires a reorganization and redistribution of assets among corporate affiliates in a manner that is fair and equitable.²¹¹ Although a bankruptcy court will recognize limited liability when considering the allocation of the debts of an enterprise, it does not recognize that principle in a vacuum. While adopting a policy of consolidation to assist a troubled thrift or bank in reorganization would displace the theory of limited liability, it may equitably serve the interests of depositors, the insurance fund, and other creditors.²¹²

Prefailure consolidation may involve a troubled banking subsidiary, as well as a healthy one.²¹³ Most significant is the relation-

²¹⁰ As the court recognized in the Bank of New England litigation, when the healthy banking subsidiary has not disregarded corporate form, it is unfair to infringe its protections under the corporate law doctrine of limited liability. See discussion *infra* note 208.

²¹¹ Usually, substantive consolidation occurs when each of the affiliated entities is bankrupt, although it can be applied when one affiliate is insolvent and one is solvent. Some commentators are critical of this approach and look instead to elements identified by the bankruptcy courts. See Thornton, *supra* note 207, at 451.

²¹² Cf. FDIC v. Sea Pines, 692 F. 2d 973 (4th Cir. 1982), *cert. denied*, 461 U.S. 928 (1983).

²¹³ Consolidation may be necessary when institutions are nominally solvent. Under the Bankruptcy Code, a trustee may reach a debtor's assets without regard to the debtor's insolvency. If the trustee determines that there has been either a fraudulent transfer, 11 U.S.C. § 548 (1988), or a preferential transfer, *id.* § 547, the trustee may recover properties that the debtor transferred to third parties, *id.* § 550. This recovery occurs even if the parties were solvent at the time of the transfer and remain solvent throughout the bankruptcy proceeding.

ship between the banking subsidiaries prior to a status of capital deficiency. Consolidation should be triggered in a manner consistent with the prompt corrective action provision—when capital levels fall below the regulatory minimum.²¹⁴ At the point of capital deficiency, if regulators determine that the banking subsidiaries are functioning as an economic unit, the regulators could require that the troubled financial institution's capital restoration plan call for the consolidation of economic resources.

The legal issue to be addressed is what factors determine the decision to consolidate. In determining the economic relationship of the corporate groups, the issues to be addressed are: (1) whether the subsidiaries have separate economic identities; and (2) whether consolidation benefits the public interest.²¹⁵

1. *Do the Subsidiaries Have Separate Economic Identities?*

An examination of economic separateness focuses on the relationship of the troubled subsidiary to the healthy subsidiary as well as the relationship of the troubled subsidiary to all of the subsidiaries and to the parent company. To determine whether individual subsidiaries within the multibank holding company have a separate economic identity, there must be an evaluation of the relationship between the healthy and troubled banking subsidiaries. This evaluation focuses on the parent company's exercise of its control over the siblings. Since by statute, a parent company's "control" of a subsidiary is determined by virtue of its percentage of stock ownership, this evaluation focuses on whether the parent company has exercised that control vis-à-vis the conduct of its subsidiaries.

To reach the assets of a capital deficient banking subsidiary, or one that complies with FDICIA's capital standards, the regulators should bear the burden of proving that the economic circumstances favor consolidation over other resolution alternatives. Before proceeding with consolidation, the FDIC should be required to make a factual finding on the relationship of the two entities.²¹⁶ That fac-

²¹⁴ As stated in the Treasury Department report, "[t]his presupposes that reported capital levels are a meaningful reflection of the economic condition of the bank." MODERNIZING THE FINANCIAL SYSTEM, *supra* note 14, at X-2.

²¹⁵ In a recent decision, *In re Augie/Restivo Baking Co.*, 860 F. 2d 515, 518 (2d Cir. 1988), the court concluded that most factors considered are merely variants on two critical factors: (1) whether creditors dealt with the entities as a single economic unit and did not rely on their separate economic identities; and (2) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors. See Landers, *supra* note 25, at 592-93.

²¹⁶ In order to avoid the abuse of administrative remedies, the FDIC should be required to adopt regulations and provide administrative proceedings for an expedited hearing on

tual finding is necessarily different depending upon whether the subsidiary is healthy or troubled.

To support a finding that the parent company controls a healthy subsidiary that is a part of the bank holding company structure, the agency would consider the following relevant factors:

- (1) whether the parent company refers to all of the subsidiaries as a unit of the parent;
- (2) whether the parent company is responsible for the policy-making of all of the subsidiaries;
- (3) whether the parent company owns a majority of the stock of all of the subsidiaries;
- (4) whether the parent company and subsidiary have common officers and directors; and
- (5) whether the parent company directs the daily operation of funds management.²¹⁷

These factors focus on the parent company's conduct and its relationship to the subsidiaries under its control. The factors tends to show whether the subsidiary is a separate corporation distinct from the other subsidiaries owned by the parent. Although no one factor may be decisive, these provide a basis for the agency to balance the circumstances in an equitable fashion.

