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BANK INSOLVENCY LAW NOW THAT IT MATTERS AGAIN

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INTRODUCTION

Even though the word "bankruptcy" derives from bank failure,[1] modern banks never technically go bankrupt, no matter how hard it sometimes seems they try. Instead, since well back into the nineteenth century, American banks have been subject to a special regime of bank insolvency that places their failure outside the jurisdiction of bankruptcy courts. In 1976, Robert Clark observed that "[t]he theory behind special insolvency proceedings for financial intermediaries appears not to have received careful and sustained attention."[2] His observation remains true today, and legal

1. The word "bankrupt" derives from the Italian "banca rotta," which means "bank broken" or "bench broken." The term appears to derive from Italian money-changers or banks, whose bench in the market square would be broken when insolvency occurred. 1 OXFORD ENGLISH DICTIONARY 934 (2d ed. 1989).

2. Robert C. Clark, *The Soundness of Financial Intermediaries*, 86 YALE L.J. 1, 99

academics have almost entirely failed even to notice the existence of a special bank insolvency regime.[3]

For most of the past sixty years, since the creation of the Federal Deposit Insurance Corporation (FDIC) in 1933, the special bank insolvency regime probably deserved the neglect that it received. Very few banks failed,[4] the few failures were almost invariably quite small,[5] and practices developed which insulated al-

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(1976).

3. My research identified only three law review articles that have taken any real notice of the special regime. Clark, *supra* note 2, at 99–100 (giving short discussion of reasons for special bank insolvency regime); Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 317–18 (1987) (same); Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1182–93 (1988) (discussing choice of FDIC mechanisms for handling insolvent banks, but not discussing special rules applying in insolvency). Other articles have discussed due process issues that arise when the FDIC or a similar agency processes claims against the failed bank. *See, e.g.*, Lawrence G. Baxter, *Life in the Administrative Track: Administrative Adjudication of Claims Against Savings Institution Receiverships*, 1988 DUKE L.J. 422, 512–18.

My research has also uncovered only two articles by legal academics since 1989 that focus on bank insolvency issues. One article primarily discusses federal jurisdiction and statutory interpretation issues, rather than the appropriate nature of banking regulation. W. Robert Gray, *Limitations on the FDIC's* D'Oench *Doctrine of Federal Common-Law Estoppel: Congressional Preemption and Authoritative Statutory Construction*, 31 S. TEX. L. REV. 245 (1990). The second discusses only one of the numerous special insolvency rules addressed here. Richard E. Flint, *Why* D'Oench, Duhme? *An Economic, Legal, and Philosophical Critique of a Failed Bank Policy*, 26 VAL. U. L. REV. 465 (1992). Practitioners have written about bank insolvency, but generally from a heavily practice-oriented perspective. *See, e.g.*, BARRY S. ZISMAN, BANKS AND THRIFTS: GOVERNMENT ENFORCEMENT AND RECEIVERSHIP (1992). A number of student notes have also appeared that discuss particular issues in bank insolvency. *See, e.g.*, Jennifer B. Arlin, Note, *Of Property Rights and the Fifth Amendment: FIRREA's Cross-Guarantee Reexamined*, 33 WM. & MARY L. REV. 293 (1991); Alan J. Cooke, Note, *Shareholders' Rights of Recovery When Banks Fail: Why the FDIC Should Not Receive Priority*, 11 ANN. REV. BANKING L. 449 (1992); Samantha Evans, Note, *An FDIC Priority of Claims over Depository Institution Shareholders*, 41 DUKE L.J. 329 (1992); Mark Jakubik, Note, *FDIC Claims of Priority in the Case of the Failed Bank*, 36 VILL. L. REV. 1151 (1991); Mark Simpson, Note, *Scaling Back FIRREA: Federal Judges Begin to Place Limits on RTC's Conservatorship/Receivership Powers*, 25 GA. L. REV. 1375 (1991); Note, *Unsecured Creditors of Failed Banks: It's Not a Wonderful Life*, 104 HARV. L. REV. 1052 (1991).

4. In the seven years before federal deposit insurance, 1925 to 1932, an average of 1,021 state and national banks failed each year. FDIC ANNUAL REPORT 94 (1934). From 1934 to 1942, an average of 43 insured banks were resolved each year by the FDIC. FDIC ANNUAL REPORT 84 (1990). From 1943 to 1980, an average of 4.8 insured banks were resolved each year by the FDIC. *Id.*

5. *See* FDIC ANNUAL REPORT 23 (1990). Until 1969, failures in most years involved banks with average assets of far below $10 million. A bank with $10 million in assets is considered quite small in comparison with, for instance, Citicorp's banking assets of about $215 billion. *The Top 100 Banking Companies in the World*, AM. BANKER, July

most everyone except shareholders and bank officers from loss in the event of failure.[6]

Few would think that the neglect is still deserved today. Thrift failures, which are now treated in essentially the same way as bank failures,[7] have risen dramatically after 1980.[8] The number and size of bank failures have risen too, although with a slightly later start.[9] By 1992, the FDIC, which manages failed banks, and the Resolution Trust Corporation (RTC), which manages failed thrifts, each had institutions totalling hundreds of billions of dollars of assets under their control and subject to the special bank insolvency rules.[10] Congress has responded to these failures by passing four important laws affecting bank insolvency: the Competitive Equality Banking Act of 1987 (CEBA);[11] the Financial Insti-

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27, 1992, at 31A.

6. The common practice of "purchase and assumption" transactions meant that insured and uninsured depositors, and borrowers, typically could smoothly continue their business with whatever bank acquired the failed bank. *See* JONATHAN R. MACEY & GEOFFREY P. MILLER, BANKING LAW AND REGULATION 646 (1992).

Practices in other countries do not seem to have followed the U.S. model. England, for instance, treats bank insolvencies under the same rules as other corporate insolvencies. 7(2) HALSBURY'S LAWS OF ENGLAND ¶ 1241 (4th ed. 1988). The United States is unique in the number of banks—over 12,000—that it has. FDIC, A STATISTICAL PROFILE OF THE UNITED STATES BANKING INDUSTRY, 1991, at 12 (1992). Other industrialized countries have a far smaller number of banks, and regulators typically consider it too risky to the economy to allow major banks to fail. *See, e.g.*, Robert M. Garsson, *Japanese Banks Are Poised on a Precipice*, AM. BANKER, July 27, 1992, at 10A ("Many analysts . . . believe it unlikely that authorities will permit any major bank to fail.").

7. The term "thrifts" includes such institutions as savings and loans, building and loans, and savings banks. Since 1989, the strong trend in the law has been to regulate thrifts in the same manner as banks. Except where noted in this Article, the term "banks" applies to both, and references to the FDIC apply to both the FDIC and the Resolution Trust Corporation (RTC).

8. Thrift failures numbered 35 in 1980, 81 in 1981, and rose to 252 in 1982. R. DAN BRUMBAUGH, THRIFTS UNDER SIEGE 11 (1988). A combination of economic and political factors then slowed the number of closures until substantial funding became available to the RTC in 1989. The RTC took over 651 failed thrifts between August 1989 and June 1992. *Thrift Closings*, RTC REV., July 1992, at 3, 3.

9. The FDIC took over 11 banks, totalling $8 billion in assets, in 1980. This number rose to 80 failures with assets of nearly $37 billion in 1984, and over 200 failures per year from 1987 to 1990, with assets peaking at $53 billion in 1988. U.S. DEP'T OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM Table 8 (1991).

