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NOTE

FSLIC FEDERAL RECEIVERSHIP APPOINTMENTS FOR ALLEGEDLY INSOLVENT STATE SAVINGS AND LOAN ASSOCIATIONS: A PLOT TO FEDERALIZE STATE SAVINGS AND LOANS AGAINST THEIR WILL? *TELEGRAPH SAVINGS AND LOAN ASSOCIATION v. SCHILLING*

Evaluating the financial viability of a state-chartered savings and loan association (S&L) invariably involves complicated issues of financial analysis.[1] If an evaluation reveals that a S&L's financial base[2] has eroded sufficiently, then an appropriate state or federal regulatory official[3]

1. Issues such as solvency are central to any discussion of the viability of a savings and loan (S&L). Generally, S&Ls are viable if solvent. A S&L's solvency is measured by its ability to pay outstanding debts as they mature and its ability to satisfy depositors' withdrawal demands dollar-for-dollar. Warner v. Mutual Bldg. & Inv. Corp., 128 Ohio St. 37, 45, 190 N.E. 143, 147 (1934); Mott v. Western Sav. & Loan Ass'n, 142 Or. 344, 351, 20 P.2d 236, 238 (1933). Conversely, S&Ls are not viable if they are insolvent. A S&L's insolvency is defined as a reduction in the available and collectible assets of the S&L below the level of its paid-in stock, thereby rendering it impossible for the S&L to repay stockholders' contributions. People *ex rel.* Barret v. Logan County Bldg. & Loan Ass'n, 369 Ill. 518, 528, 17 N.E.2d 4, 10 (1938); Chapman v. Young, 65 Ill. App. 131, 138 (1896). For an evaluation of a S&L, see STANDARD AND POOR'S INDUSTRIAL SURVEYS 28-34 (July A-L, 1983) (negative spreads between mortgage portfolio returns and cost of funds threaten viability). *See also* 1982 FEDERAL HOME LOAN BANK BOARD ANNUAL REPORT 25 (1983) (historical cost basis does not accurately reflect the financial condition of a S&L) [hereinafter cited as 1982 ANNUAL REPORT].

2. A S&L's financial base consists of its cash reserve and its net worth. The cash reserve is a fund out of which depositors' withdrawals are taken and bad debts are absorbed. The net worth is a reflection of a S&L's equity position, assets less liabilities. Serious concern develops when a S&L's financial base erodes below statutory minimums. First, the statutory cash reserve minimum is a dollar amount equal to three percent of all insured account balances in a S&L on the date of calculation. 12 C.F.R. § 563.13(a)(2) (1983). Second, the statutory net worth minimum is a dollar amount equal to the sum of (i) three percent of all liabilities of a S&L, (ii) two percent of recourse liabilities resulting from the sale of any loan, and (iii) an amount equal to twenty percent of a S&L's scheduled items. *Id.* § 563.13(b)(2). For an example of problems in evaluating a S&L's financial base, see Zabrenski, *Changes In Savings and Loan Deposit Account Structure,* 14 FED. HOME LOAN BANK J. 20-26 (1981) (confusion in evaluating statistical data).

3. Whether it is a state or federal regulatory official that takes action hinges upon whether the S&L is state-chartered or federally-chartered. If it is federally-chartered, the Federal Home Loan Bank Board (FHLBB) has the authority to take control and appoint a receiver. 12 U.S.C. § 1464(d)(6)(a) (1982). If it is state-chartered, the state Commissioner of Savings and Loan Associations (Commissioner) has the authority to take control and appoint a receiver. *See, e.g.,* Illinois Savings and Loan Act, § 7-8, ILL. REV. STAT. ch. 17, § 3191 (1983). For a discussion of the duties of receivers, see Student Project, *Savings and Loan Insolvency In The 80's,* 15 AKRON L. REV. 441, 447 (1982).

may take custody and appoint a receiver[4] for the ailing S&L's assets.[5] Illinois statutes that permit state authorities to appoint receivers for state-chartered S&Ls have been examined frequently by the courts.[6] Yet, the federal statute that grants the Federal Home Loan Bank Board (FHLBB) the exclusive power and jurisdiction to appoint a federal receiver for a defaulted state-chartered S&L[7] has received limited judicial review.[8]

The United States Court of Appeals for the Seventh Circuit recently had

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4. As used in this Note, receiver is defined as an entity empowered by a court or statute to take into its custody, control, and management the property and funds of a defaulted S&L. Receiver is also defined in the Home Owners' Loan Act as a person or agency charged by law with the duty of "winding-up" the affairs of an institution. Home Owners' Loan Act, ch. 78, § 5(d), 12 U.S.C. §§ 1461-1468 (1982).

5. A S&L's charter determines who will be appointed receiver upon default. If federally-chartered, the Federal Savings and Loan Insurance Corporation (FSLIC) must be appointed federal receiver by the FHLBB. Federal Savings and Loan Insurance Corporation, 12 C.F.R. § 547.6 (1983). As receiver, the FSLIC is authorized to take over the assets of, and operate a S&L, to merge it with another FSLIC insured S&L, to organize a new federal S&L to take over its assets, and to liquidate a S&L's assets in an orderly manner. 12 U.S.C. §1729(b)(1) (1982). §1729(b)(1) (1982).

If it is state-chartered, the state Commissioner may either appoint the FSLIC as the state receiver or appoint any qualified person, firm, or corporation as the receiver for a defaulted S&L. *See, e.g.*, Illinois Savings and Loan Act, § 10-1, ILL. REV. STAT. ch.17, § 3261 (1983). *But see* 12 U.S.C. § 1464(d) (1982) (FHLBB has authority to appoint the FSLIC federal receiver of a state S&L).

6. *See, e.g.*, Hulman v. Old Reliable Sav. & Loan Ass'n, 115 Ill. App. 2d 313, 253 N.E.2d 163 (1969) (Commissioner of S&L has no power to remove receiver absent express powers to remove); People *ex rel.* Knight v. O'Brien, 40 Ill. 2d 354, 240 N.E.2d 686 (1968) (powers and duties of receivers); People *ex rel.* Barret v. Logan County Bldg. & Loan Ass'n, 369 Ill. 518, 17 N.E.2d 4 (1938) (Commissioner's appointment of state receiver to take possession of property of an allegedly insolvent S&L).

7. As amended, the National Housing Act (NHA) grants the FHLBB exclusive power and jurisdiction to appoint the FSLIC as a federal receiver for a defaulted state S&L. Three prerequisites, however, must be satisfied before the FHLBB can preempt the state Commissioner and appoint the FSLIC. Section 406(c) of the NHA, as amended, provides in pertinent part:

> (A) that (i) a conservator, receiver, or other legal custodian (whether or not the [FSLIC]) has been or is hereafter appointed for an insured institution which is not a Federal association other than by the [FHLBB] (whether or not such institution is in default) and that the appointment of such conservator, receiver or custodian, or any combination thereof, has been outstanding for a period of at least fifteen consecutive days, or (ii) an insured institution (other than a Federal Association) has been closed by or under the laws of any State;
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> (B) That one or more of the grounds specified in paragraph (6)(A) of section 5(d) of the Home Owners' Loan Act of 1933 [12 U.S.C. §1464(d) (1982). For full text, see *infra* note 62.], existed with respect to such institution at the time a conservator, receiver, or other legal custodian was appointed, or at the time such institution was closed, or exists thereafter during the appointment of the conservator, receiver, or other legal custodian or while the institution is closed; and
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> (C) That one or more of the holders of withdrawable accounts in such institution is unable to obtain a withdrawal of his account, in whole or in part; the [FHLBB] shall have exclusive power and jurisdiction to appoint the [FSLIC] as sole conservator or receiver for such institution.

12 U.S.C. § 1729(c)(2) (1982).

8. Since the 1968 amendment was added to § 1729(c)(2), that amendment has been inter-

occasion to examine, for the first time, the federal statute granting federal receivership appointment powers over state S&Ls. Confronted with a particularly strained application of this statute, the Seventh Circuit ruled in *Telegraph Savings and Loan Association v. Schilling*[9] that the statutory prerequisites for a federal receivership were satisfied by a sham, prearranged, "emergency" closing of a state S&L that was still financially able to pay depositors.[10] Through the decision in *Telegraph,* the Seventh Circuit has granted unbridled discretion to a single federal agency to both determine insolvency and to scheme with state officials to close state S&Ls irrespective of federally-mandated closing criteria.[11] In so doing, the *Telegraph* court demonstrated a murky understanding of the potential abuse of such discretion, and indicated a resolve to defer to the FHLBB's insolvency determinations under virtually all circumstances.

In order to analyze the importance of *Telegraph,* this Note will consider the historical development of the federal receivership appointment statute. This Note also will examine and criticize the reasoning of the Seventh Circuit in the *Telegraph* decision and will discuss the impact of that decision on the S&L industry nationwide. Finally, this Note will present a sample statute designed to limit federal receivership appointment powers as a legislative alternative for the protection of thė state S&L industry from overzealous federal authoritites.

BACKGROUND

The regulation of financial institutions[12] is a relatively recent development. Prior to the Banking Act of 1933,[13] banks were free to operate as they wished,[14] subject primarily to market conditions.[15] After the 1929 market

preted by the courts in only three decisions. *See* Biscayne Fed. Sav. & Loan Ass'n v. Federal Home Loan Bank Bd., 720 F.2d 1499 (11th Cir. 1983); Telegraph Sav. & Loan Ass'n v. Schilling, 703 F.2d 1019 (7th Cir. 1983); Fidelity Sav. & Loan Ass'n v. Federal Home Loan Bank Bd., 689 F.2d 803, 811 (9th Cir. 1982), *cert. denied,* 103 S. Ct. 1893 (1983). For a discussion of the 1968 amendment to 12 U.S.C. § 1769(c)(2), see *infra* notes 55-69 and accompanying text.

9. 703 F.2d 1019 (7th Cir. 1983).

10. *Id.* at 1030.

11. *See infra* note 186 and accompanying text.

12. The term "financial institutions" as used in this Note includes all banks, S&Ls, bank holding companies, and trust companies. BLACK'S LAW DICTIONARY 568 (5th ed. 1979).

13. In 1933, Congress passed the Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended at 12 U.S.C. § 1701-1750(g) (1982)). The purpose of the Banking Act was to provide for safer and more effective use of the assets of banks, to regulate interbank control, and to prevent the diversion of funds into speculative operations. *Id. See generally* Molet, *Great Bank Rescue of 1933,* 151 BANKERS MAG. 9-27 (1968) (the Banking Act saved the industry by regulating capital commitment and preventing speculative investments by banks).

14. *See, e.g.,* Lochner v. New York, 198 U.S. 45 (1905) (the *Lochner* decision promoted free commerce by advocating active judicial intervention to invalidate economic regulation). For a comprehensive summary of the judicial decisions of the pre-Depression era, see B. WRIGHT, THE GROWTH OF AMERICAN CONSTITUTIONAL LAW (1942) (laissez-faire reigned).

15. The supply of banking funds and consumers' demands dictated the market conditions in the early part of the twentieth century. *See generally* A. SCHLESINGER, JR., THE COMING OF THE NEW DEAL 1-26 (1959) (President Roosevelt created new restraints on supply and demand

collapse,[16] however, the abuse[17] and inadequacies[18] of the banking system created grave concern in Congress. The home mortgage[19] market had also been a cause of great concern in Congress since the turn of the century.[20] In response to the volatile nature of the abusive practices in the banking

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in the banking industry during his first 100 days in office); A. SMITH, THE WEALTH OF NATIONS 47-59 (1789) (regulation is unnecessary, impractical, and dangerous); C. Cononer, *The Market As Regulator,* 159 S. BANKER 23-25 (1983) (the price of loanable funds rises and falls according to the strengths of market demand and money supply). *But see* National Banking Act of 1864, ch.106, 13 Stat. 99 (codified as amended at 12 U.S.C. § 21-213 (1982)) (first major piece of banking legislation ever); Federal Reserve Act, ch. 84, 38 Stat. 251 (1913) (codified as amended at 12 U.S.C. § 226 (1982)) (major legislation establishing a more effective supervision of banking in the United States).