The presence of these circumstances also tends to support the conclusion that the parent company is not the typical shareholder—the passive investor allowing the financial markets to reflect changes in the enterprise's liability. They may also support the conclusion that the parent company has played a role in the subsidiary's management of its financial resources. The parent company's actions may result in changes in the financial markets.²¹⁸ Thus, the parent company of a federally insured banking subsidiary that shifts the losses away from a healthy subsidiary to a troubled one may be externalizing the losses of its troubled subsidiary to the insurance fund. These factors should operate to make the parent company accountable for its conduct in the control of its subsidiar-

the record because property rights of the healthy subsidiary are involved. *See Aman, supra* note 104, at 881-82; *see also Note, Of Property Rights and the Fifth Amendment: FIRREA's Cross-Guarantee Reexamined*, 33 WM. & MARY L. REV. 293 (1991) (discussing the fairness of FIRREA's cross-guarantee provisions under a substantive due process analysis).

²¹⁷ The factors to be considered are similar to those used in the bankruptcy context, as explained by the court in *Fish v. East*, 114 F.2d 177, 191 (10th Cir. 1940). The existence of the insurance fund makes the application of the factors different. *See infra* text accompanying note 220.

²¹⁸ *See* discussion in text *supra* note 61.

ies and thereby shift the risk of losses away from the insurance fund to the bank holding company.²¹⁹

In determining whether a banking subsidiary has become financially troubled for the benefit of the parent, the evaluation focuses on the control that the parent company has exercised over the troubled subsidiary. The factors that the FDIC should consider relevant are:

- (1) whether the subsidiary is undercapitalized as defined in the § 38 of FDICIA;
- (2) whether the capital deficient subsidiary has "captive funding";²²⁰ and
- (3) whether a healthy subsidiary may withdraw its accounts upon a determination of either capital deficiency or insolvency.

Requiring the FDIC to make these findings is necessary for several reasons. First, consolidation involves the use of the healthy subsidiary's assets, and therefore, the rights of shareholders and creditors of the solvent subsidiary must be taken into account.²²¹ Therefore, a determination of the relationship between the healthy subsidiary and the troubled one as well as the control that the parent company exercises over both is critical. Second, it may be shown that the healthy subsidiary is protecting itself against insolvency by engaging in transactions with the financially troubled subsidiary. As an affiliate lender to the troubled subsidiary, the healthy subsidiary withdraws the deposits made to the troubled subsidiary when that subsidiary threatens insolvency. However, allowing the healthy subsidiary to withdraw funds from the troubled subsidiary in these circumstances may be unwarranted because the healthy subsidiary is in a position to monitor the troubled subsidiary's operations and may have made imprudent transactions with

²¹⁹ The FDIC's cross-guarantee powers, recently enacted by Congress, are postfailure powers with a similar underlying premise. See 12 U.S.C. § 1815(e) (Supp. V 1993). Under those powers, the FDIC may assess payment from the solvent affiliates toward the resolution of the entire enterprise. See Broome, *supra* note 7, at 960-63; see also Branch v. U.S., No. 93-133C, 1994 WL 380903 (Ct. Cl. July 20, 1994), *appeal granted*, 42 F.3d 1409 (Fed. Cir. 1994) (denying the use of FIRREA's cross-guarantee remedy without a specific finding that the subsidiary banks did not have separate economic and/or corporate identities).

²²⁰ See *supra* text accompanying note 58.

²²¹ Creditors and shareholders of a healthy bank subsidiary may be able to raise due process claims based on the value of their assets. A provision similar to the one found in the Emergency Bank Consolidation Act of 1988, S. 2715, 100th Cong., 2d Sess. (1988) (proposed but unpassed legislation), which requires that shareholders and creditors receive within 30 days of consolidation an assessment of their debt or equity interest in the combined enterprise, is needed. Such a provision would also protect those healthy bank subsidiaries which have negative economic values, but positive regulatory capital.

the troubled subsidiary.²²² The recommended factors allow the FDIC to detect when a parent company has chosen to operate the troubled subsidiary in a way that is not profitable. They also help to support a finding that the actions of the parent are unfair and unjust when the troubled subsidiary is becoming insolvent for the benefit of another healthy subsidiary, and ultimately for the benefit of the parent.²²³

2. *Does Consolidation Benefit the Public Interest?*²²⁴

Consolidation allows the FDIC to use the resources of the holding company's healthy subsidiaries to resolve the problems of the capital deficient ones. In assessing whether consolidation benefits the public interest, the evaluation focuses on the impact of consolidation on local economic conditions as well as on the costs of consolidation to the insurance fund.²²⁵

First, requiring consolidation protects the insurance fund in several ways. Consolidation could restrict affiliate lending. A parent company that knows that captive funding can be used at the cost of possible temporary consolidation may decide to limit its use of captive funding. If the parent company does limit its captive funding, this reduces or eliminates the healthy subsidiary as a creditor of the troubled subsidiary. Consolidation also could prohibit healthy subsidiary banks from withdrawing their funds from a financially troubled subsidiary. Since captive funding is one of the factors that demonstrates an interrelationship between a healthy and troubled subsidiary, the losses of the lead bank that would be absorbed by the insurance fund when a healthy subsidiary withdraws its deposits would be eliminated. When consolidation occurs, the deposits of the banking subsidiaries are combined, therefore the healthy subsidiary is no longer able to withdraw

²²² See *supra* text accompanying notes 49-62.