10. As of early 1992, the RTC still retained $93.5 billion of mostly hard-to-sell assets out of the $367 billion in assets that it assumed from 630 failed thrifts. An estimated 65 additional thrifts, with $49 billion in assets, were expected to fail and come under the control of the agency. Barbara A. Rehm, *RTC Plans to Speed up Disposal of S&L Assets*, AM. BANKER, Mar. 27, 1992, at 1, 8.

11. Pub. L. No. 100-86, 101 Stat. 552 (codified in scattered sections of 2, 12, 15, 31

tutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA);[12] the Crime Control Act of 1990;[13] and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).[14] Congress and the courts have provided the agencies with "superpowers" in their handling of an institution's estate. That is, the FDIC and RTC gain powers in insolvency that would not have been available to the institution pre-insolvency, or to a non-bank in insolvency—to the disadvantage of third parties.[15] This Article seeks both to describe reasons for the growth of special insolvency rules for banks and to make a normative assessment of the current regime.

A natural first explanation for the growth of special insolvency rules for banks would be that banking benefits from federal deposit insurance. To protect the insurance fund, the government has created a system of pervasive regulation both in and out of insolvency. I argue, however, that this explanation is seriously incomplete. Special insolvency rules for banks date back well into the nineteenth century, long before the creation of deposit insurance. In addition, the mere desire to save the insurance fund does not convincingly explain the *particular ways* that bank insolvency law differs from the law applying to insolvent non-bank corporations. This Article puts forth three accounts which together explain modern bank insolvency law: the systemic effects of bank runs, the increased likelihood of insider abuse in bank failures, and the political incentives of the banking agencies and Congress.

Part I of the Article traces the history of special bank insolvency law. It also briefly describes ten categories of current special

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U.S.C.).

12. Pub. L. No. 101–73, 103 Stat. 183 (codified as amended in scattered sections throughout U.S.C.).

13. Pub. L. No. 101–647, 104 Stat. 4789 (codified in scattered sections of 11, 12, 18, 28 U.S.C.). It is perhaps suggestive of the current congressional attitude toward bank failure that the significant banking amendments contained in § 2501 were placed in a "Crime Control Act," sandwiched between penalties for drug paraphernalia, § 2401, 104 Stat. at 4858–59, and bans on opium imports, § 2601, 104 Stat. at 4911–12.

14. Pub. L. No. 102–242, 105 Stat. 2236 (codified in scattered sections of 5, 12, 15 U.S.C.).

15. Additional evidence of the importance of insolvency law is that litigation proceeds at a rapid pace. In 1991, the FDIC listed approximately 25 decisions per month in the insovency area as "critical cases" having an agency-wide effect. Interview with Ira Parker, Associate General Counsel of the FDIC for Closed Bank Litigation, in Washington, D.C. (July 30, 1991) [hereinafter Parker Interview].

rules, in order to show the broad scope of the rules examined later in the Article.

Part II shows how the systemic effects of bank failures could explain the need for special insolvency rules. Each bank failure can harm the broader economy by blocking depositors' immediate access to their funds and by creating the risk of a generalized bank run. When individual depositors perceive a risk that their bank will fail, it may be individually rational to "run" (withdraw their money from the bank). But the result of many depositors doing so would be failure of the bank, and large losses to depositors who were slow to withdraw their money.[16] A run benefits no one in a bank; all depositors would be as well off (if they withdrew deposits quickly) or better off (if they withdrew deposits slowly) if the run had never started. By the late nineteenth century, special insolvency rules developed to address this collective action problem: Shareholders were required to put up extra funds in the event of bank failure, liquidations were to be handled speedily, and the government was given monopoly power to close banks.[17] All of these measures reduced the temptation for individual depositors to run at the first sign of trouble. Amidst the bank failures of 1929 to 1933, however, policymakers decided that these measures did not work well enough. To stop the perceived systemic effects of bank failures, federal deposit insurance was extended to banks in 1933 and to thrifts the following year.[18]

Deposit insurance created two new reasons for special insolvency rules. Insolvency rules could be justified as necessary to save the insurance fund. In addition, because the FDIC "steps into the shoes" of the insured depositors it pays, it is the dominant creditor in almost all bank failures, and its expertise could justify special insolvency powers.

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16. The bank can fail even if it has positive net worth before the run. Facing the need to pay depositors immediately, the bank is forced to sell its assets at less, often much less, than their usual market value. The run can therefore reduce the total amount available to all depositors.

17. *See infra* text accompanying notes 107–11.

18. Beginning in 1934, thrifts were insured by the Federal Savings and Loan Insurance Corporation (FSLIC), which was administered by the Federal Home Loan Bank Board (FHLBB). In 1989, FIRREA abolished these agencies and created the Savings Association Insurance Fund (SAIF), within the FDIC, to insure thrift deposits. The Office of Thrift Supervision (OTS) regulates solvent thrifts, and the RTC administers insolvent thrifts.

The "save the fund" and expertise arguments do not, however, explain the existence of the many rules that pick and choose just who will be disadvantaged by special insolvency rules. Part III of the Article argues that many bank insolvency rules arose from a "model of insider abuse." Under this model, it is assumed that bank and thrift failures result from fraud or egregious mismanagement rather than from the usual workings of competitive markets. Many thrift scandals of the 1980s popularized the idea that Charles Keating and other "thrift kingpins" were to blame for savings and loan losses, and thus that managers and other insiders should be made to reimburse the insurance fund for their ill-gotten gains. The case for special insolvency rules is bolstered by theoretical reasons for believing that banks might be especially susceptible to insider abuse: Banks cannot be monitored in many of the usual ways, and banking is a business that is peculiarly subject to fraud--banks engage in numerous, liquid, and large transactions which are ready subjects of forgery and embezzlement schemes. Insiders thus may deserve to be subject to special, strict rules when their institutions become insolvent.

Parts II and III together suggest that systemic concerns and the risk of insider abuse could provide sound policy explanations for the development of special bank insolvency rules. But, as discussed in Part IV, there is good reason for fearing that political considerations, rather than sound policy, have been the source for many of the recent rules. In examining the public choice of bank insolvency rules, I argue that the FDIC's chief goal has been to maximize the bank and thrift insurance funds, while Congress's has been to prevent blame for the bailout from being traced back to itself. In the four recently passed statutes mentioned earlier, the result has been a "strict" approach to bank insolvency. Many new special rules have become law, giving the FDIC additional superpowers and redirecting a portion of the bailout cost onto the backs of bank insiders and numerous third parties. There has often been no effective counterweight to the FDIC and Congress, with the result that the recent rules are likely stricter than sound policy would warrant.

The three accounts of systemic effects, insider abuse, and public choice combine to give a good description of how the FDIC has gained its extraordinary range of special powers in bank insolvency. These major forces have all pushed toward stricter laws favoring the FDIC and hurting third parties. The result has

been a trend toward greater divergence of law applying to banks before and after insolvency, and greater divergence of insolvency law applying to banks and to other corporations.

The next task, undertaken in Part V, is assessing whether the current rules are normatively desirable. Looking at two prominent areas of bank insolvency law, Part V argues that some rules have gone too far. Although solid arguments support the "cross-guarantees" power of the FDIC, which allows the agency to tax affiliated solvent banks for losses to the insurance fund, the rules derived from *D'Oench, Duhme & Co. v. FDIC*[19] have probably expanded too far, giving the FDIC and RTC undeserved victories over some legitimate borrowers from failed banks.