16. The market collapse was exemplified by the stock market crash of 1929 and the depression which followed. The decline of the *New York Times* stock averages illustrated the unprecedented plummet in stock prices. In September 1929, the *New York Times* average of industrial stocks stood at 452 (452 is the aggregate value of one share of each stock listed in the index). By mid-November, the average had fallen to a shattering 224 and in July 1932, the *New York Times* average bottomed at 58. 1982 ANNUAL REPORT, *supra* note 1, at 6. *See generally* L. WENDT, THE WALL STREET JOURNAL 197-216 (1982) (a history of the *Wall Street Journal's* articles relating to the market collapse of late 1929 and the early 1930's). Other statistics reveal an equally grim story. More than 100,000 businesses failed between 1929 and 1932. Further, in 1929, 659 banks closed with total deposits of about $200 million. In 1931, 2,294 additional banks closed with $1.7 billion in deposits. 1982 ANNUAL REPORT, *supra* note 1, at 6. *See generally* A. SCHLESINGER, JR., *supra* note 15, at 456-470 (a discussion of how President Roosevelt gained control of the nation's stock exchanges).

17. Banking abuse was a grave concern because of its potential for nationally devastating effects. *See* Williams, *Fresh Light On 1927-1935 Banking Period,* 79 BANKERS MAG. 28 (1962) (publicized incidents of banking abuse undercut the public's confidence in national banking).

18. One inadequacy that emerged as a result of heavy reliance by the S&Ls on the ailing commercial banking system as their primary source of credit was the depletion of commercial banks' liquid assets. The honoring of depositors' withdrawal requests drained these liquid assets. The resulting lack of liquid assets caused the S&Ls' source of credit to be eliminated. A cessation of mortgage lending resulted. To compound the problem, the number of mortgage foreclosures increased from 75,000 in 1928 to over 275,000 in 1932. 1982 ANNUAL REPORT, *supra* note 1, at 6.

Another inadequacy which developed was the hesitancy of S&Ls to tie-up their funds in long-term loans because of the uncertainty surrounding the financial market during the Depression. *See* J. BOYKIN, FINANCIAL REAL ESTATE 39 (1979) (the S&Ls' hesitancy to issue long-term loans caused the real estate purchasing and building markets to collapse).

19. The term "home mortgage," as defined in the NHA, means a first mortgage upon real estate in fee simple, or leasehold under a renewable lease for not less than 99 years, upon which there is located a dwelling for not more than three families, and includes, in addition to first mortgages, such classes of first liens as are commonly given to secure advances on real estate by institutions authorized to become members, under the laws of the state in which the real estate is located. National Housing Act, Pub. L. No. 73-479, 48 Stat. 1246, 1247 (1934).

20. Regulation of the home mortgage field was necessary to provide a source of funds to the public to provide citizens with the opportunity to finance housing purchases. In the early 1900's, citizens could not buy or build a home until they had saved enough money to pay for it completely.

From 1910 through 1919, there was a population migration into urban areas to support the war effort. These migrators filled the housing vacancies created by departing soldiers. A severe housing shortage developed at the end of World War I when the soldiers returned to the United States only to find all the homes occupied. These soldiers demanded mortgage loans to pay for new housing. There was a shortage of investment capital, however, because S&Ls

and home mortgage markets, Congress enacted extensive New Deal legislation regulating various financial industries.[21] One such piece of legislation, the Home Owners' Loan Act of 1933,[22] created federally chartered S&Ls[23] "to provide for the financing of homes." The Home Owners' Loan Act generally was designed to relieve home owners of oppressive mortgage market conditions.[24]

Congress also passed the Federal Home Loan Bank Act in a further attempt to promote favorable mortgage market conditions.[25] This act created a hierarchical federal system to supervise the S&L industry.[26] The system is comprised of, in descending order, the FHLBB,[27] twelve regional Federal Home Loan Banks,[28] and The Home Loan Bank's member institutions,[29] which

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were slow to accept the concept of mortgage loans. An acute shortage continued into the 1930's. Despite the shortage, S&Ls refused to assume the risk of long-term lending of large sums of money at fixed rates of interest during an unprecedented period of financial depression. As a result, with no indication of recovery in sight, demands for housing vastly exceeded the supply of mortgage loans. 1982 ANNUAL REPORT, *supra* note 1, at 6-7; *see also, supra* note 18 (depletion of commercial banks' liquid assets resulted in cessation of mortgage lending).

21. *See* A. SCHLESINGER, JR., *supra* note 15, at 1-26 (a presentation of President Roosevelt's extensive legislation during his first 100 days).

22. Pub. L. No. 73-43, 48 Stat. 128 (codified as amended at 12 U.S.C. §§ 1461-1470 (1982)).

23. Home Owners' Loan Act of 1933, Pub. L. No. 73-43, § 5(a), 48 Stat. 128, 132.

24. The specified purposes of the Home Owners' Loan Act were to provide emergency relief for home mortgage indebtedness, to refinance home mortgages, to extend relief to homeowners who are unable to amortize their debts elsewhere, and to provide financial institutions in which people may invest their funds. Home Owners' Loan Act of 1933, Pub. L. No. 73-43, § 5(a), 48 Stat. 128, 132; *cf.* S. REP. No. 1263, 90th Cong., 2d Sess., *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS 2530, 2535 (the home building industry and millions of American home buyers depend upon S&Ls to help finance the construction and purchase of homes).

25. Federal Home Loan Bank Act, 12 U.S.C. §§ 1421-1449 (1982).

26. The Federal Home Loan Bank Act established the Federal Home Loan Bank System to serve as a reserve credit system for member S&Ls, the FHLBB, a regulatory agency, and twelve regional district banks. *Id.* §§ 1421-1449. The act also marked the beginning of organized growth in the S&L industry. D. COHEN & R. FREIER, THE FEDERAL HOME LOAN BANK SYSTEM 7 (1980).

27. The FHLBB is an independent agency of the executive branch of the federal government. It is the agency that regulates all federally chartered S&Ls and shares regulatory authority with the states over those state institutions whose deposits are insured by the FSLIC. The FHLBB both oversees and serves the 12 regional Federal Home Loan Banks and their member institutions. Further, the FHLBB supervises the activities of the FSLIC. *See* 12 U.S.C. §§ 1421-1449 (1983). *See generally* 1982 ANNUAL REPORT, *supra* note 1, at 3 (annual report gives a listing of the FHLBB's duties).

28. The regional Federal Home Loan Banks serve 12 geographical areas of the country (Chicago, New York, Boston, San Francisco, Pittsburgh, Atlanta, Cincinnati, Indianapolis, Little Rock, Des Moines, Topeka, and Seattle). Although the banks operate within a framework established by the FHLBB, they are wholly owned by their member institutions and are responsive to their members' needs. A major function of the regional banks is to lend funds in the form of advances to member institutions for savings withdrawals, seasonal needs, expansion of mortgage lending, and special purposes such as community investment. *See* D. COHEN & R. FREIER, *supra* note 26, at 21-42 (discussing the responsibilities and operations of Federal Home Loan Banks).

29. The final component of the hierarchical system is the membership of about 4,200 financial institutions. These S&Ls hold nearly 98% of all S&L assets in the country. D. COHEN & R. FREIER, *supra* note 26, at 3.

include both federally-chartered[30] and state-chartered[31] S&Ls.

In 1934 the FHLBB's supervisory and regulatory powers were expanded by the National Housing Act (NHA),[32] which authorized the FHLBB to oversee the Federal Savings and Loan Insurance Corporation (FSLIC).[33] The FSLIC, a newly created governmental agency,[34] was considered fundamental to the financial stability of the entire S&L industry.[35] Since its inception,

30. Approximately one-half of the S&Ls are federally-chartered by the FHLBB and subject to the FHLBB's regulation. These institutions must always carry the word "Federal" in their names. *Id.* at 43-50. Federal S&Ls do not engage in general banking business, but are set up for the declared congressional purpose of providing S&L institutions in which people may invest their funds and provide for the financing of homes. North Arlington Nat'l Bank v. Kearny Fed. Sav. & Loan Ass'n, 187 F.2d 564, 567 (3d Cir. 1951); *accord* United States *ex rel.* Wisconsin v. First Fed. Sav. & Loan Ass'n, 151 F. Supp. 690, 697 (E.D. Wis. 1957), *modified on other grounds,* 284 F.2d 804 (7th Cir. 1957). All federal S&Ls are chartered and supervised by the FHLBB, and may be either new institutions or converted state-chartered institutions. 12 U.S.C. § 1464(f) (1982).

31. Approximately one-half of all S&Ls are state-chartered. Ninety-eight percent of state S&Ls insure their customers' deposits with the FSLIC. Further, almost all states require state-chartered member S&Ls to carry FSLIC insurance. By virtue of FSLIC insurance, the state chartered S&Ls are subject to FHLBB regulation. *See* J. WHITE, TEACHING MATERIALS ON BANKING LAW 43 (1976) (the S&L system in the United States consists of federally-chartered and state-chartered institutions).

32. Pub. L. No. 73-479, 48 Stat. 1246 (1934) (codified as amended at 12 U.S.C. §§ 1701-1750(g) (1982)).

33. The NHA created the FSLIC, 12 U.S.C. § 1725(a) (1982), to insure savings accounts and to prevent the default of an insured institution. D. COHEN & R. FREIER, *supra* note 26, at 54. When the FSLIC was created, insurance coverage was $5,000 per account. Coverage was raised to $10,000 in 1950, $15,000 in 1966, $20,000 in 1969, $40,000 in 1974, and finally to $100,000 in 1980. 1982 ANNUAL REPORT, *supra* note 1, at 8. *See generally* 1982 ANNUAL REPORT, *supra* note 1, at 13-18 (a presentation of the FSLIC's role in insuring deposit accounts).

34. A controversy exists as to whether the FSLIC is a governmental agency or a private corporation. Most depositors undoubtedly deposit their funds in FSLIC insured associations in the belief that such deposits are safe because they are insured by an agency of the federal government. *See* Alexander, *The Ohio Deposit Guarantee Fund—The Ohio Alternative To FSLIC,* 15 AKRON L. REV. 431 (1982) (the FSLIC is not an agency of the federal government, even though the "the word 'federal' in the title of FSLIC suggests that the entity is an agency of the federal government"). *But see* Guardian Fed. Sav. & Loan Ass'n v. FSLIC, 589 F.2d 658 (D.C. Cir. 1978); FSLIC v. Quinn, 419 F.2d 1014 (7th Cir. 1969); Investments, Inc. v. FSLIC, 353 F.2d 236 (9th Cir. 1966) (all three cases declaring that the FSLIC is a federal agency).

35. During the early 1930's, the S&L industry encountered several serious problems. Defaults on mortgage loans surged as the unemployment rate reached unprecedented levels. Property used as collateral against outstanding loans, as well as property that had already been repossessed, declined in value, often below the amount of the loan. Savings account withdrawals were also extremely heavy, exerting further pressure on the industry's liquidity. As a result of these problems, approximately 1,700 institutions failed, causing losses to depositors of more than $200 million. Congress established the FSLIC to remedy the immediate problems facing the S&L industry and to ensure its future stability.

Since its creation, the FSLIC has assured the public of the existence of sound financial institutions that, in turn, serve as intermediaries for the public's thrift and home financing needs. Federal insurance of deposited accounts restored the public's confidence in financial institutions enough to relieve the panic that had caused increasing withdrawals. D. COHEN & R. FREIER, *supra* note 26, at 8-9; *see* S. REP. No. 1263, 90th Cong., 2d Sess., *reprinted in*

the FSLIC's two principal functions have been to insure funds deposited with all federal[36] and some state[37] S&Ls, and to administer insurance payouts[38] and liquidation procedures when an insured S&L becomes insolvent.[39]

The NHA focused on the liquidation function of the FSLIC in the event of a S&L default[40] and placed great significance on whether the failing

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1968 U.S. CODE CONG. & AD. NEWS 2530, 2535 (the FSLIC is fundamental to the financial stability of the S&L industry). *See generally* Note, *Savings And Loan Stabilization Resulting From FSLIC*, 7 WIS. L. REV. 255, 268 (1938) (the FSLIC's creation slowed net withdrawals enabling S&Ls to retain adequate capital accounts).