²²³ The court considering the claims of the FDIC to use its cross-guarantee assessment powers against healthy subsidiaries in the holding company structure, recognized that under the BHCA, each bank in the multibank holding system is a separate corporation. Although there was no statutory predicate for a finding of wrongdoing, mismanagement, or disregard of corporate separateness, that court found that there could be no assessment until it made such an inquiry. See *Branch v. U.S.*, No. 93-133C, 1994 WL 380903 (Ct. Cl. July 20, 1994), *appeal granted*, 42 F.3d 1409 (Fed. Cir. 1994).

²²⁴ The FDIC must choose the least costly alternative in resolving the failure of a bank or thrift. See 12 U.S.C. § 1823(c)(4)(A) (Supp. V 1993).

²²⁵ The financial costs of consolidation under this extension of the prompt corrective action provision may not be capable of determination. Although some commentators view early efforts like prompt corrective action as "costless," this may not be accurate since it is difficult, if not impossible, to assess the changes in market value when the policy is used. See MODERNIZING THE FINANCIAL SYSTEM, *supra* note 14, at X-21.

funding from the troubled subsidiary. This ultimately reduces the amount of FDIC assistance needed to resolve the capital deficiency of the troubled subsidiary. By reducing the losses of the troubled subsidiary, the FDIC reduces the amount of financial assistance needed to resolve the financial losses.²²⁶

Second, the problems of the troubled subsidiary become the problems of the healthy one. This provides an incentive for the parent company to attempt the rescue of the troubled bank.²²⁷ By combining the assets of the troubled banking subsidiary with those of the healthy banking subsidiary, consolidation makes joint funds available for repayment of any FDIC financial assistance. This repayment from the assets of the combined subsidiaries protects the insurance fund.²²⁸

Finally, consolidation may address some of the concerns raised regarding the effect of a banking crisis on the local economic condition.²²⁹ A financial crisis in a bank holding company system may signal distress to other financial markets and affect them adversely. The erosion of public confidence justifies the actions to be taken when a bank in a multi-bank holding company threatens failure.²³⁰ The alternatives for failure resolution balance the potentially adverse impact on the local and national economy against use of the deposit insurance funds to abate the crisis.²³¹ Since regulators have often moved to abort failure either by arranging a merger, a recapitalization or a managed reduction in size,²³² consolidation will provide the same remedy from among the entire corporate enterprise's own resources.²³³

²²⁶ See *supra* text accompanying note 47.

²²⁷ Although it has been argued that an "early closure" procedure such as consolidation may negatively affect the bank's franchise value, those same institutions may suffer additional losses in franchise value when they continue to operate at an undercapitalized level, losing valuable personnel, customers, and business opportunities. See MODERNIZING THE FINANCIAL SYSTEM, *supra* note 14, at X-17.

²²⁸ See *supra* text accompanying notes 46-48.

²²⁹ See *supra* text accompanying note 63.

²³⁰ See *supra* text accompanying note 64.

²³¹ See *supra* text accompanying note 66.

²³² During 1988 and 1989, failed and assisted banks in Texas comprised over 80% of total U.S. failed bank assets and over 80% of total FDIC reserves for losses of failed banks. From 1980 to 1989, 349 Texas commercial banks failed and an additional 76 requested FDIC assistance. See John O'Keefe, *The Texas Banking Crisis: Causes and Consequences 1980-89*, 3 FDIC BANKING REV. 1, 2 (Winter 1990).

²³³ The FDIC should have the discretion to determine which of several options will provide the best solution. In proposed legislation that Congress did not pass, those options were identified as an order by the FRB (or, in some cases, OTS) to the parent company to:

- 1) transfer the stock of one or more of its healthy banks to the troubled bank;
- 2) merge one or more of its subsidiary banks into the troubled bank;

CONCLUSION

The legal rule of limited liability allows bank holding companies to shift the costs of engaging in risky banking activities to the federal deposit insurance fund. To reduce the social and economic costs of limited liability and to control corporate conduct in a regulated industry, Congress created a new type of parental guarantee—prompt corrective action. It becomes operable when a bank subsidiary has the greatest incentive to engage in risk taking activity—when it is undercapitalized. As an extension of prompt corrective action, Congress should consider prefailure enterprise consolidation. This change would consider the totality of the circumstances leading to a banking subsidiary's troubled status and may reduce the social and economic costs of risky corporate conduct while also providing better protection to the federal deposit insurance fund.

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- 3) merge the troubled bank into one or more of its healthy banks;
 - 4) contribute or transfer or provide to a troubled bank, or require a subsidiary to contribute, or transfer or provide to a troubled bank any such assets or services as are customarily utilized by a bank in the conduct of its business operations; or
 - 5) any combination of the specified actions.

See Emergency Consolidation Act of 1988, S. 2715, 100th Cong., 2d Sess. (1988) (proposed but unpassed legislation).