More generally, there are strong reasons for believing that the overall group of special insolvency rules has gone too far. Most important is what I call the "black hole" effect for nearly insolvent institutions. The many special insolvency rules make it more costly for almost anyone—investor, borrower, contractor, employee, or even depositor—to do business with a troubled bank. Once a bank becomes troubled, it is rational for any of these persons to consider a modern form of bank run, by ceasing to do business with the weak bank. The overall result of the current rules, many of which were designed to prevent bank failures, may ironically be to encourage additional failures. With so many billions of dollars of taxpayer money at stake, these potential costs of the special bank insolvency regime deserve careful attention which they have not previously received.

I. THE HISTORY AND CURRENT NATURE OF SPECIAL BANK INSOLVENCY LAW

Little history about special rules for bank insolvency has previously been published. A striking aspect of the history is the degree to which the special regime developed before the creation of federal deposit insurance in 1933. The mere existence of deposit insurance, or of government regulation of banking more generally, thus does not sufficiently explain why the special regime has developed. The analysis in later Parts of this Article attempts to provide a more satisfactory set of explanations. This Part lays out

19. 315 U.S. 447 (1942).

the key portions of the history of the special bank insolvency regime and describes its current nature.

A. *The History of the Special Bank Insolvency Regime*

The perceived need for a special bank insolvency regime dates back at least to 1837 and to 1857, when Presidents Van Buren and Buchanan, respectively, introduced bills in Congress that would have provided for a federal bankruptcy system confined to banks.[20] Even in a period in which the federal government played no role in banking regulation, these bills, although they did not pass, show the perceived special nature of bank insolvency.[21]

The National Banks Act (NBA), approved in 1864 to help finance the Civil War, began the federal practice of giving bank receivers extraordinary powers.[22] Procedurally, the Comptroller of the Currency, rather than a court, gained the power to appoint a receiver for national banks.[23] Over time, doctrine developed that courts had only limited powers to interfere with actions of these "statutory receivers."[24] Statutory receivers also gained at least two specific superpowers. For a time, they could sue in federal courts without regard to diversity.[25] In addition, upon insolvency they could enforce the "double liability" provision, which allowed assessment of stockholders for up to the par value of their stock.[26]

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20. President Van Buren argued that his bill would be the most effective way to deal with banks which did not redeem their notes and would provide the only practical relief to noteholders. CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 56–57 (1935). President Buchanan made his request in the wake of the panic of 1857. *Id.* at 95–96.

21. Both bills were introduced during the "free banking" era that existed between the closure of the Second Bank of the United States in 1836 and the passage of the National Bank Act in 1863. During this period, bank regulation was exclusively the province of the states.

22. Act of June 3, 1864, ch. 106, 13 Stat. 99.

23. *Id.* § 32, 13 Stat. at 109.

24. Lawrence F. Bates, *The FDIC and Failed Banks*, *in* FAILING FINANCIAL INSTITUTIONS 419, 426–30 (ALI-ABA Course of Study Materials 1988).

25. *But see* Act of July 12, 1882, ch. 290, § 4, 22 Stat. 162, 163 (repealing all federal laws inconsistent with national bank being subject to the same jurisdictional rules as a non-national bank).

26. *See* Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31, 31 (1992).

A system of state-chartered banks flourished alongside the national banks regulated by the Comptroller.[27] Most states established special statutory regimes for supervising banks and governing insolvencies.[28] These regimes were established even though the states had no direct financial stake in bank failures comparable to the FDIC's deposit insurance. Most of the key elements of the NBA scheme were reproduced in the states: appointment of a statutory receiver by a government official, streamlined administration of the estate, and double liability provisions.[29] The general rule, however, continued to be the normal rule in bankruptcy—the bank receiver merely "stepped into the shoes" of the bank and did not, by virtue of being receiver, acquire any enhanced powers to collect debts or otherwise.[30]

The Great Depression and the creation of the FDIC in 1933 led to a sharp break from past practices in bank insolvency. The Bankruptcy Act of 1898 had permitted the existing Comptroller and state bank insolvency proceedings to continue, and had explicitly excluded banks from its coverage.[31] The FDIC became the exclusive receiver for failed national banks, and also gained the power to be receiver for state insured banks at the discretion of

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27. One original goal of the NBA was that the national bank monopoly on the issue of bank notes would eliminate state banks. In a classic example of regulatory avoidance, state banks developed the checking account as a new way to finance themselves, with the result that the current "dual banking" system developed contrary to the intent of the NBA. MACEY & MILLER, *supra* note 6, at 12.

28. *See* Legislation, *Legal Devices for the Rehabilitation of Banks*, 32 COLUM. L. REV. 1395, 1395–96 & nn.3–4 (1932) (collecting statutes on statutory receiverships); *see also* Charles F. Albert, Administrative Liquidation of Banks (1927) (unpublished J.D. thesis, Harvard Law School, on file with author).

29. States did not have a direct financial stake in banks comparable to the U.S. government's guarantee of bank notes. With the rise in a number of states of state deposit insurance funds, however, at least a moral obligation of the state existed to assure that depositors did not lose their money. State guaranty funds date back at least to 1907, showing the early public concern for special provisions for bank insolvencies. EUGENE N. WHITE, THE REGULATION AND REFORM OF THE AMERICAN BANKING SYSTEM, 1900–1929, at 207–18 (1983).

30. 9 CARL ZOLLMANN, THE LAW OF BANKS AND BANKING § 6103 (1936 & Supp. 1954). Statutory receivers may, however, have gained some enhanced powers to set aside transactions based on fraud or illegal preferences. Flint, *supra* note 3, at 490–91.

31. *See* Bankruptcy Act §4, 30 Stat. 544, 547 (1898). The exclusions continue today in 11 U.S.C. § 109(b)(2), (3) (1988). Insurance companies and most thrifts were also excluded from the 1898 Act. *See generally* Michael I. Sovern, *Section 4 of the Bankruptcy Act: The Excluded Corporations*, 42 MINN. L. REV. 171 (1957) (giving history of exclusions to bankruptcy acts).

state authorities. Similar receivership powers were granted to the Federal Home Loan Bank Board (FHLBB) for thrifts insured by the Federal Savings and Loan Insurance Corporation (FSLIC).[32]

Creation of the FDIC and FSLIC began a half-century in which bank insolvency law nearly disappeared as a topic of legal interest. The number of bank and thrift failures dropped sharply after passage of deposit insurance, and most subsequent failures involved very small institutions.[33] The only development of continuing interest was the 1942 case *D'Oench, Duhme & Co. v. FDIC*,[34] discussed below, which has become the source of an elaborate set of rules favoring the government receiver in cases in which written bank files have not been meticulously kept.

The enormous thrift failures of the 1980s eventually caused the FSLIC to run out of money, prompting passage of FIRREA in 1989. Among its numerous provisions,[35] FIRREA codified the powers of the FDIC and RTC acting as "receiver" (liquidating the failed institution) or "conservator" (conserving the failed institution as a going concern in hopes of reselling it).[36] FIRREA continued the centralization of power over insolvencies into FDIC hands. After FIRREA, the FDIC is the exclusive receiver and conservator for failed national banks by law, and for failed state-insured banks by practice.[37]

The FDIC was also put on the path to controlling thrift insolvencies. FIRREA created the Resolution Trust Corporation (RTC), which serves as the receiver or conservator for all thrifts that fail between January 1, 1989 and October 1, 1993.[38] The

32. For the history of FHLBB power over thrift failures, see ZISMAN, *supra* note 3, § 15.04[1][b]; Baxter, *supra* note 3, at 486.

33. *See supra* notes 4–5.

34. 315 U.S. 447 (1942).

35. The Senate bill covered 564 pages and the House version 311 pages. S. 774, 101st Cong., 1st Sess. (1989); H.R. 1278, 101st Cong., 1st Sess. (1989). The House version was enacted following a joint resolution. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101–73, 103 Stat. 183 (codified in part in 12 U.S.C. §§ 1811–1833(d)).