36. 12 U.S.C. § 1726(a)(1) (1982); *see supra* note 30.

37. 12 U.S.C. § 1726(a)(2) (1982). The FSLIC is not compelled to insure any state S&L. For a discussion of relevent factors considered by the FSLIC when determining whether to insure a state S&L, see Case Comment, *FSLIC Discretion In Insuring State-Chartered Institutions*, 91 HARV. L. REV. 1090, 1118 (1978). Nor are state S&Ls required to obtain FSLIC insurance. *See, e.g.*, Alexander, *supra* note 34, at 438 (some state S&Ls have the option of obtaining FSLIC insurance or a state sponsored insurance). If FSLIC insurance is not obtained, alternative insurance is available. *Id.* at 450 (Ohio established alternative state insurance); *see* J. WHITE, *supra* note 31, at 48 (approximately 97% of all S&Ls in the United States are FSLIC insured). *See generally* West Helena Sav. & Loan Ass'n v. Federal Home Loan Bank Bd., 553 F.2d 1175 (8th Cir. 1977) (FHLBB had no power to reject a FSLIC insurance application on the basis of lack of economic need for the services proposed in a particular area).

38. S&Ls whose applications are approved by the FSLIC are entitled to insurance coverage up to the full withdrawal value of the accounts of each of its depositors holding withdrawable accounts or investment certificates. 12 U.S.C. § 1728(a) (1982). For a discussion of what constitutes the full withdrawal value, see Mahoney v. FSLIC, 393 F.2d 156 (7th Cir. 1968). No individual depositor of any S&L, however, shall be insured for an aggregate amount in excess of $100,000 (one exception exists: insurance of public funds can exceed $100,000). 12 U.S.C. § 1728(d) (1982). In the event of an insured S&L's default, payment of each insured account in such S&L shall be made by the FSLIC, as soon as possible, either in cash or by making available to each insured depositor a transferred amount in another insured institution in the same community. *Id.* § 1728(b).

39. In order to facilitate liquidation of a defaulted, but insured S&L, the FSLIC is authorized to sell the assets and account-deposits to another insured S&L. The FSLIC is also authorized to provide for the organization of a new federal S&L to which the defaulted S&L's assets could be sold. 12 U.S.C. § 1729(a) (1982). Aside from the insurance and insurance payout functions, the FSLIC has or had other functions. For example, Congress created the FSLIC to encourage investors to redeposit their funds in depression-ravaged S&Ls' accounts. Many depositors' funds had been transferred to commercial banks in the first year of the Federal Deposit Insurance Corporation in search of financial security. 78 CONG. REC. 11,196 (1934). Another function of the FSLIC is the collection of the premium charges paid by member institutions for insurance. Such money is placed into reserve funds which credit the amount of any prepayments made by insured institutions. *See* 12 U.S.C. § 1727(a) (1982); *infra* notes 48-54 and accompanying text. Yet another function is the termination of insurance coverage whenever an insured S&L violates its duty or engages in unsafe or unsound business practice. *See* 12 U.S.C. § 1730(b) (1982).

40. Default means an adjudication or determination by a proper authority "pursuant to which a conservator, receiver, or other legal custodian is appointed for an insured institution for the purpose of liquidation." 12 U.S.C. § 1724(d) (1982) (adopted in Fidelity Sav. & Loan Ass'n v. Federal Home Loan Bank Bd., 689 F.2d 803 (9th Cir. 1982)). To prevent the default of an insured S&L, or to restore it to normal operation, the FSLIC may make loans to, purchase the assets of, or make a financial contribution to such a S&L. 12 U.S.C. §§ 1724-1730 (1982).

institution was a federally-chartered or state-chartered association. If the failing association was federally-chartered, section 406(b) of the NHA empowered the FHLBB to appoint a FSLIC receiver to manage the defaulted association.[41] If the failing association was state-chartered, however, the NHA did not grant the FHLBB independent authority to appoint a FSLIC receiver,[42] but did require the FSLIC to make insurace payouts. Section 406(c) of the NHA authorized the FSLIC to act as the receiver for a state association only if an appropriate state official appointed the FSLIC as receiver.[43] Once appointed by the appropriate state authority, the FSLIC had the same powers and duties with respect to a defaulted state association as it did with respect to a defaulted federal association.[44]

Serious shortcomings of the NHA's state-federal dichotomy surfaced during the Illinois banking crisis of the 1960's.[45] Most notable was the strain on the FSLIC's cash reserve[46] which resulted from a rash of defaults of

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41. In its original language, section 406(b) of the NHA provides:

> In the event that a federal savings and loan association is in default, the [FSLIC] shall be appointed as conservator or receiver and is authorized as such (1) to take over the assets of and operate such association, (2) to take such action as may be necessary to put it in a sound and solvent condition, (3) to merge it with another insured institution, (4) to organize a new federal savings and loan association to take over its assets, or (5) to proceed to liquidate its assets in an orderly manner, whichever shall appear to be in the best interests of the insured members of the association in default; and in any event the [FSLIC] shall pay the insurance as provided in section 405 and all valid credit obligations of such association.

Pub. L. No. 73-479, 48 Stat. 1246, 1260 (1934) (codified at 12 U.S.C. § 1729(b) (1982)).

42. *Telegraph,* 703 F.2d at 1023.

43. Before substantial amendment, the original text of § 406(c) provided:

> In the event any insured institution other than a federal savings and loan association is in default, the [FSLIC] shall have the authority to act as conservator, receiver, or other legal custodian of such insured institution, and the services of the [FSLIC] are hereby tendered to the court or other public authority having the power of appointment.

National Housing Act, Pub. L. No. 73-479, 48 Stat. 1246, 1260 (1934) (codified at 12 U.S.C. § 1729(b) (1982)); *see supra* note 7 for the current version of § 406(c). In Illinois, the state official authorized to appoint the FSLIC receiver is the Commissioner. Illinois Savings and Loan Act, ILL. REV. STAT. ch. 17, § 10-1 (1983).

44. 12 U.S.C. § 1729(c)(1) (1982). For a description of the FSLIC's powers and duties, see *supra* notes 36-39 and accompanying text.

45. Illinois S&Ls faced many problems in the 1960's. Illinois productivity fell, the rate of inflation almost doubled over the previous decade, and interest rates skyrocketed. Faced with high interest rates and increased competition for direct deposits from unregulated financial intermediaries such as money market mutual funds, S&Ls experienced savings outflows and deteriorating net worth. 1980 FEDERAL HOME LOAN BANK BOARD OF CHICAGO ANNUAL REPORT 10 (1981). At a time when S&Ls were saddled with long-term, low-yielding loan portfolios, savers fled banks and S&Ls for the money markets. For the first time in the post-Depression period, cash reserve requirements and net-worth requirements were difficult to satisfy. *Id.* For a definition of cash reserves and net worth, see *supra* note 2.

46. The FSLIC maintains a cash reserve which is a general reserve from which loans to ailing S&Ls are made and from which FSLIC insurance payouts are made to depositors of defaulted S&Ls. 12 U.S.C. § 1728 (1982).

Illinois-chartered S&Ls.[47] These defaulting, federally insured S&Ls demanded and received insurance payouts pursuant to section 406(c) of the NHA. After the state associations obtained federal payouts, the Commissioner of Savings and Loans (Commissioner) of Illinois refused to grant reciprocal FSLIC receivership appointments, taking advantage of the state-federal dichotomy created by section 406(c) of the NHA. Consequently, the FSLIC was required to disburse substantial amounts of funds without a voice in the liquidation process,[48] despite the adverse disposition by Illinois-appointed receivers of the FSLIC's claimed assets.[49] The FSLIC was thus placed in the financially precarious position of disbursing large amounts of funds with little chance of repayment.[50] In the absence of statutory relief from such a financial drain,[51] serious doubts arose as to the FSLIC's ability to meet insurance requests in other similar situations.[52] Not surprisingly, the potential inability of the FSLIC to fulfill one of its principal functions created serious public concern.[53]

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47. Prior to 1980, only 13 S&Ls were so financially troubled that the FSLIC closed those S&Ls and made insurance payments. Seven closings occurred during the Depression; the remaining six S&L closings occurred during the 1960's. *See* D. COHEN & R. FREIER, *supra* note 26, at 11. Of the six S&L closings in the 1960's, five occurred in Illinois. *See* S. REP. NO. 1263, 90th Cong., 2d Sess., *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS 2530, 2536.

48. The FSLIC made insurance payouts in the State of Illinois exceeding $216 million. None of those funds were ever recovered. S. REP. NO. 1263, 90th Cong., 2d Sess., *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS 2530, 2536. Under the existing laws, the FSLIC and FHLBB were "completely powerless" during the liquidation of the Illinois S&Ls because the FHLBB could not appoint the FSLIC as receiver to safeguard the state S&Ls' assets and effect an orderly liquidation. *Id.* at 2537; *see* 114 CONG. REC. 18,299 (1968).

49. In all Illinois S&L closures, receivers for the S&Ls were appointed by the Illinois Commissioner. Although Illinois law permitted the FSLIC to be appointed receiver for Illinois S&Ls, the Illinois Commissioner did not choose to appoint the FSLIC, despite the FSLIC's claim to more than 95% of the assets of the S&Ls. Thus, the FSLIC had a vital stake in the management and disposition of the assets of the state S&L in receivership. S. REP. NO. 1263, 90th Cong., 2d Sess., *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS 2530, 2536.

50. FSLIC insurance payouts are automatically triggered when a S&L defaults, even though FSLIC reimbursement appears unlikely because of an uncooperative state appointed receiver. In 1968, for example, the Illinois receiver for the defaulted Marshall Savings & Loan Association refused to disclose Marshall's financial records. When finally disclosed, the records revealed that the receiver tied up $83 million of the FSLIC's capital for three years at a cost to the FSLIC of $12 million in interest. The receiver also increased the S&L's insolvency by more than $4 million and failed to pay back "a single penny" to the FSLIC for insurance payouts or interest expenses on the FSLIC's capital. S. REP NO. 1263, 90th Cong., 2d Sess., *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS 2530, 2536-2538. The FSLIC does have a sound claim for interest cost reimbursement, but this claim can only be satisfied from any surplus remaining after payment in full of principal owed to creditors, the FSLIC, and uninsured depositors. *See* Jamison v. FDIC, 149 F.2d 199, 208 (5th Cir. 1945); *see also* Wilhoit v. FDIC, 143 F.2d 14, 19 (6th Cir. 1943).

51. The FSLIC insurance payouts financially drain the FSLIC cash reserve fund. *See supra* note 46 and accompanying text.

52. *See* S. REP. NO. 1263, 90th Cong., 2d Sess., *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS 2530, 2536.

53. *Id.* The ability of the S&L industry to help meet the nation's housing needs would

In 1968, Congress sought to remedy this plague upon the FSLIC's financial integrity by amending section 406(c) of the NHA, which, as previously noted, allowed the FSLIC to serve as receiver for defaulted state S&Ls only if appointed by the state.[54] The amendment sought "to enable the FSLIC to effect an orderly disposition of the assets of insured associations whose depositors have been reimbursed by FSLIC insurance payments."[55] As originally proposed, the Senate amendment to section 406(c)[56] added an additional paragraph, 406(c)(2), which empowered the FHLBB to appoint the FSLIC as receiver for state S&Ls provided that two prerequisites were satisfied: a receiver had to be appointed for the S&L under state law (or the association had to be closed under state law); and the FHLBB had to determine that "such an appointment would be advisable in the public interest."[57]

Believing that these two prerequisites were too broad and afforded virtually no substantive judicial review,[58] the Conference Committee altered the Senate bill and increased to three the number of prerequisites which must be satisfied before the FHLBB can appoint the FSLIC as receiver for a state S&L. With respect to section 406(c)(2)(A), the committee retained the Senate bill's prerequisite that the association be closed under state law,[59] but also allowed that prerequisite to be satisfied in the alternative if "a conservator, receiver, or other custodian" has been appointed for at least fifteen days under state law.[60] With respect to section 406(c)(2)(B), the committee deleted

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not have been possible without the public being confident that their deposits were safe and secure. *Id.*

54. *See supra* notes 42-44 and accompanying text.

55. S. REP No. 1263, 90th Cong., 2d Sess., *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS 2530, 2531; *see* 114 CONG. REC. 18,298 (1968) ("Congress concluded that, in order to enable FSLIC to make prompt payments of insurance to depositors and to ensure an orderly disposition of assets, the [FHLBB] needed the authority to make FSLIC a federal receiver for state-chartered associations in certain circumstances.").

56. For the text of § 406(c) prior to amendment, see *supra* note 43.

57. S. 3436, 90th Cong., 2d Sess. (1968).

58. *See* S. REP No. 1263, 90th Cong., 2d Sess., *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS 2530, 2541 (state S&Ls would have been placed in the position of having fewer legal challenges than federal S&Ls to the appointment of the FSLIC as receiver).

59. *See supra* note 57 and accompanying text.

60. The first prerequisite for FSLIC receivership appointment for defaulted state S&Ls is

> (A) that (i) a conservator, receiver, or other legal custodian (whether or not the FSLIC) has been or is hereafter appointed for an insured institution which is not a federal savings and loan association other than by the FHLBB (whether or not said institution is in default) and that the appointment of such conservator, receiver, or custodian, or any combination thereof, has been outstanding for a period of at least fifteen consecutive days, or (ii) an insured institution (other than a federal savings and loan association) has been closed by or under the laws of any state.

Bank Protection Act of 1968, Pub. L. No. 90-389, 82 Stat. 294, 295 (codified at 12 U.S.C. § 1729(C)(2)(A) (1982)). The 15-day waiting period was added to confine the use of the FHLBB's appointment authority to only the most urgent situations and to preclude FSLIC receivership in those cases were state authorities appointed a receiver for only a brief period. *See* S. REP No. 1263, 90th Cong., 2d Sess., *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS 2530, 2541.

the Senate bill's original prerequisite that the FSLIC appointment be "advisable in the public interest"[61] and replaced it with a new provision. The new prerequisite required the FHLBB to determine whether one or more of the conditions specified in paragraph (6)(A) of section 5(d) of the Home Owners' Loan Act of 1933[62] existed with respect to a S&L at the time a receiver was appointed, or at the time the S&L was closed.[63] For example, one condition specified under section 5(d) is the insolvency of a S&L.[64] The committee created a third and final prerequisite, section 406(c)(2)(C), which requires that account holders be unable to withdraw their funds.[65] These committee changes were adopted, and Congress enacted the Senate bill as amended—the Bank Protection Act of 1968.[66] In essence, the legislative amendment outlined above, which remains in force today, grants the FHLBB independent authority to appoint the FSLIC as receiver for state S&Ls in some circumstances regardless of whether the state desires such an appointment.[67]

During the late 1970's and early 1980's, the pressures of severe inflation, fueled by unprecedented high interest rates,[68] threatened the viability of some S&Ls.[69] The high interest costs paid by S&Ls to acquire money for loans to prospective mortgage buyers, coupled with locked-in low interest mort-

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61. *See supra* note 57 and accompanying text.

62. 12 U.S.C. § 1464 (1982). The five grounds specified in ¶ (6)(A) of § 5(d) of the Home Owners' Loan Act of 1933 are:

> (i) insolvency in that the assets of the association are less than its obligations to its creditors and other, including its members; (ii) substantial dissipation of assets or earnings due to any violation of laws, rules, or regulations, or to any unsafe or unsound practice or practices; (iii) an unsafe or unsound condition to transact business; (iv) willful violation of a cease-and-desist order which has become final; (v) concealment of books, papers, records or assets of the association or refusal to submit books, papers, records, or affairs of the association for inspection to any examiner or to any lawful agent of the FHLBB.

Id. § 1464(d)(6)(a).

63. According to the text of 12 U.S.C. § 1729(c)(2)(B), the second prerequisite for FSLIC receivership appointments for defaulted state S&Ls is met when

> one or more grounds specified in paragraph (6)(a) of section 1464(d) of this title (United States Code, Title 12), existed with respect to such institution at the time a conservator, receiver, or other legal custodian was appointed, or at the time such institution was closed, or exists thereafter during the appointment of the conservator, receiver, or other legal custodian or while the institution is close.

Id. § 1729(c)(2)(B).

64. *Id.* § 1464(d)(6)(a)(i).

65. The third prerequisite for FSLIC receivership is "[t]hat one or more of the holders of withdrawable accounts in such institutions [be] unable to obtain a withdrawal of his account, in whole or in part." *Id.* § 1729(c)(2)(C).

66. Bank Protection Act of 1968, Pub. L. No. 90-389, 82 Stat. 294 (1982).

67. *See* S. REP No. 1263, 90th Cong., 2d Sess., *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS 2530, 2541.

68. *See generally* 1981 FEDERAL HOME LOAN BANK BOARD ANNUAL REPORT 16 (1982) (graph showing 1975-1981 interest rates) [hereinafter cited as 1981 ANNUAL REPORT].

69. The FHLBB reported that 70% of all S&Ls suffered a decrease in net worth (assets minus liabilities) in 1981. Also, during the same period, approximately 35% of all S&Ls suffered operating losses. Wall. St. J., Sept. 29, 1981, at 10, col. 2.

gage revenues,[70] created serious cash flow and net-worth difficulties for many S&Ls.[71] As a result, many state S&Ls were declared insolvent.[72] A particularly significant aspect of the 1980's crises was that, for the first time in history, the FHLBB exercised its section 406(c)(2) appointment powers to appoint the FSLIC as a federal receiver for those insolvent state S&Ls without state approval.

These appointments of federal receivers for state S&Ls precipitated the first judicial interpretation of the 1968 amendment to section 406(c) of the NHA.[73] Upset by the appointment of a federal receiver, a failing California S&L challenged the FSLIC's appointment in court and sought the removal of the FSLIC and other equitable relief in *Fidelity Savings and Loan Association v. Federal Home Loan Bank Board.*[74] Fidelity had been experiencing severe financial difficulties as a result of speculative loan commitment practices.[75] To meet its financial obligations,[76] Fidelity borrowed in excess of $1.3 billion from the Federal Home Loan Bank of San Francisco.[77] Moreover, Fidelity's financial decline caused its depositors to withdraw nearly $70 million in deposits during the week of April 5, 1982.[78] On April 13, 1982, the California Commissioner seized Fidelity for the purpose of liquidation and appointed the FSLIC as a state receiver.[79] Subsequently, the FHLBB appointed the FSLIC as a federal receiver pursuant to section 406(c)(2), as amended by the 1968 legislation.[80] The federal appointment abrogated the

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70. Revenues are generated by S&Ls when mortgage note holders pay the interest-cost attached to the principal of the note. Since many long term mortgage holders had secured their mortgages in an era of lower interest rates, the cost of doing business for S&Ls exceeded the revenues generated from such business. The FHLBB reported that the average cost to acquire funds in the S&L industry was 10.31% while the average earnings on home mortgage loans was only 9.72%. *Id.*

71. *See* 1982 FEDERAL HOME LOAN BANK OF CHICAGO ANNUAL REPORT 11 (1983) (cash flow problems and net-worth inadequacies affect a S&L's financial viability and could result in insolvency).

72. Many state chartered S&Ls were declared insolvent between 1978 and 1983. 1981 ANNUAL REPORT, *supra* note 68, at 17.

73. 12 U.S.C. § 1729(c)(2) (1982).

74. 689 F.2d 803 (9th Cir. 1982), *cert. denied,* 103 S. Ct. 1893 (1983). Never before had a faltering state S&L challenged the FHLBB's FSLIC appointment.

75. Gambling that interest rates would fall, Fidelity had sold large amounts of short-term commercial paper in order to obtain the funds to make long-term mortgage loans at then current market rates. When interest rates rose sharply, Fidelity suffered substantial operating losses and a decrease in net worth because the earnings on its low-yielding portfolio were less than the interest cost of its short-term borrowing. 689 F.2d at 805.

76. Fidelity had two types of financial obligations. First, Fidelity was required to satisfy depositors' account withdrawal requests. Second, Fidelity was obligated to pay its short-term liabilities as they came due. *Id.* at 808.

77. *Id.* at 805. These loans were made pursuant to a special credit program in which Fidelity was charged interest penalties and higher interest rates than other borrowing member S&Ls. *Id.*

78. *Id.*

79. *Id.* at 805-07 n.2 (full text of California Commissioner's order to take possession of Fidelity).

80. 12 U.S.C. § 1729(c)(2) (1982).

California Commissioner's ability to control or terminate the state association's receivership.[81] Following the FSLIC's intervention, Fidelity's assets were transferred to a newly created federal institution, Fidelity Federal Savings and Loan Association of San Francisco.[82]

In the United States District Court,[83] Fidelity argued that the statutory prerequisites for the federal receivership appointment had not been satisfied. Fidelity essentially claimed that the association had not been closed under state law and that no depositor had been unable to withdraw funds. The district court accepted Fidelity's contentions and ordered the FHLBB to remove the federal receiver and return to Fidelity certain assets in the federal receiver's possession.[84] The United States Court of Appeals for the Ninth Circuit, however, reversed the district court and held that the prerequisites had been satisfied.[85] The Ninth Circuit concluded that the closing and withdrawal prerequisites under the federal statute are automatically satisfied whenever the FSLIC is appointed as state receiver for the purpose of liquidation.[86]

As the first judicial interpretation of the amendment to section 406(c), the *Fidelity* court's analysis established the standard for reviewing federal appointments of the FSLIC as receiver for state S&Ls. While the statutory construction in *Fidelity* appeared reasonable, a similar construction under the very different facts of *Telegraph* yielded an extremely harsh result.

THE *TELEGRAPH* DECISION

The Facts

In 1865, Telegraph obtained an Illinois charter to operate as a state S&L.[87] Late in the 1970's, Telegraph began experiencing difficulties in meeting the reserve and net-worth requirements imposed by federal regulations.[88] When Telegraph's financial condition began to decline at an increasing rate,[89] state

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81. 689 F.2d at 807.

82. *Id.*

83. Fidelity Sav. & Loan Ass'n v. Federal Home Loan Bank Bd., 540 F. Supp. 1374 (N.D. Cal. 1982).

84. *Id.* at 1385.

85. 689 F.2d at 809.

86. *Id.* at 810.

87. Telegraph was an Illinois state-chartered, FSLIC insured institution, with its main offices located at the corner of LaSalle Street and Jackson Boulevard in Chicago, Illinois. Chartered by the State of Illinois in 1895, Telegraph had deposits in excess of $200 million by 1980. Brief for Appellant at 7, *Telegraph,* 703 F.2d 1019 (7th Cir. 1983) [hereinafter cited as Brief for Appellant]

88. 703 F.2d at 1021. All federally insured S&Ls must satisfy certain reserve and net worth minimums. For a discussion of reserve and net worth minimums, see *supra* note 2 and accompanying text. Several years prior to 1980, Telegraph began experiencing financial difficulties as a result of an adverse "spread" between the yield on its portfolio mortgages and the rising cost of money. 564 F. Supp. at 865.

89. In 1977 and 1978, Telegraph met the minimum reserve and net worth requirements only by earmarking paid-in surplus from the issuance of preferred stock. On June 30, 1979, Telegraph failed to meet its minimum reserve requirement by $303,480 and fell short of its

and federal officials charged with regulating the S&L industry began monitoring more closely Telegraph's financial status. As part of this monitoring process, a special conference was scheduled in 1979 by the Illinois Commissioner and representatives of the FHLBB.[90] At that conference, the Illinois Commissioner concluded that undercapitalization[91] was causing Telegraph's shaky financial condition.[92] A subsequent meeting was held in 1980 to develop plans for infusing the ailing S&L with additional capital.[93] Perceiving the potential for insolvency, the Illinois Commissioner warned that he would close Telegraph unless its financial instability was remedied.[94]

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net worth requirement by $704,513. On this date, Telegraph's net worth was $4,806,938. Over the following 10 months, Telegraph's net worth steadily declined to an April 30, 1980 level of $49,389. In the month of April 1980 alone, the S&L lost over $730,000. Telegraph's daily operating losses accelerated from $15,500 per day in February, to $18,700 in March, to $24,500 in April. 564 F. Supp. at 866.