36. 12 U.S.C. § 1821(c) (Supp. III 1991).

37. The FDIC even has the power to name itself receiver or conservator for failed state insured banks if state authorities are slow to act. *Id.* § 1821(c)(4)–(5). This provision gives the FDIC broad discretion to appoint itself, such as for "[a]ny violation of any law or regulation, or an unsafe or unsound practice or condition which is likely to cause insolvency or substantial dissipation of assets or earnings, or is likely to weaken the condition of the institution or otherwise seriously prejudice the interests of its depositors." *Id.* § 1821(c)(5)(H).

38. The original time period ended on August 9, 1992. Congress later extended the

FDIC was given an exclusive management role over the RTC, and the Chairman and Board of the FDIC were made the Chairman and Board of the RTC.[39] Furthermore, the FDIC will be the exclusive receiver or conservator for thrifts that fail after October 1, 1993.

Congress continued to expand the agency insolvency powers in the Crime Control Act of 1990 and FDICIA in 1991. Under FDICIA, the agency's powers in insolvency began to be leveraged for the first time into significant powers over solvent institutions. Prior to 1991, other federal regulatory agencies had successfully protected their turf,[40] leaving the FDIC only a modest role in regulating solvent state non-member banks and administering the deposit insurance system.[41] The 1991 "prompt corrective action" provisions, discussed in Part V, gave the FDIC increasing powers over all insured institutions as they approach insolvency, perhaps setting the stage for continued expansion of the agency's power in the future.[42]

B. *The Current Superpowers of the Banking Agencies*

One aim of this Article is to draw attention to the remarkable group of superpowers that have accumulated in the hands of the FDIC and RTC. This Section describes the current superpowers. Much of the rest of the Article examines why they exist, and whether they should exist in their present form.

Structurally, bank insolvency is special because the government agency that charters a bank holds a monopoly power to

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date to October 1, 1993. *See* Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991, Pub. L. No. 102-233, 105 Stat. 1761-62 (codified at 12 U.S.C. § 1441a(b)(3)(A)(ii) (Supp. III 1991)).

39. 12 U.S.C. §§ 1441a(b)(1)(C), 1441a(b)(8)(A)-(B) (Supp. III 1991). However, the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 created a chief executive officer for the RTC, 105 Stat. at 1766 (codified at 12 U.S.C. § 1441a(b)(9)(C) (Supp. III 1991)), and reduced the FDIC oversight role.

40. The Comptroller of the Currency supervises national banks, the OTS supervises solvent thrifts, and the Federal Reserve Board and the states supervise state banks that are members of the Federal Reserve (which includes most large state banks).

41. Because removal of deposit insurance is considered such a drastic measure, the FDIC's role as insurer has not in practice led the agency to have important supervisory powers over solvent institutions.

42. *See* Alfred M. Pollard, *Alteration of Regulatory Jurisdiction and Its Impact Under the 1991 Banking Law*, 58 Banking Rep. (BNA) 361 (Mar. 2, 1992) (describing expanded FDIC powers over solvent institutions).

declare insolvency.[43] The structure also requires the FDIC and RTC to play many of the roles split in bankruptcy among the creditors, trustee, and bankruptcy judge.

The FDIC and RTC have assumed a remarkable list of superpowers once insolvency is declared. This Article selects two prominent types of superpowers for particular attention—cross-guarantees and *D'Oench* powers. They illustrate how systemic effects, insider abuse, and public choice can assist a normative assessment of special insolvency rules. The other special insolvency rules are described more briefly, giving the reader a sense of the pervasive way in which different rules apply before and after a bank's insolvency. Where helpful, the special rules are contrasted with bankruptcy law in order to highlight the unique nature of these agency superpowers.

1. *Cross-Guarantees.* Under the cross-guarantees provision of FIRREA,[44] the FDIC gained new and strong powers with respect to banks and thrifts affiliated with an insolvent institution. The provision requires that any loss incurred by the FDIC due to the failure of one institution is automatically assessed against affiliated banks and thrifts. Shareholders and non-bank affiliates of the failed bank are not required to pay, but their claims against the failed bank are subordinated to the FDIC's claim. These insiders will often not get paid even for secured claims against the failed bank.[45]

In bankruptcy, no special power exists for creditors to reach the assets of affiliates. To reach those assets, creditors must succeed on claims that are available outside of bankruptcy, such as fraudulent conveyance, equitable subordination, or piercing of the

43. The Office of the Comptroller of the Currency charters national banks, the OTS charters thrifts, and state banking agencies charter state banks. The FDIC has now gained the power to name itself receiver or conservator for state banks when the state agency is slow to close the bank. 12 U.S.C. § 1821(c)(4) (Supp. III 1991). By contrast, the bankruptcy rules usually require three creditors to force an insolvent debtor into bankruptcy. 11 U.S.C. § 303(b)(1) (1988). If there are fewer than twelve creditors, § 303(b)(2) allows one creditor with at least $5,000 in claims to initiate an involuntary bankruptcy proceeding. *Id.* § 303(b)(2).

44. 12 U.S.C. § 1815(e) (Supp. III 1991).

45. *Id.* § 1815(e)(2)(C)(i). The FDIC's claim under cross-guarantees is subordinated to general and subordinated claims against the failed bank by those other than the shareholders and affiliates. *Id.* § 1815(e)(2)(C)(ii).

corporate veil.[46] Each of these claims can be laborious, and often impossible, to prove.

2. D'Oench *Powers.* Perhaps most surprising of all the agency superpowers are the *D'Oench* powers, which bar many claims and defenses against conservators and receivers that would have been valid against the bank itself. Three interrelated sources of law aid the agencies in increasing the value of the failed institution. First, the *D'Oench* case announced an equitable doctrine that prevents a person doing business with a bank from benefitting from any "secret agreement" undocumented in bank records and thus not discoverable by bank regulators.[47] Second, section 1823(e) of Title 12, a strict statutory version of the *D'Oench* doctrine, creates a specialized statute of frauds that defeats all claims or defenses against a bank except those based on contemporary approval by the bank's board of directors. The approval must also be continuously maintained in bank records.[48] Finally, the "federal holder in due course" doctrine has developed judicially to allow agencies to win in related cases even where *D'Oench* and section 1823(e) may not apply.[49]

The upshot of these powers has been agency victories over borrowers, even in quite extreme cases, such as where the bank unilaterally altered the terms of a note,[50] or forged the signature on a loan renewal and diverted the funds to a bank officer's

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46. *See generally* Robert C. Clark, *The Duties of the Corporate Debtor to Its Creditors,* 90 HARV. L. REV. 505 (1977) (discussing means of creditors reaching affiliates' assets).

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

48. The statute provides:

> No agreement which tends to diminish or defeat the interest of the Corporation in any asset . . . shall be valid against the Corporation unless such agreement—(1) is in writing, (2) was executed by the depository institution and any person claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the depository institution, (3) was approved by the board of directors of the depository institution or its loan committee, which approval shall be reflected in the minutes of said board or committee, and (4) has been, continuously, from the time of its execution, an official record of the depository institution.

12 U.S.C. § 1823(e) (Supp. III 1991). Since FIRREA, these provisions also apply to claims against the receivership or conservatorship. *Id.* § 1821(d)(9).

49. *See, e.g.,* FSLIC v. Murray, 853 F.2d 1251, 1256–57 (5th Cir. 1988); Gunter v. Hutcheson, 674 F.2d 862, 873 (11th Cir.), *cert. denied,* 459 U.S. 826 (1982).