90. A special meeting was held in October 1979, to identify the cause of Telegraph's financial decline and to propose solutions. Telegraph's Board of Directors and representatives of the Commissioner, the FSLIC, and the FHLBB attended. 703 F.2d at 1021.

91. *Id.* In Illinois, the capital of a S&L may consist of withdrawable capital accounts or permanent reserve shares or both, as authorized by a S&L's articles of incorporation and as provided by § 4-1 of the Illinois Savings and Loan Act. ILL. REV. STAT. ch. 17, § 3091 (1983). Withdrawable capital is frequently referred to as deposits, capital accounts, savings accounts, shares, share accounts, or withdrawable accounts. Permanent reserve shares are a form of non-withdrawable capital which constitute a reserve out of which losses are paid after all other available reserves have been exhausted. *Id.* § 3093. Permanent reserve shares are issued upon cash payment; in exchange for the withdrawl value of withdrawable capital accounts; in connection with a merger, sale of all assets, or conversion; or as stock dividends. *Id.* When the Commissioner referred to "undercapitalization," *see infra* note 92 and accompanying text, he was referring to a deficiency in the permanent shares reserve. When the Commissioner finds, from a report or examination of a S&L, that the permanent reserve capital is impaired, he may direct the S&L's Board of Directors to require the permanent reserve shareholders to contribute an amount sufficient to eliminate the impairment, or reduce the par value of the permanent reserve capital in the amount of the impairment and allocate such reduction to undivided profits or reserves to absorb the loss which created the impairment. ILL. REV. STAT. ch. 17, § 3188 (1983).

92. 703 F.2d at 1021. Telegraph's shaky financial condition resulted from an adverse "spread" between the yield on its mortgages portfolio and the rising cost of acquiring money. 564 F. Supp. at 865.

93. Another special meeting of Telegraph's Board of Directors was held on March 5, 1980. The Illinois Commissioner attended the meeting. At the meeting, the Board presented a number of resolutions intended to prevent Telegraph's financial demise. The minutes of the meeting reflect that several merger possibilities were discussed in detail. 564 F. Supp. at 866.

94. The Commissioner indicated that unless Telegraph's shaky financial condition was remedied, the state would assume custody of Telegraph. 703 F.2d at 1021. The Commissioner has the discretionary authority to take custody of the books, records, and assets of every kind of association, trust, or association in liquidation if it appears from reports made to the Commissioner, or from examination made by the Commissioner,

> (a) That the directors, officers, trustees, or liquidators have neglected, failed, or refused to take any action which the Commissioner may deem necessary for the protection of the association or trust, or have impeded or obstructed an examination; or (b) That the withdrawable capital of the association is impaired to the extent that the realizable value of its assets is insufficient to pay in full its creditors

Responding to the Illinois Commissioner's concerns, Telegraph considered merging with another corporation in an attempt to stabilize its financial position. Under the merger plan, a second company, known as the Heron Corporation, agreed to infuse new capital into Telegraph. In particular, the Heron Corporation offered to purchase $7 million worth of Telegraph's preferred stock.[95] The FHLBB, however, rejected the Heron proposal.[96]

After the FHLBB rejected the Heron proposal and determined that no legitimate proposal for infusing capital had materialized, the Illinois Commissioner and the FHLBB conferred secretly[97] and decided to take control of Telegraph.[98] As a result of this ex parte hearing, the federal and state officials orchestrated a scheme whereby the Illinois Commissioner and the FHLBB would act in tandem to transfer Telegraph's assets to a new federal S&L. Pursuant to his emergency powers,[99] the Illinois Commissioner took custody of Telegraph and seized its assets on May 22, 1981, fifteen minutes before Telegraph was scheduled to close.[100] At the time of the seizure,

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> and holders of its withdrawable capital; or that its permanent reserve capital is impaired; or (c) That the association is unable to continue operation; or (d) That the business of the association, trust, or association in liquidation is being conducted in a fraudulent, illegal, or unsafe manner; or (e) That the officers, employees, trustees, or liquidators have continued to assume duties or perform acts without giving bond as required by the provisions of this Act.

Illinois Savings and Loan Act, § 7-8, ILL. REV. STAT. ch. 17, § 3191 (1983).

95. Telegraph obtained a written commitment from the Heron Corporation to purchase 80% of Telegraph's preferred stock for $7 million. This stock sale would have cured Telegraph's permanent reserve capital deficiency. The deal was conditioned, however, on the FSLIC's promise to provide Telegraph with a 15-year, $15 million interest-free loan. This loan would have increased Telegraph's withdrawable capital reserve. 564 F. Supp. at 866.

96. The FHLBB vetoed the Heron proposal. 703 F.2d at 1021. The proposal was evaluated by the FHLBB on May 22, 1980, at a closed meeting in Washington, D.C. The proposal was rejected for two reasons. First, it was thought to be insufficient to supply the permanent reserve capital needed to stabilize Telegraph. 564 F. Supp. at 866-67. Second, the FHLBB believed that the cost to the FSLIC under the Heron proposal would have been $3 million greater than the cost to the FSLIC for transferring the business to another S&L under a purchase and assumption agreement. *Id.* at 867 n.2. The same footnote, however, reflects that a FHLBB staff member submitted a written recommendation to the FHLBB urging that the Heron proposal be accepted. *Id.*

97. Telegraph was neither given notice of, nor represented by counsel at the May 22, 1980 meeting. The main topic of discussion was the Heron proposal, which was rejected. The result of this closed meeting was the FHLBB's appointment of the FSLIC as receiver for Telegraph. Brief for Appellant, *supra* note 87, at 116.

98. 703 F.2d at 1021.

99. Just before Telegraph's regular closing time, the Commissioner served Telegraph's president with a notice that the state was assuming immediate custody. *Id.* Generally, the Illinois Commissioner must give written notice to the directors, trustees, or liquidators prior to taking custody of a failing S&L. The notice must specify the S&L's criticized conditions and state a reasonable time within which correction may be made. Illinois Savings and Loan Act, § 7-8, ILL. REV. STAT. ch. 17, § 3191 (1983). However, when the Commissioner finds that an emergency exists which may result in loss to members or creditors and requires that he take custody immediately, the Commissioner may seize the assets of a S&L without written notice. *Id.*

100. 703 F.2d at 1021.

Telegraph's vault contained more than $11 million worth of liquid assets.[101]

After taking custody of Telegraph, the Commissioner sent his deputy to a teller's window where a FHLBB employee with an account at Telegraph had been instructed to wait.[102] The FHLBB employee approached the teller's window, as instructed, and requested a twenty-five dollars withdrawal from his account.[103] The deputy intervened and denied the withdrawal request.[104]

Concomitant with Telegraph's closing, the FHLBB exercised its statutory authority to appoint the FSLIC as receiver for Telegraph's assets.[105] Following the denial of the attempted withdrawal, the FSLIC immediately transferred Telegraph's assets to First Federal Savings and Loan Association under a purchase and assumption agreement.[106] The next day, Telegraph's financial operation opened in the same buildings under its new name—First Federal Savings and Loan Association of Chicago.[107]

On June 3, 1980 Telegraph filed a complaint in the United States District Court[108] challenging the takeover, sale, and FSLIC receivership appointment

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101. *Id.* at 1027 n.6. Liquid assets represent those assets that are cash or easily converted into cash.

102. *Id.* Early in the afternoon on the day of Telegraph's closing, an employee of the Federal Home Loan Bank of Chicago, A. Raymond Bacon, was contacted at his place of employment by the FHLBB. Bacon worked across the street from Telegraph and had a passbook account at Telegraph. Bacon was instructed by the FHLBB to wait in the lobby of Telegraph while the Commissioner and his deputy presented Telegraph's president with notice that the Commissioner was taking custody of Telegraph's assets. Bacon waited to request a withdrawal until the Commissioner's deputy returned to the lobby from the president's office. Brief for Appellant, *supra* note 87, at 13. Although Bacon could have obtained a withdrawal at any time during his wait, he made no such attempt.

103. 703 F.2d at 1022. Bacon requested a withdrawal solely because the FHLBB had requested Bacon to do so. *Id.* At the time Bacon requested a withdrawal, there were only four to six customers in the institution. Brief for Appellant, *supra* note 87, at 13. Bacon stood at the end of the line of customers who were attempting to transact business. Consequently, Bacon was the last customer to request a withdrawal. *Id.* at 14.

104. The deputy Commissioner and Bacon stood side-by-side while Bacon was waiting in line to make his withdrawal. After all of the customers' requests prior to Bacon's had been honored, the deputy Commissioner stepped between Bacon and the teller window. Then, the deputy stated to Bacon that this "withdrawal request" would not be honored. After making this statement, the deputy took Bacon's withdrawal slip out of Bacon's hand and handed it to a FHLBB agent. A previously prepared affidavit that stated that Bacon had attempted to make a withdrawal and had been denied was then placed in Bacon's hands by a private FHLBB attorney. Bacon signed the affidavit, which was immediately notarized, and then left the premises. Brief for Appellant, *supra* note 87, at 15.

105. 564 F. Supp. at 867.

106. 703 F.2d at 1022.

107. *Id.*

108. Telegraph filed identical actions in both state and federal courts. The original federal case was decided in two separate opinions by Judge Grady. 564 F. Supp. at 864 (memorandum opinion granting defendant's motion for summary judgment on two of the three issues before the court); 564 F. Supp. 880 (N.D. Ill. 1982) (memorandum opinion following trial to consider the third issue, the FHLBB's insolvency determination). The state action was filed in the Circuit Court of Cook County, 80 CH 4170. The state action was removed to federal court. Judge Marshall held that federal courts have exclusive jurisdiction over any state action to remove

by the FHLBB. After a bench trial to determine whether Telegraph was insolvent within the meaning of section 1464(d)(6)(A), the court upheld the FHLBB appointment of the FSLIC as receiver.[109] The Court of Appeals for the Seventh Circuit affirmed the lower court's decision.[110] The Seventh Circuit concluded that the three prerequisites for a FSLIC receivership appointment had been satisfied.[111]

The Court's Analysis

The bulk of the Seventh Circuit's decision addressed three issues which, according to Telegraph, were decided incorrectly by Judge Grady at the district court level. Telegraph contended that Judge Grady erred by ruling: 1) that a prearranged closing of a state-chartered S&L satisfies the closing requirement of section 406(c)(2)(A) of the NHA and that Telegraph had not been denied the opportunity to challenge the Illinois Commissioner's closing order;[112] 2) that the withdrawal denial requirment of section 406(c)(2)(C) of the NHA is satisfied when the request is denied merely because the S&L has been closed by the state Commissioner, notwithstanding the fact that there are sufficient liquid assets on hand to satisfy the request;[113] and 3) that the FHLBB had correctly used the book net worth standard to determine Telegraph's solvency.[114] Despite Telegraph's arguments, the Seventh Circuit affirmed the district court's rulings.[115]

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the FSLIC as receiver. Noting that the state court therefore never had jurisdiction over the action, Judge Marshall concluded that the state court had no authority to remove the case to federal court. Declining to grant Telegraph's request to remand back to the state court, Judge Marshall dismissed the action. 703 F.2d at 1022.

109. 564 F. Supp. at 895.

110. 703 F.2d at 1030.

111. 703 F.2d at 1022-30.

112. *See infra* notes 116-21 and accompanying text.

113. *See infra* notes 130-34 and accompanying text.

114. *See infra* notes 141-60 and accompanying text.

115. 703 F.2d at 1030. The *Telegraph* court summarily rejected Telegraph's challenge to three other rulings of the trial court. Telegraph had argued that,

> (1) the issue of whether the FHLBB properly rejected the Heron Proposal should not have been excluded from trial; (2) the receivership should not be evaluated according to notions of "trends in operating losses" and "public confidence"; and; (3) counsel for the federal agencies have been disqualified.