50. *Murray,* 853 F.2d at 1254–55.

use.[51] *D'Oench* cases most often involve a borrower's defense against FDIC or RTC enforcement of a loan. The agencies routinely win, usually on summary judgment, even where the claim or defense would have been valid under state or federal law if proved. To date, the agencies have won against a notable list of claims and defenses that includes fraud in the inducement;[52] various forms of misrepresentation;[53] various lender liability claims;[54] recklessness or negligence;[55] material alteration of a promissory note;[56] inaccurate recital of note terms;[57] unrecorded agreement;[58] improper notarization;[59] mechanic's lien;[60] failure of consideration;[61] accord and satisfaction;[62] novation;[63] unjust enrichment, waiver, and estoppel;[64] duress;[65] lack of mental capacity;[66] usury;[67] violation of federal securities laws;[68] and setoff rights of participating bank.[69]

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51. FDIC v. McClanahan, 795 F.2d 512, 514 (5th Cir. 1986).

52. Langley v. FDIC, 484 U.S. 86, 93–95 (1987).

53. FSLIC v. Dillon Constr. Co., 681 F. Supp. 1359 (E.D. Ark. 1988).

54. Bowen v. FDIC, 915 F.2d 1013 (5th Cir. 1990); FSLIC v. Locke, 718 F. Supp. 573 (W.D. Tex. 1989); R.S.R. Properties v. FDIC, 706 F. Supp. 524 (W.D. Tex. 1989).

55. FSLIC v. Gordy, 928 F.2d 1558, 1566 (11th Cir. 1991) (listing cases and then holding that the *D'Oench* doctrine applies "even in the absence of bad faith, recklessness or negligence").

56. FSLIC v. Murray, 853 F.2d 1251, 1254–55 (5th Cir. 1988); FDIC v. Armstrong, 784 F.2d 741, 745 (6th Cir. 1986).

57. Buchanan v. FSLIC, 935 F.2d 83, 86 (5th Cir.), *cert. denied*, 112 S. Ct. 639 (1991).

58. FDIC v. Hamilton, 939 F.2d 1225, 1228 (5th Cir. 1991); Bell & Murphy & Assoc. v. Interfirst Bank Gateway, 894 F.2d 750, 753 (5th Cir.), *cert. denied*, 111 S. Ct. 244 (1990).

59. FDIC v. McCullough, 911 F.2d 593, 602–04 (11th Cir. 1990), *cert. denied*, 111 S. Ct. 2235 (1991).

60. Twin Constr. v. Boca Raton, Inc., 925 F.2d 378, 383–84 (11th Cir. 1991).

61. FDIC v. McClanahan, 795 F.2d 512, 516–17 (5th Cir. 1986).

62. Public Loan Co. v. FDIC, 803 F.2d 82, 84–85 (3d Cir. 1986).

63. FDIC v. Fisher, 727 F. Supp. 1306 (D. Minn. 1989).

64. FDIC v. Gulf Life Ins. Co., 737 F.2d 1513, 1516 (11th Cir. 1984).

65. Cerar v. FDIC (*In re* Cerar), 84 B.R. 524, 531–32 (Bankr. C.D. Ill. 1988), *aff'd on other grounds*, 97 B.R. 447 (C.D. Ill. 1989).

66. FDIC v. Ohlson, 659 F. Supp. 490, 492 (N.D. Iowa 1987).

67. FDIC v. Claycomb, 945 F.2d 853, 861 (5th Cir. 1991), *cert. denied*, 112 S. Ct. 2301 (1992).

68. FDIC v. Aroneck, 643 F.2d 164, 166 (4th Cir. 1981).

69. FDIC v. Bank of Am. Nat'l Trust & Sav. Ass'n, 701 F.2d 831, 836 (9th Cir.), *cert. denied*, 464 U.S. 935 (1983).

3. *Other Special Insolvency Rules.* A substantial number of other special insolvency rules have developed in addition to the cross-guarantees and *D'Oench* powers. To understand this Article, it is not necessary to understand the intricacies of these special rules, many of which are still being contested in the courts. It is important, however, to grasp the general point that bank insolvency law overall is quite distinctive, and varies both from the law applying to banks pre-insolvency and from the insolvency law applying to non-bank corporations.[70] The reader may wish to review these special powers quickly, and refer back to this Section when the powers are discussed later in the Article.

The largest category of special bank insolvency rules singles out those with some insider connection to the failed bank and attempts to shift the costs of failure from the insurance fund to the insiders. In this category fall special rules concerning: repudiation of contracts and leases, fraudulent conveyance, asset freezes, priority among creditor claims, agency enforcement powers, and bankruptcy. Other special rules include: a unique definition of when a bank becomes insolvent, rules exempting the FDIC and RTC from state and local taxation, and special procedural rules.

A bankruptcy trustee or debtor, subject to the court's approval, has broad powers to repudiate executory contracts or unexpired leases.[71] This power prevents "sweetheart" contracts that allow insiders to get higher priority than other claimants. The banking agencies have essentially the same powers as the trustee, but with two material additions. First, the agencies appear to retain almost unlimited discretion about whether to repudiate,[72] in contrast to the bankruptcy court's supervision of a trustee's decision. Second, the agencies need not pay the full measure of contract damages that repudiation in bankruptcy requires;[73] instead, the receiver or

70. By far the most detailed survey of agency superpowers is contained in ZISMAN, *supra* note 3, chs. 19–28.

71. 11 U.S.C. § 365(a) (1988).

72. The chief statutory limit on agency discretion is that the repudiation be within a "reasonable" time. 12 U.S.C. § 1821(e)(2) (Supp. II 1990). One Court of Appeals has given the agency practically unlimited ability to avoid even this restriction by the device of switching between receivership and conservatorship, and thereby recommencing the "reasonable" time. RTC v. CedarMinn Building Ltd. Partnership, 956 F.2d 1446, 1451 (8th Cir.), *cert. denied*, 113 S. Ct. 94 (1992).

73. *See* 11 U.S.C. § 365(a) (1988).

conservator is excused from payment for lost profits on contracts and for future rent on leases.[74]

Three aspects of the fraudulent conveyance provision of the Crime Control Act of 1990[75] illustrate the extraordinary powers granted to the FDIC and RTC by that Act. First, the FDIC and RTC can avoid fraudulent transfers made five years before or after appointment of the receiver or conservator.[76] Second, the agencies may avoid transfers not only of the bank itself, but of all "institution-affiliated parties," a broad term including any director, officer, employee, controlling stockholder, or agent for a bank.[77] Third, the rights of the agencies in the fraudulent transfer are superior to any rights of a bankruptcy trustee for the fraudulent transferee. The agencies will thus stand ahead of all other claimants, except federal agencies, on the estate of that transferee.[78]

The Crime Control Act of 1990 gave the FDIC and RTC the power to request a court to freeze the assets of any person, with the assets held by a trustee.[79] Recovery on the assets goes to the estate of the failed institution. The agencies may seek this prejudg-

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74. 12 U.S.C. § 1821(e)(3)–(4) (Supp. III 1991).

75. Pub. L. No. 101–647, § 2528(a), 104 Stat. 4789, 4877–79 (1990) (codified at 12 U.S.C. § 1821(d)(17) (Supp. III 1991)). The first court to construe this statute has given it a broad reading. FDIC v. Cafritz, 762 F. Supp. 1503, 1506–08 (D.D.C. 1991).