Id. at 1028 n.8.

Before the Seventh Circuit, Telegraph also challenged the insolvency provision as not accurately reflecting an institution's solvency and therefore depriving Telegraph of substantive due process. The court concluded, however, that the solvency provision should be evaluated under the rational basis test, rather than the higher standard of review urged by Telegraph. Consequently, the court held that the solvency provision satisfied the rational basis test and thus did not violate Telegraph's substantive due process rights. *Id.* at 1029.

The final issue raised by Telegraph was Judge Marshall's refusal to remand the state law counts against the Illinois Commissioner in the state suit that was removed to the federal district court. Telegraph contended that Judge Marshall's determination that the state claims were "part and parcel" of the federal action, coupled with Judge Grady's later ruling that the propriety of the Commissioner's action should be litigated in the state court, operated to deny Telegraph

a. Closed Under State Law

Telegraph's initial contention was that the first prerequisite to the appointment of the FSLIC as receiver, that the S&L be closed under state law, could not be satisfied by a sham, prearranged, momentary closing orchestrated by state and federal authorities.[116] According to Telegraph, such a staged closing undermined the purpose of the first statutory prerequisite.[117] Telegraph emphasized that section 406(c) of the NHA was amended simply to give the FSLIC a voice in the liquidation process for the purpose of preventing state receivers from adversely disposing of failing associations' assets. Telegraph further asserted that state and federal authorities who cooperate and conspire to close a viable association subvert this statutory purpose.[118] In addition, Telegraph argued that the district court contributed to Telegraph's plight by refusing to consider whether true "emergency" circumstances as defined by Illinois law existed when the Illinois Commissioner closed Telegraph.[119] Telegraph contended that the trial court's failure to explore the basis for the declared "emergency" erroneously reduced the federal closure requirement to a minor technicality satisfied by mere notification to the FHLBB that a state official had closed an insured association.[120] Finally, Telegraph claimed that the lack of effective judicial review of the Illinois Commissioner's closing decision left Telegraph without a forum to dispute the constitutionality of the ex parte, "emergency" decision to close the association.[121] For these reasons, Telegraph believed that section 406(c)(2)(A) had not been satisfied.

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a forum in which to challenge the Commissioner's ex parte action. *Id.* at 1029. The Seventh Circuit, however, found nothing contradictory in the two rulings. Judge Marshall believed that all of Telegraph's claims were part of its challenge to the FHLBB appointment of the FSLIC as receiver and he refused to remand on the ground that a federal receivership could only be challenged in federal court. Judge Grady held that review of state law questions was not part of an action to challenge a federal receivership and should thus be litigated in state court. *Id.* According to the *Telegraph* court, Judge Grady's dismissal of Telegraph's challenge to the Commissioner's action cannot be read as a ruling on the validity of the state claims and Telegraph must pursue its challenge to the Commissioner's action in the state courts. *Id.*

116. Brief for Appellant, *supra* note 87, at 18-27.

117. *Id.* at 19-24.

118. *Id.* Telegraph maintained that the court's determination that Telegraph's momentary closing satisfied the federal closing requirement was an "affront to congressional intent." Telegraph asserted that the court's illogical premise required the assumption either that Congress was not committed to proper application of the statute or that Congress did not understand the import of the amendment creating the closing requirement. *Id.* at 19-20.

119. *Id.* at 24-26. Telegraph argued that the district court compounded its error by implying that the legality of the Commissioner's conduct under state law was irrelevant to the FHLBB's authority to appoint the FSLIC as receiver. *Id.* at 24. Further, Telegraph maintained that judicial review of the "emergency" closing would reveal the absence of a true emergency. *Id.* at 27.

120. *Id.* at 124. Telegraph believed that Congress intended the closing requirement to be satisfied only by an arms-length association between the state and federal agencies, whereby the regulators in Washington were merely notified that a state official had closed an insured S&L, rather than a cooperative effort between the agencies to close a S&L. *Id.* at 25.

121. Telegraph asserted that the lack of meaningful judicial review of the Commissioner's

The court responded to Telegraph's contention that the district court's refusal to review the propriety of Telegraph's closing under state law was erroneous by emphasizing that neither the statutory language nor the legislative history supported Telegraph's position.[122] To support its position, the *Telegraph* court noted that the language of section 406(c)(2)(A) did not require the FHLBB to evaluate whether the closing complied with state law.[123] The Seventh Circuit also noted a Senate Report which stated that Congress amended section 406(c) of the NHA "to enable the FSLIC to defend its appointment under federal law instead of requiring it to defend the legality of the state S&L administrator's determinations under state law."[124]

The Court of Appeals similarly rejected Telegraph's contention that Telegraph was without a forum to litigate its claims concerning the propriety of the closing under state law. The court first declared that Telegraph was not deprived of effective judicial review in federal court: although the statute does not provide for review of state officials' actions, it does provide for full review to determine whether the FHLBB was justified in appointing the FSLIC as receiver.[125] In the overall statutory scheme, the court continued, Telegraph's loss of state court review was merely a tradeoff for federal insurance.[126] Citing *Fidelity*,[127] Seventh Circuit stated that when "state and federal authorities cooperate to close a state institution and appoint the FSLIC receiver in an effort to minimize financial risks and prevent depositor panic, compliance with the precondition becomes 'substantially a ceremonial formality.'"[128] Accordingly, the *Telegraph* court held that the closing requirement had been met.[129]

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actions in either federal or state court resulted in a gap between state and federal jurisdiction, leaving Telegraph without a forum in which to litigate the propriety of the closing under Illinois law. *Id.* at 31. Further, Telegraph maintained that this lack of review granted the Commissioner and the FHLBB unbridled discretion to scheme and plot to satisfy the closing conditions. *Id.* at 29-31. Telegraph noted that fundamental due process rights require either an opportunity to be heard prior to governmental deprivation of property or post-seizure review, and argued that the lack of meaningful judicial review, coupled with the emergency closing, violated Telegraph's due process rights. *Id.* at 31; *see* Fuentes v. Shevin, 407 U.S. 67, 72 (1972) (governmental seizure without review deprives owners of due process rights); *accord* Mitchell v. W.T. Grant Co., 416 U.S. 600, 611 (1974) (due process rights require adequate review).

122. 703 F.2d at 1024.

123. *Id.*

124. *Id.* (quoting S. REP No. 1263, 90th Cong., 2d Sess., *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS 2530, 12,540).

125. 703 F.2d at 1024-25. The court of appeals believed that Telegraph was not deprived of effective judicial review because Telegraph had the opportunity to challenge the federal receivership appointment in federal court. While the Seventh Circuit did not review the Illinois Commissioner's actions, it did review whether the FHLBB was justified in appointing the FSLIC.

126. *Id.* at 1024.

127. *See supra* notes 74-86 and accompanying text.

128. 703 F.2d at 1025 (quoting *Fidelity*, 689 F.2d at 813).

129. *Id.*

b. Depositor's Withdrawal Request Denied

Telegraph next challenged the district court's conclusion that the federal statute's prerequisite that an account holder be unable to obtain a withdrawal is automatically satisfied whenever an association is closed. Specifically, Telegraph argued that section 406(c)(2)(C), the requirement that a savings account holder be unable to withdraw funds from his account, had not been satisfied because the FHLBB and state authorities had deliberately orchestrated and manipulated the denial of a withdrawal request.[130] According to Telegraph, such a sham procedure subverted the purpose of section 406(c).[131] Telegraph asserted that Congress amended section 406(c) to enable the FSLIC to make prompt insurance payments and to ensure orderly dispositions of assets when S&Ls default.[132] Thus, Telegraph maintained that the withdrawal requirement under section 406(c)(2)(C) was satisfied only if Telegraph's cash reserve was so depleted that it lacked funds to honor withdrawal requests, necessitating an insurance payout to preserve public confidence and prevent undue hardship to account holders.[133] Finally, Telegraph emphasized that the district court's statutory construction rendered the withdrawal denial requirement superfluous.[134]

In reply to Telegraph's contentions, the court noted that the withdrawal denial requirement of subsection (c)(2)(c) was added to section 406(c) of the NHA at the same time that the fifteen day waiting period requirement of subsection (c)(2)(a) was added.[135] Drawing on this parallel, the *Telegraph* court reasoned that the closing and withdrawal provisions must be construed together.[136] Under the court's construction, the withdrawal denial requirement has independent significance only where a receiver has been appointed by an authority other than the FHLBB (most often the state Commissioner), the appointment has been in effect for at least fifteen days, and that receiver continues to operate the S&L. When this occurs, the FHLBB has the authority to appoint the FSLIC receiver without the S&L being closed only if the S&L is unable to meet a depositor's withdrawal request.[137] Since the fifteen day waiting period provision was not involved in *Telegraph,* the Seventh Circuit

130. Brief for Appellant, *supra* note 87, at 19-24.

131. Telegraph asserted that the court's conclusion, that a sham denial of a withdrawal request satisfied the withdrawal requirement, subverted Congress' intent. Telegraph maintained that the Court's unfounded premise required the assumption either that Congress was not committed to proper application of the statute or that Congress did not understand the impact of the amendment creating the withdrawal requirement. *Id.* at 19-20.

132. *Id.* at 48-53.

133. *Id.* at 32-36.

134. According to Telegraph, the trial court's construction rendered the withdrawal request denial superfluous or insignificant because in *Telegraph* the requirement was declared satisfied without a depositor ever having suffered any hardship and without any insurance payout ever being made by the FSLIC in connection with Telegraph. *Id.* at 23.

135. 703 F.2d at 1025-26 (quoting S. REP No. 1263, 90th Cong., 2d Sess., *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS 2530, 2540-2591).

136. 703 F.2d at 1026.

137. *Id.* The court of appeals believed that the withdrawal requirement's only purpose was

concluded that the withdrawal requirement was automatically satisfied when the state Commissioner opted to close Telegraph rather than to appoint a receiver to operate it.[138] Turning to the *Fidelity* decision for additional support, the *Telegraph* court declared that satisfying the withdrawal denial requirement was "substantially a ceremonial formality" when state and federal authorities cooperated to close the S&L and appoint a receiver.[139] Accordingly, the *Telegraph* court concluded that the withdrawal requirement, like the closure requirement, had been satisfied.[140]

c. Insolvency

In addition to challenging the rulings concerning the closing and withdrawal-denial prerequisites, Telegraph challenged the FHLBB's determination that the final statutory prerequisite for the appointment of the FSLIC was met: that Telegraph was insolvent on the day the FSLIC was appointed receiver. Specifically, Telegraph believed that the district court would not have found Telegraph to be insolvent if the court had examined the FHLBB's rejection of the capital-infusing Heron proposal.[141] Alternatively, Telegraph contended that the FHLBB's insolvency test, subtracting liabilities from assets valued at book value, did not accurately reflect Telegraph's viability because the test was "economically and financially irrational in application."[142]

Telegraph supported its assertion that it should not have been found insolvent by referring to the closed meeting during which federal and state regulators rejected the Heron proposal.[143] Telegraph maintained that it would have been found solvent under the FHLBB's test had the FHLBB not erroneously blocked Telegraph's attempt to raise millions of dollars of capital via the Heron proposal.[144] Arguing in support of its financial viability, Telegraph cited the testimony of a FHLBB officer who was directly responsible for studying Telegraph's financial position and who urged that the Heron proposal be accepted.[145]

With respect to its contention that the FHLBB test was financially irrational, Telegraph presented four arguments as to why the trial court's acceptance of the FHLBB's insolvency determination was an error. First, Telegraph maintained that the FHLBB's book net-worth test of insolvency produced irrational predictions of the risk to the FSLIC's cash reserve fund.[146]

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to confine the FHLBB's intervention to situations where depositors were unable to withdraw their deposits despite the state Commissioner's efforts to keep a S&L open. *Id.*

138. *Id.*

139. *Id.*

140. *Id.*

141. Brief for Appellant, *supra* note 87, at 32.

142. *Id.* at 36.