76. 12 U.S.C. § 1821(d)(17)(A) (Supp. III 1991). This contrasts with bankruptcy law, which allows the trustee to avoid such transactions made only within one year before bankruptcy, 11 U.S.C. § 548(a) (1988), or to use state law, *id.* § 544(b), which may allow avoidance for a set number of years, often two or three, before insolvency.

77. 12 U.S.C. § 1813(u) (Supp. III 1991). Even independent contractors such as attorneys are considered such a party, if they recklessly participated in activities that caused more than a minimal financial loss to the bank. *Id.* § 1813(u)(4). To be an institution-affiliated party, the independent contractor must "knowingly or recklessly participate[] in—(A) any violation of any law or regulation; (B) any breach of fiduciary duty; or (C) any unsafe or unsound practice,—which caused or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the insured depository institution." *Id.*

78. 12 U.S.C. § 1821(d)(17)(D). That is, the agency will apparently come even before administrative expenses of the estate. In a bankruptcy law dispute between a fraudulent transferor and a fraudulent transferee, which creditor first gets a judicial lien wins; in bank insolvencies, the agencies always win.

79. 12 U.S.C. § 1821(d)(18) (Supp. III 1991). The stated purpose of the provision is "Protecting Assets From Wrongful Disposition." Crime Control Act of 1990, Pub. L. No. 101–647, tit. XXV, subtit. B, 104 Stat. 4789, 4863 (1990). It would appear the statute should be read more narrowly than its "all persons" language would suggest. The power should arise only with respect to assets sought by the agencies acting as receiver or conservator or in their related failed-bank capacities. A similar power to seek prejudgment attachment is also given to the FDIC as an enforcement power against open banks. 12 U.S.C. § 1818(i)(4) (Supp. III 1991).

ment attachment under the injunction provisions of Rule 65 of the Federal Rules of Civil Procedure, but with one remarkable change: They are not required to make the usual showing that the injury is "irreparable and immediate."[80]

FIRREA granted the FDIC and RTC the power to discriminate among claims on the failed institution, in contrast to the traditional rule that all claims in the same class must receive the same percentage recovery.[81] The agencies are obligated to pay only the amount a claimant would have received if the agencies had liquidated the assets and liabilities of the institution,[82] which is often a steep discount from full recovery.[83] The agencies also retains discretion to select some claimants for additional payments,[84] thus enabling the agencies to treat insiders less well than other claimants.

Government agencies have wide-ranging enforcement powers both before and after insolvency, with no close analogues to creditor powers in bankruptcy. Notably, the FDIC and OTS can levy civil money penalties of up to $1 million per day for violations of banking rules.[85] And temporary cease-and-desist orders can freeze assets of institution-affiliated parties upon a mere prima facie showing that money penalties are appropriate.[86] Such enforcement actions have been allowed to go forward against a holding company despite the automatic stay provisions in bankruptcy.[87] Such enforcement proceedings can obviously enhance the ability of agencies to recover for losses arising from insolvent institutions.[88]

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80. 12 U.S.C. § 1821(d)(19) (Supp. III 1991).

81. The traditional rule for failed national banks had been strict pro rata treatment of creditors, 12 U.S.C. § 194 (1988), and a prohibition on preferences of one creditor over another, *see* First Empire Bank v. FDIC, 572 F.2d 1361, 1371 (9th Cir.) (applying sections 91 and 194 to FDIC receiverships), *cert. denied*, 439 U.S. 919 (1978).

82. 12 U.S.C. § 1821(i)(2) (Supp. III 1991).

83. When the FDIC decides the failed bank's assets are not enough to satisfy higher-priority creditors (such as secured creditors and depositors), the agency has the additional power under the "prudential mootness" doctrine simply to bar suits and claims by general creditors against the receivership. *See* ZISMAN, *supra* note 3, § 21.02[2][c].

84. 12 U.S.C. § 1821(i)(3)(A).

85. *Id.* § 1818(i)(2).

86. *Id.* § 1818(c). This power was the basis of the freeze against the law firm Kaye, Scholer, Fierman, Hays & Handler.

87. *See* Carlton v. Firstcorp, Inc., 967 F.2d 942, 945 (4th Cir. 1992) (bankruptcy court lacks jurisdiction to stop OTS enforcement action due to anti-injunction provision of 12 U.S.C. § 1818(i)(1)).

88. One possible limit on agency enforcement powers has been suggested by the

The Crime Control Act of 1990 also gave the agencies new powers that trump rules otherwise applying in bankruptcy. In order to ensure that bank insiders do not benefit from their acts, the Act declared certain banking-related claims no longer dischargeable in bankruptcy.[89] In addition, the Act created new rules that apply to any entity, such as a bank holding company, that commits to maintain the capital of an insured bank. If the holding company later becomes bankrupt, the FDIC is given high priority to the amount of the commitment.[90] These rules became more important in 1991 with passage of FDICIA, which routinely requires such commitments by holding companies to maintain the capital of undercapitalized banks.[91]

In 1991, FDICIA established a regime for prompt corrective action for undercapitalized banks. A series of increasingly stringent rules now apply to banks as their capital levels fall below statutorily required levels towards insolvency. Most important for purposes of this Article, the Act introduces a new trigger for bank insolvency. Instead of waiting for banks to exhaust their capital, the Act requires that "severely undercapitalized" banks (those whose capital is less than two percent of assets) be closed within ninety days of becoming severely undercapitalized.[92] The bank is thus subject to the full range of agency receivership powers even before the usual definitions of insolvency are met. One solid ratio-

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Fifth Circuit. In Akin v. Office of Thrift Supervision, 950 F.2d 1180, 1185 (5th Cir. 1992), the court implied that the OTS's enforcement proceeding could continue after insolvency only if begun and substantially pursued before insolvency.

89. Individuals' debts are not dischargeable if they arise from fraud or defalcation while acting in a fiduciary capacity to an insured depository institution, or from reckless failure to fulfill any commitment by the individual to maintain the capital of the institution. 11 U.S.C. § 523(a)(11)–(12) (Supp. III 1991).

90. 11 U.S.C. §§ 365(o), 507(a)(8) (Supp. III 1991). A Chapter 11 trustee or debtor is required to assume and immediately cure any deficit under any commitment by the debtor to banking agencies to maintain the capital of an insured depository institution. *Id.* § 365(o). Such obligations pursuant to assumed executory contracts are administrative expense claims given first priority under the Bankruptcy Code. *Id.* §§ 503(b)(1)(A), 507(a)(1). In slight contrast, the same obligations in a Chapter 7 liquidation proceeding are given a new eighth priority. *Id.* § 507(a)(8). No explanation is given in the legislative history for the differing treatment between reorganization and liquidation. *See* H.R. REP. NO. 868, 101st Cong., 2nd Sess., pt. 1, at 179–80 (1990), *reprinted in* 1990 U.S.C.C.A.N. 6472, 6585–86.

91. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102–242, § 131, 105 Stat. 2236, 2253–67 (codified at 12 U.S.C. § 1831o (Supp. III 1991)).

92. 12 U.S.C. § 1831o(h)(3)(A) (Supp. III 1991).

nale for this rule is that, due to accounting imperfections, banks reporting two-percent capital are actually likely to be insolvent.[93]

The FDIC and RTC acting as receiver are exempt from all taxation imposed by any state or local taxing authority, except for certain real property taxes.[94] These agency advantages both reduce the costs to the insurance fund of a receivership,[95] and, echoing *McCulloch v. Maryland*,[96] prevent the FDIC and RTC from being subjected to state and local taxation.