143. *See supra* notes 96-98 and accompanying text.

144. Brief for Appellant, *supra* note 87, at 36.

145. Joseph Arendes, a FHLBB staff member, submitted a written recommendation to the FHLBB urging acceptance of the Heron proposal. 564 F. Supp. at 867 n.2.

146. Brief for Appellant, *supra* note 87, at 40-44.

In particular, Telegraph argued that the test distorted both the amount at risk and the relative risk posed by individual institutions.[147]

Second, Telegraph believed that the trial judge should have placed more reliance on the testimony of the Assistant United States Treasury Secretary for Domestic Finance, Roger Mehle, who explained that there is "no link" between insolvency and zero book net worth.[148] Mehle also testified that the FHLBB's standard for insolvency was meaningless because the figure indicated nothing about the real "cushion" between an association's assets and liabilities.[149]

Third, Telegraph argued that the FHLBB's book net worth insolvency test valued assets and liabilities incorrectly, suggesting instead that the "true value" of savings and loan assets should be their present value measured at fair market value, an amount much less than their book value.[150] To illustrate the obsolescence of the book value test, Telegraph noted that in the event of a depositor panic or "run,"[151] the association could not liquidate its assets at their book value.[152] Instead, Telegraph would only be able to obtain the fair market value[153] of its assets. Consequently, since book value would be meaningless in the face of mass withdrawals, Telegraph considered book value to be a useless standard that should be replaced with fair market value.

Finally, Telegraph claimed that the district court erred by ignoring the significant change in financial circumstances throughout the S&L industry that had occurred since the enactment of the insolvency statute.[154] Noting that there was little difference between book and market value in 1954 when the insolvency standard became part of the federal statutory framework, Telegraph asserted that by the late 1970's and early 1980's, the two valuation methods differed significantly as a result of dramatic decreases in the amount of money held in S&L passbook accounts to long-term certificate

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147. *Id.* at 41.

148. Assistant Secretary of the Treasury, Robert Mehle, testified that the FHLBB's book net worth standard of insolvency was meaningless. Further, Mehle declared that the FHLBB standard reveals nothing about the current cushion between assets and liabilities for S&Ls. *Id.* at 34.

149. *Id.* at 35.

150. *Id.* at 41. Secretary Mehle testified that the industry-wide discount for all S&Ls was approximately 30%. This figure indicates that a S&L would have to sacrifice 30% of its future revenues from a mortgage note by selling the right of future revenues to a discount broker. By doing so, Telegraph would receive 70% of the note. For example, a $100,000 mortgage on Telegraph's books would only net $70,000 to Telegraph.

151. A S&L run is used by Telegraph to represent an unprecedented level of withdrawal requests in a short time span. A "run" is usually caused by the public's lack of confidence in the security of their deposits. *See* A. SCHLESINGER, JR., *supra* note 15, at 57.

152. Brief for Appellant, *supra* note 87, at 41. A S&L wishing to sell mortgage notes quickly could not recover the value of the note as indicated on the S&L's record books. The mortgage notes would have to be discounted. *Id.*

153. Fair market value is the value an asset commands in the market place at the present time.

154. Brief for Appellant, *supra* note 87, at 48-50.

accounts.[155] Despite this shift from short-term passbook accounts to long-term certificates, under the FHLBB's book net worth method, S&Ls remained obligated to record all certificate accounts as "present-liabilities," even though many certificates could not be withdrawn without penalty for eight years.[156] Thus, Telegraph contended that the FHLBB's book net worth construction of the statutory insolvency standard rendered that standard arbitrary, meaningless, and misleading.[157] Telegraph concluded, therefore, that the statutory insolvency requirement had not been satisfied because the standard employed by the FHLBB was inappropriate.

The Seventh Circuit rejected Telegraph's insolvency arguments and stressed that whether the statute was "unique" or "irrational" was a matter of legislative concern for Congress to address.[158] The court noted that the statute requires the FHLBB to determine a S&L's solvency by subtracting obligations from assets. Concluding that the FHLBB's definitions of "assets" and "obligations" complied with the statute, the court declared that it was bound by the statutory test.[159] Moreover, since Congress had twice revised the insolvency provision since 1954 without modifying the insolvency standard, thereby suggesting implicit congressional approval, the court concluded that Congress intended insolvency to be determined by the book net worth standard, despite the changing circumstances of the S&L industry. Accordingly, the court ruled that the FHLBB's insolvency determination was reasonable, and therefore satisfied the final statutory prerequisite for a FSLIC receivership appointment.[160]

CRITICISM

Although the *Telegraph* court recognized the need to review the legislative history of FHLBB receivership appointments, several aspects of the decision appear questionable. One particularly weak aspect of the Seventh Circuit's opinion in *Telegraph* was the treatment given to the Ninth Circuit's decision in *Fidelity*. The court attempted to use *Fidelity* as the standard for FHLBB appointments of the FSLIC as receiver for defaulted state S&Ls. In particular, the Seventh Circuit relied upon *Fidelity* to support the court's refusal to analyze Telegraph's closing. The court also relied on *Fidelity* to conclude

155. In the early 1950's, most of the money in accounts at a S&L was in passbook accounts. Today, only about 20% of a S&L's accounts are passbook, the remainder are in long-term certificates of deposit. As a result of this shift to certificates of deposit, the entire amount of interest due on a certificate is not a short term liability because the depositor must sacrifice a substantial penalty for withdrawal before maturity. *Id.* at 49; *see* Bernstein, *A Bailout The S&Ls No Longer Need*, 106 FORTUNE, Nov. 29, 1982, at 90 (synopsis of the change in passbook accounts).

156. For a discussion of the reasons for this dramatic shift, *see supra* notes 70-72 and accompanying text.

157. Brief for Appellant, *supra* note 87, at 47.

158. *Id.* at 52.

159. 703 F.2d at 1028.

160. *Id.*

that the section 406(c)(2)(A) closing requirement was automatically satisfied whenever the state Commissioner appoints the FSLIC as state receiver and orders the liquidation of the state association.[161]

Although *Telegraph* and *Fidelity* implicated the same statutory receivership requirements, the factual settings in those cases were significantly different. Fidelity was in serious, if not precarious, financial straits at the time of the FSLIC receivership appointment, having borrowed in excess of $1.3 billion from the Federal Home Loan Bank of San Francisco.[162] More importantly, Fidelity's financial decline caused its depositors to panic and withdraw nearly $70 million in deposits during the week prior to Fidelity's closing.[163] Indeed, Fidelity was forced to turn away depositors because it had depleted its funds.[164] Moreover, the panic and mass withdrawal were precipitated, at least in part, by shoddy management practices.[165] In view of the grave circumstances facing Fidelity, the California Commissioner decided, without consulting the FHLBB, to place the failing association in receivership and appoint the FSLIC as receiver for the state.[166]

Unlike the situation in *Fidelity*,[167] there was no run on Telegraph's assets and Telegraph's account holders did not withdraw large sums before Telegraph's closing.[168] Another contrast was that Telegraph did not borrow funds from the Federal Home Loan Bank in Chicago to stay afloat. Finally, Telegraph's problems were symptomatic of the ailing S&L industry, and not attributable to any questionable management practices.[169]

The foregoing distinctions demonstrate that Fidelity and Telegraph posed significantly different risks to the FSLIC's cash reserve fund. Because the amendment to section 406(c) granted the FHLBB receivership appointment powers to protect the FSLIC's ability to meet insurance requests via its reserve fund,[170] a FHLBB receivership appointment of the FSLIC was appropriate in *Fidelity*: Fidelity's demise directly and immediately threatened to drain the FSLIC's cash reserve fund because Fidelity was closed and unable to pay depositors. Fidelity's lack of funds left it insolvent by anyone's standard, forcing it to close its doors and turn away depositors. Thus, all three federal receivership prerequisites were satisfied in *Fidelity*.

Conversely, the FHLBB receivership appointment in *Telegraph* was inappropriate because Telegraph's decline merely presented a potential threat to the FSLIC's insurance fund, and not a fait accompli as in *Fidelity*.

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161. *Id.*
162. *Id.* at 1024.
163. *Fidelity*, 689 F.2d at 805.
164. *Id.*
165. *Id.*
166. *Id; see supra* note 75 (Fidelity gambled heavily on highly speculative investment opportunities).
167. 689 F.2d at 805.
168. 703 F.2d at 1021.
169. *See supra* notes 70-72 and accompanying text.
170. 12 U.S.C. § 1729(c)(2) (1982).

Telegraph had $11 million on hand in its vaults at the time of its closing, and could easily have satisfied the twenty-five dollar withdrawal demand made by the government's straw man.[171] Telegraph could not satisfy the demand solely because the Illinois Commissioner invoked his emergency powers and declared Telegraph "closed" irrespective of its actual cash position. This questionable decision to close Telegraph remains in state litigation today.[172] Nevertheless, it provided the FHLBB with the "closing" and "withdrawal denial" needed to satisfy the statutory prerequisites to the appointment of the FSLIC as receiver for Telegraph.

The cursory review of the prearranged withdrawal denial is another shortcoming of the Seventh Circuit's decision. Despite the admittedly contrived plan between the FHLBB and the Illinois Commissioner to deny a depositor's request to withdraw funds from his account, the court concluded that the legislative history of section 406(c) of the NHA, as amended, mandated that compliance with the withdrawal denial requirement, when coupled with a state closing, was "substantially a ceremonial formality."[173] Because the *Telegraph* court reduced the statutory requirement to a mere technicality, the court failed to scrutinize the sham denial of the depositor's request to withdraw twenty-five dollars when more than $11 million in liquid assets were on hand. The *Telegraph* court thus ignored the implicit irony that the withdrawal denial requirement could be satisfied when funds were immediately available to satisfy the demand of not only the straw man account holder, but also 440,000 account holders similarly situated.[174] The result of the court's broad interpretation of the withdrawal denial requirement is to emasculate, if not eliminate, the congressionally mandated withdrawal denial prerequisite to FHLBB appointments of the FSLIC as receiver for state S&Ls.

Another criticism of the *Telegraph* decision concerns the Seventh Circuit's superficial analysis of the FHLBB's rejection of the capital-infusing Heron proposal. In footnote eight of the court's opinion, the court summarily dismissed Telegraph's contention that the FHLBB's rejection of the Heron proposal should have been reviewed at trial.[175] The court of appeals simply announced in a single sentence that it had "carefully examined [the question] and [found it] to be without merit." Contrary to the implied insignificance of the Heron proposal suggested by the court's brief statement, the Heron proposal would have infused $7 million in capital and an additional $15 million in cash, thus potentially stabilizing Telegraph's

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171. *See supra* note 102.

172. Telegraph Sav. & Loan Ass'n v. Schilling, 115 Ill. App. 3d 331, 450 N.E.2d 804 (1983).

173. 703 F.2d at 1024 (quoting *Fidelity*, 689 F.2d at 813); *see supra* notes 43-45 and accompanying text.

174. If every depositor requested $25, Telegraph's $11 million could be divided between 440,000 depositors.

175. The court stated: "Telegraph also challenges other trial court rulings. It maintains that: (1) the issue of whether the FHLBB properly rejected the Heron proposal should not have been excluded from trial. . . . We have carefully examined these arguments and find them to be without merit." 703 F.2d at 1028 n.8.

operation.[176] Although such an infusion would have rendered Telegraph solvent on the date of the takeover under any valuation method, the district court refused to consider the propriety of the Heron proposal rejection.[177] In view of the importance of the proposal to Telegraph's ultimate existence and the significance of the rejection of that proposal, the FHLBB's rejection of the the Heron proposal warranted more than the *Telegraph* court's summary conclusion that the argument was without merit.

Another troubling aspect of the *Telegraph* decision is the court's grant to the FHLBB of discretion to adopt its own method of evaluating S&L solvency. Under its solvency measure, the FHLBB has the power to declare financially troubled S&Ls insolvent by subtracting short-term and long-term liabilities from an inflated, book value asset figure instead of subtracting short-term liabilities from short-term assets. The latter method more accurately measures the ability to pay. As a practical matter, long-term liabilities are less important to liquidity considerations because stiff penalties discourage early withdrawals by long-term certificate holders. By including less relevant long-term liabilities in its solvency calculations, the FHLBB in effect inflates the affected institution's liabilities, thus diminishing the institution's solvency.