The FDIC and RTC enjoy a number of special procedural rules that a bank would not have available pre-insolvency. The agencies have a broad right to remove to federal court,[97] and can remove a suit from state court without bond.[98] They can stay litigation against the bank for ninety days in the case of receivership and forty-five days for conservatorship.[99] These last powers are similar, although far from identical, to the automatic stay in bankruptcy,[100] and the use of a federal bankruptcy court to replace

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93. Banks report their capital under generally accepted accounting principles, which value most assets and liabilities at book, or historical, value rather than current market value. To the extent regulators and investors rely on bank balance sheets, banks have an incentive to realize profits promptly (with the books reflecting the higher market value), but to delay realizing their losses (with the books reflecting the higher book value).

94. 12 U.S.C. § 1825(b)(1) (Supp. III 1991); *see id.* § 1441a(b)(1)(B). The agencies also are not subject to any penalty or fine arising from nonpayment of *ad valorem* taxes. *Id.* § 1825(b)(3). The FDIC in its corporate capacity had enjoyed this tax immunity since 1950. Act of Sept. 21, 1950, ch. 967, § 15, 64 Stat. 873, 890. The question of whether the FDIC acting as receiver enjoyed the immunity was not decided by the courts before 1989, although the agency likely would have succeeded under the analysis of First Agric. Nat'l Bank of Berkshire County v. State Tax Comm'n, 392 U.S. 339 (1968) (holding national banks immune from state sales tax). FIRREA clarified the immunity of the FDIC acting as receiver. H.R. REP. No. 54, 101st Cong., 1st Sess., pt. 1, at 337 (1989), *reprinted in* 1989 U.S.C.C.A.N. 86, 133.

95. It is possible that the tax advantages can be passed on to subsequent purchasers, further increasing the value of the failed institution. *See* Barry S. Zisman & Marguerite N. Woung, *The Superpowers of the FDIC/RTC and Their Availability to Third Parties*, 108 BANKING L.J. 516, 530–32 (1991).

96. 17 U.S. (4 Wheat.) 316 (1819) (disallowing state tax on Second National Bank of the United States).

97. *See* 12 U.S.C. § 1819(b)(2)(B) (Supp. III 1991); *see, e.g.*, Capizzi v. FDIC, 937 F.2d 8 (1st Cir. 1991) (upholding removal despite failure to meet "well-pleaded complaint" rule).

98. 12 U.S.C. § 1819(b)(4) (Supp. III 1991).

99. *Id.* § 1821(d)(12)(A).

100. *See* 11 U.S.C. § 362 (1988 & Supp. III 1991). The relative shortness of the stay can be explained by the mandatory claims process, administered by the FDIC, that claimants must enter in order to recover from the estate of the bank.

state proceedings by creditors. Additional advantages to the agencies acting as receiver or conservator are an extended statute of limitations,[101] and broad investigative powers, such as the ability to issue a subpoena or subpoena *duces tecum*.[102]

C. *Summary*

Since well before the creation of deposit insurance, receivers for failed banks and thrifts have enjoyed powers that the institutions would not have had pre-insolvency. In recent years, the number of these "superpowers" has grown substantially. The remainder of this Article seeks to explain the development of these special rules, and to assess their desirability.

II. SYSTEMIC EFFECTS OF BANK FAILURE AND SPECIAL BANK INSOLVENCY RULES

The unusual problems of bank failure—contagious bank runs and the blocking of depositors' immediate access to their funds—have led to special rules to prevent systemic losses from bank failures. The creation of the FDIC and deposit insurance has provided new rationales for special bank insolvency rules, such as saving the insurance fund and deferring to FDIC expertise. This Part examines the persuasiveness of these rationales for special rules, concluding that the current rules are substantially more favorable to the FDIC and RTC than is justified by concern for systemic losses.

A. *Special Bank Insolvency Rules Before Deposit Insurance*

An initial question is why special insolvency rules originally developed. In the period before deposit insurance, a bank failure posed two sorts of threats to the local or national economy. First, depositors would lose access to their transaction accounts—their checks would not clear, and they would in general lose the key benefit of "immediacy," or immediate access to their money.[103]

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101. The applicable period is six years for contracts and three years for torts, or longer if permitted by state law. 12 U.S.C. § 1821(d)(14) (Supp. III 1991).

102. 12 U.S.C. § 1821(d)(2)(I) (Supp. III 1991).

103. *See* Sanford J. Grossman & Merton H. Miller, *Liquidity and Market Structure*, 43 J. FIN. 617 (1988) (describing "immediacy demanders" willing to accept lower price in exchange for higher assurance of immediate access to funds).

Thus, depositors would prefer a deposit contract that protected immediacy. As discussed below, special bank insolvency rules have done precisely that.

The second threat posed by the failure of a bank was that failure would spread to other banks in a contagious bank run. Observers in the nineteenth and early twentieth centuries had no doubt about the bad effects of bank runs. Consider this vivid description by a Kansas court:

> [In case of insolvency,] the mischief takes a wide range. Those who have been accommodated with loans must pay, whatever their readiness or ability to do so. Further advances cannot be obtained. Other banks must call in their loans and refuse to extend credit in order to fortify themselves against the uneasiness and even terror of their own depositors. Confidence is destroyed. Enterprises are stopped. Business is brought to a standstill. Securities are enforced. Property is sacrificed, and disaster spreads from locality to locality. All these incidents of the banking business are matters of common knowledge and experience.[104]

This description shows how bank runs were thought to be tightly linked with the three main reasons that banks historically have been considered "special" and thus deserving of a special regulatory regime: "1. Banks offer transaction accounts. 2. Banks are the backup source of liquidity for all other institutions. 3. Banks are the transmission belt for monetary policy."[105] Transaction accounts have already been discussed in terms of depositors' loss of immediacy; the Kansas court's description suggests how bank runs would squeeze businesses that had transaction accounts, forcing them to repay loans "whatever their readiness or ability to do so." To fortify their own balance sheets, banks would cease providing backup liquidity for (that is, stop lending to) other institutions. Finally, banks' reluctance to extend credit would contract the money supply, as effects of the run spread "from locality to locality."

The threat of depositors' loss of immediate access to funds, and the fear of contagious bank runs, led early on to a special bank insolvency regime. Three sorts of insolvency rules were de-

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104. Schaake v. Dolley, 118 P. 80, 83 (Kan. 1911).

105. E. Gerald Corrigan, *Are Banks Special?*, *in* FEDERAL RESERVE BANK OF MINNEAPOLIS, ANNUAL REPORT 1982, at 5, 7.

veloped which reduced the likelihood of bank failures by lowering the incentive of depositors to begin runs.[106]

First, depositors could take comfort in substantial extra capital and liquidity that was likely available to a bank in distress or insolvency. National banks and many state banks operated under the double liability rule.[107] Substantial assistance was also often available from a bank's clearinghouse,[108] or, after 1913, from the Federal Reserve. The likelihood of fresh funding, in turn, made it less likely that a creditor would feel insecure and be tempted to start or participate in a run.

A second way to protect immediacy and stem contagion was to assure that bank insolvencies were handled as quickly as possible. A short interruption in access to funds had lower costs to depositors and induced less panic than the likelihood of the long, often multi-year, receiverships common in non-bank settings. The use of statutory receivers helped to speed up liquidations by allowing administrative determinations of many claims without time-consuming recourse to the courts. Statutory receivers did not have their salaries and expenses paid out of the estate, so they did not have the usual incentives to stretch out the receivership in order to increase their remuneration. In addition, statutory receivers early made a practice of partial distributions to depositors so that bank creditors could expect to get much of their funds quickly.[109]

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106. A few economists have recognized the importance of insolvency rules to an optimal deposit contract in a deregulated banking system. *See* Tim S. Campbell & David Glenn, *Deposit Insurance in a Deregulated Environment*, 39 J. FIN. 775 (1984); Michael Becker, Bank Runs, Immediacy, and Bankruptcy Law: Deposit Contracts as a Problem in Hostage Taking 80 (1991) (unpublished Ph.D. dissertation, George Mason University, on file with author).