In a final attempt to legitimate its acceptance of the insolvency determination, the court of appeals altered the premise of Telegraph's argument that the FHLBB's interpretation of the solvency statute was financially irrational. In the court's effort to reach the desired result, it responded to Telegraph's argument as if Telegraph had asserted that section 406(c)(2)(C), rather than the FHLBB's *interpretation* of that section, was irrational.[178] The court of appeals's focus on the statute instead of on the interpretation of the statute allowed the court both to evade Telegraph's penetrating argument and to answer an irrelevant question. Easily discarding the altered argument, the court declared that the statute's uniqueness or alleged irrationality was "a legislative matter for Congress to address and "[was] irrelevant to the resolution of this controversy."[179] This position, however, fails to explain why the FHLBB's irrational statutory application can be implemented without accurately evaluating the assets and liabilities of Telegraph or any other state S&L. It simply allows the court to circumvent financial reality—perhaps in the hope that aversion will lend validity.

IMPACT

Thrust into a case involving issues of first impression, the *Telegraph* court resolved questions of nationwide import. These questions are significant not only to Telegraph and hundreds of other financially troubled state-chartered S&Ls, but also to financial institutions in general. The *Telegraph* decision

176. *See supra* notes 95-98 and accompanying text.

177. 703 F.2d at 1028 n.8.

178. Telegraph's premise was that the FHLBB interpreted the receivership statute incorrectly, not that the statute was irrational. *See* Brief for Appellant, *supra* note 87, at 40-45.

179. 703 F.2d at 1028.

extended prior case law by expanding the discretionary power of the federal government to seize and sell the assets of state S&Ls with virtually no substantive judicial review. This expansion granted the FHLBB unfettered discretion to scheme with friendly state regulators, to stage sham closing procedures and withdrawal denials, and to appoint the FSLIC to seize and sell undervalued assets of "insolvent" state S&Ls to lurking federal bidders.[180] The broad statutory interpretation in *Telegraph* also grants the FHLBB the power to plot and attempt to federalize the state S&L industry.

Authorized federal S&Ls which purchase a closed state institution have now acquired the power to wreak havoc on both the surviving Illinois state S&Ls and Illinois banks by selling a closed S&L's assets to a fiercely competitive national bank holding company. In turn, the national bank, through its subsidiaries, has the opportunity to operate the acquired association's branch offices throughout Illinois, even to the detriment of state S&Ls and banks.[181] If a chain of branch offices were acquired by a national bank, then the Illinois banks would be at a great disadvantage because they would be limited to three branches under state law. Such a situation possibly would force Illinois to abandon what remains of its ban on branch banking.[182]

An illustration of the injurious effects such a merger would have on Illinois' financial community was provided by the recent controversy over the Citicorp National Bank (Citicorp) take-over of First Federal Savings and Loan Association of Chicago. A few weeks after purchasing Telegraph from the FSLIC,[183] First Federal sold its assets to Citicorp. Although the Citicorp take-over was bitterly opposed by Illinois bankers and politicians alike, the Federal Reserve Board approved the acquisition.[184] The most significant aspect of Citicorp's entry into the local market will be Citicorp's newly acquired ability to take customer deposits throughout Illinois for the first time. The ability to con-

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180. The assets of a S&L are undervalued because the real estate assets are valued at book value which is considerably lower than the fair market value. Fair market value is much greater because of the severe inflation this country has experienced in the past decade. *See* Bernstein, supra note 155, at 34 (real estate values have sky-rocketed because of dramatic inflation).

181. A national bank holding company must purchase S&Ls through a subsidiary to avoid violating branch banking law. *See infra* note 182 and accompanying text.

182. For the regulations concerning branch banking in Illinois, see Illinois Banking Act, § 6, ILL. REV. STAT. ch. 17, § 313 (1983)

183. First Federal did not purchase Telegraph's assets from Telegraph because the FSLIC controls the assets. Brief for Appellant, *supra* note 87, at 17. In this purchase, First Federal paid the FSLIC $17.55 million for allegedly worthless assets.

184. Illinois Attorney General Neil F. Hartigan brought suit to block the Citicorp merger. Hartigan argued that "as a result of the [FHLBB] decision, an enormous bank holding company from outside Illinois will become, virtually overnight, the operator of the functional equivalent of 62 banks throughout the state, thereby wreaking havoc on the Illinois banking system and regulatory structure." Chicago Tribune, Jan. 9, 1984, § 3, at 1. Further, Hartigan asserted that "Citicorp's acquisition of a 62-office savings and loan association chain would put Illinois banks at a great disadvantage because they were unable to have more than three branches under state law." Chicago Tribune, Jan. 10, 1984, § 3, at 1. Finally, Hartigan maintained that this acquisition would force the State of Illinois to abandon its "historic ban on branch banking." Chicago Tribune, Dec. 18, 1983, § 7, at 2.

trol the aggregate cash supply from customer deposits at sixty-two branch associations will give New York-based Citicorp an undue competitive advantage over Illinois banks which have restricted ability to take deposits. Overnight, Citicorp will gain more than $3 billion in deposits throughout a network of sixty-two Chicago and central Illinois offices.[185] As United States Senator Charles Percy correctly feared, "[i]n one stroke, this sale would bring about the most fundamental change in the way banks and S&Ls operate in Illinois."[186]

By expanding the FHLBB's seizure powers without expanding substantive judicial review of those powers, *Telegraph* provides the FHLBB with virtually unlimited power to take control and sell the assets of any state S&L. Following the Seventh Circuit's decision in *Telegraph,* federal district courts throughout the United States may now defer to the FHLBB's expanded discretion. This deference will likely take the form of permitting even more elaborate schemes than the scheme in *Telegraph* to satisfy the three prerequisites to the appointment of a FSLIC receiver to seize and sell state S&L assets.

As a result of the *Telegraph* court's statutory interpretation that allows virtually unlimited FHLBB power, it is now apparent that almost any FHLBB action will satisfy the statutory requirements. For example, in plotting to close a state S&L, the FHLBB could abuse its discretion and bribe a state Commissioner to close a S&L.[187] Despite the obvious impropriety of such tactics, the closing requirement would be satisfied under the *Telegraph* test once the state regulator appointed the FSLIC and entered a liquidation order.

The court of appeal's approval of a staged withdrawal denial in *Telegraph* is deeply troubling. After *Telegraph,* the FHLBB has broad authority to satisfy the statutory withdrawal denial prerequisite with other, perhaps more elaborate, sham denials. For example, the FHLBB could first coerce a Federal Home Loan Bank employee to request an account withdrawal. After prompting the request, the FHLBB could satisfy the withdrawal denial prerequisite by ordering a bribed state Commissioner to deny the withdrawal request. The statutory withdrawal denial requirement would thus be satisfied regardless of massive amounts of cash in the S&L's vault available to pay account holders.

Another by-product of the *Telegraph* decision is the FHLBB's increased proclivity to federalize the state S&L industry. The FHLBB has been quick to exercise its broad authority under *Telegraph,* as illustrated by the FHLBB's regulatory activities in several highly populated states where S&Ls are prevalent. After experimenting in California with Fidelity Savings and Loan Association, the FHLBB moved east across the country to Illinois to close

185. Chicago Tribune, Jan. 9, 1984, § 3, at 1.

186. Chicago Tribune, Jan. 12, 1984, § 2, at 6, col.1.

187. As defined here, bribes can consist of cash "incentives" as well as guarantees of job advancements. Soon after Telegraph was closed, the Illinois Commissioner was promoted to a high FHLBB position—Director of the Office of Examination and Supervision.

Telegraph. After the Telegraph take-over, the FHLBB acted in Florida where it took over Biscayne Federal Savings and Loan Association.[188] Finally, and most recently, the FHLBB moved to the southwest and took over Empire Savings and Loan Association in Texas.[189] Thus, the FHLBB is aggressively exercising the receivership appointment powers that were broadened under *Telegraph*.

EXPLICIT STATUTORY LANGUAGE AS AN ALTERNATIVE TO VAGUE, PERMISSIVE LANGUAGE

Legislative change would be the optimal approach to limiting the FHLBB's power to seize and sell state S&Ls. The problems of liberal statutory construction and sweeping statutory applications in the present federal receivership appointment statute, as demonstrated in *Telegraph,* can be reduced by comprehensive legislation. Further, a precise definition of the closing and withdrawal denial prerequisites would limit FHLBB discretion to plan unwarranted sales of state S&Ls. Finally, a statutory standard to determine solvency, more accurate that the FHLBB's book net worth standard would give a better indication of an ailing state S&L's potential drain upon the FSLIC's cash reserve fund.

A statutory amendment to section 406(c) should contain the following language:

> (2) In the event the Federal Home Loan Bank Board determines—
>
> (A) That (i) a conservator, receiver, or custodian (whether or not the FSLIC) has been or is hereafter appointed for an insured institution which is not a federal savings and loan association other than by the FHLBB (whether or not such institution is in default) and that the appointment of such conservator, receiver, or custodian, or any combination thereof, has been outstanding for a period of at least fifteen consecutive days, or (ii) an insured institution (other than federal savings and loan association) has been legally closed by or under the laws of any State and any challenge to the legality of the State savings and loan administrator's determinations has been fully litigated under State law;
>
> (B) That one or more of the grounds specified in paragraph (6)(A) of Section 1464(d) of this title existed with respect to such institution at the time a conservator, receiver, or other legal custodian was appointed, or at the time such institution was closed, or exists thereafter during the appointment of the conservator, receiver, or other legal custodian, or while the institution is closed; however, if the ground specified in paragraph (6)(A) is insolvency, then an institution can be declared insolvent only if either of the following 2 requirements are satisfied:
>
> (i) an institution's liquid assets are insufficient to cover short-term obligations as they come due, or

188. 1981 ANNUAL REPORT, *supra* note 68, at 17.

189. Chicago Tribune, Mar. 15, 1984, § 3, at 1, col. 2.

> (ii) all liabilities exceed all assets daily for a continuous 6 month period.
>
> (C) that one or more holders of withdrawable accounts who is not related to or employed by the FHLBB, any Federal Home Loan Bank, any state savings and loan commission, or any of its employees is unable to obtain a withdrawal from his account, in whole or in part, after a bona fide request; the FHLBB shall have exclusive power and jurisdiction to appoint the FSLIC as state receiver for such institution. As used in this paragraph (2), the term "State" includes the Commonwealth of Puerto Rico, the territories and possessions, and any place subject to the jurisdiction of the United States.

By adopting such a detailed amendment, Congress would extend vital protection to an area of the financial industry in dire need—state-chartered S&Ls. Although these proposed amendments curtail the FSLIC's discretion, the FSLIC still retains the power to seize the private assets of ailing S&Ls if the S&L is truly placing the FSLIC's cash reserve fund at risk.

CONCLUSION

The Seventh Circuit blazed an unfortunate new trail for lower courts to follow in the area of government seizures of private property. This new trail emasculates the statutory restraints placed upon the FHLBB as prerequisites to the appointment of the FSLIC as federal receiver for state-chartered S&Ls. By engaging in extremely liberal statutory interpretation, the Seventh Circuit opened a Pandora's Box, granting the FHLBB virtually non-reviewable discretion to act as it desires in appointing a FSLIC receiver.

Although the *Telegraph* decision may be limited in the future, new legislation could overcome any confusion regarding the interpretation of the federal receivership appointment statute. The legislation should focus on the nature of the FHLBB's conduct and specific, objective requirements concerning solvency, closing, and withdrawal denial. In the absence of legislation, the scope of FHLBB conduct could be restricted by closer judicial scrutiny of the purpose and function of the existing statutory receivership criteria. Considering the obvious importance of effective, but restrained, governmental regulation of the financial industry in general, and the S&L industry in particular, it will not be long before the circuit courts of appeals, the Supreme Court, or Congress reconsiders this vital issue.

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