107. *See generally* Macey & Miller, *supra* note 26. Macey and Miller conclude that the double liability rule was accompanied by quite a low rate of national bank failure and high rate of recovery from shareholders for bank losses, even during the Depression from 1929 to 1933. *Id.* at 34, 61–62. It appears that the problem of contagious bank runs afflicted state banks more sharply. The precise amount of superadded liability varied by state. For instance, Colorado imposed triple liability. *Id.* at 37.

108. Clearinghouses were associations of local banks that organized to facilitate payment of checks or notes. Once established, the clearinghouses often monitored the members' books, disciplined imprudent behavior, and supplied liquidity in times of stress. *See* Gary Gorton, *Clearinghouses and the Origin of Central Banking in the United States*, 1985 J. ECON. HIST. 277; Richard H. Timberlake, Jr., *The Central Banking Role of Clearinghouse Associations*, 1984 J. MONEY, CREDIT & BANKING 1.

109. *See* Bates, *supra* note 24, at 426–30.

A third way to protect depositors' access and stem contagion was to give the government a monopoly on declaring a bank insolvent. In the era before deposit insurance, a run might have started on the mere rumor that a creditor was seeking to have a bank declared insolvent. A creditor therefore could have strategically threatened to seek such a declaration. The bank then would have faced the unpalatable choice of either giving uneconomic concessions to the creditor or facing a run. The existence of this credible threat by a bank creditor may explain passage of "bank libel" laws, which made it a crime to threaten to spread rumors about a bank or otherwise cause a bank run.[110] In states where the government did not have a monopoly on the closure decision, a great deal of litigation arose over whether banks were insolvent, creating another way for confidence to be shaken.[111]

The avalanche of bank failures during the Great Depression[112] led to widespread political support for drastic changes in the banking system. The FDIC was created in 1933, and the FSLIC in 1934, based on the political belief that federal deposit insurance was the best way to raise confidence in the banking system and restore liquidity to the economy.[113] The existence of deposit insurance created new reasons for favoring special rules in bank insolvency.

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110. For modern examples of bank libel laws, see ALA. CODE § 5-5A-46 (1981); KY. REV. STAT. ANN. § 434.310 (Baldwin 1990); N.D. CENT. CODE § 6-08-15 (1987); TEX. REV. CIV. STAT. ANN. art. 342-907 (West 1973). The Texas law was passed to reduce panic and help resolve a state banking crisis. *See* 1925 Tex. Gen. Laws 83.

111. When confidence was shaken throughout a region, the cash market for a bank's assets would be extremely weak, making it possible for a court to find insolvency based on a short-term inability to pay debts. *See* 9 ZOLLMANN, *supra* note 30, at 407 n.36 (criticizing definition of bank insolvency that depended on ability to pay all debts during time of financial stringency); *see also* Clark, *supra* note 2, at 67-77 (discussing implications of different meanings of insolvency).

112. *See supra* note 4.

113. Economists Milton Friedman and Anna Schwartz have provided historical evidence that the bank failures and the Depression were caused much more by the Federal Reserve's contractionary monetary policy than by the contagious impact of one bank failure causing others. *See* MILTON FRIEDMAN & ANNA J. SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES 1867-1960, at 299-419 (1963).

B. *Assessing Immediacy and Bank Runs as the Bases for a Special Insolvency Regime*

Although concerns about immediacy and bank runs explain the early special bank insolvency rules, it is not clear that they remain convincing rationales for special rules today. The pre-1933 special rules for bank insolvency evolved against a background of the general rule for corporate insolvencies, under which the relative substantive rights of creditors are rarely altered by the fact of insolvency.[114] Modern bankruptcy scholarship has emphasized how this general rule solves a collective action problem facing creditors. In times of business difficulty, creditors seek to assure their interest in the debtor's assets. Creditors having a preferred status in bankruptcy will seek to throw the debtor into bankruptcy. Creditors lacking the preferred status will seek to grab assets before bankruptcy is declared. As a result, the collective group of creditors will be less well off—creditors will expend resources trying to grab the debtor's assets, and the going concern value of the debtor may well be destroyed when it is placed in bankruptcy. Under the "creditors' bargain" model advanced by Thomas Jackson and Douglas Baird,[115] the creditors as a group should prefer a bankruptcy regime where the same substantive rules apply in and out of bankruptcy.[116] Having the same rules will reduce the incentive for any creditor to begin the grab for assets.

Such a race to grab assets is very familiar in the banking context—it is known as a "bank run."[117] Creditor runs are more

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114. Limited alterations exist, such as discharge of debts incurred prior to insolvency. *See* 11 U.S.C. § 547(c) (1988).

115. For a presentation of Jackson and Baird's approach to bankruptcy, see THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986); Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987).

116. Jackson emphasizes that the *relative* rights among creditors should be maintained in bankruptcy. The process of collectively resolving all creditors' claims in bankruptcy leads inevitably to certain modifications of particular rights, such as procedural rights of secured creditors to take their collateral. JACKSON, *supra* note 115, at 20–27.

117. The similarity of the problems in banking and bankruptcy has long been recognized:

> The purpose of a bank liquidation law, as in the case of insolvency and bankruptcy acts, is to safeguard the assets of the insolvent institution for the benefit of creditors and others in interest and to prevent the injustice and the burden of liquidation and the loss which would inevitably attend a scramble for the assets under the ordinary process of law.

9 ZOLLMANN, *supra* note 30, at 419.

likely to occur in banks than in other corporations due precisely to banks' reliance on transaction accounts, from which depositors have the right to withdraw their money immediately, at full par value. These depositors have shown a high demand for immediacy,[118] and will lose the benefit of their bargain if they cannot gain access to their funds. Furthermore, because banks keep only a fraction of deposits on hand, banks cannot pay depositors' demands if a large fraction of depositors demand payment at once. Banks thus face a more acute form of the collective action problem than is handled by the bankruptcy system. An individual depositor, like an individual corporate creditor, faces the risk that the debtor will not have enough assets. Depositors or creditors thus have an incentive to grab their own assets while it is possible to get full recovery, triggering a rush for assets that will result in insolvency, a smaller pool of assets available for creditors as a group, and reduced recoveries for those who did not grab quickly enough. The collective action problem is more acute for banks because most depositors have the right to demand immediate payment, whereas many corporate creditors can demand payment only over a longer period.

Special insolvency rules are one way to reduce the likelihood of such bank runs. A consistent theme of bank insolvency rules has been to provide assurances to depositors that additional funds will be available to the bank in times of stress. That assistance might come from double liability from shareholders, or support from the bank's clearinghouse, or a guarantee by a credible insurer such as the FDIC. In each instance, the credible promise of extra funding reassures depositors, confirms their immediate access to transaction accounts, and lessens their incentive to begin a destructive bank run.

A number of observations, however, may lead one to doubt that the collective action problem justifies today's special insolvency rules only for banks and not for other corporations. The problem of bank runs explains the need to assure depositors of addi-

118. For a description of the demand for immediacy, see Grossman & Miller, *supra* note 103. Depositors have exchanged the right to immediate withdrawal for lower interest rates. Historically, American banks almost always paid zero interest on transaction accounts. Only after the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 303, 94 Stat. 132, 146 (codified at 12 U.S.C. § 1832 (1988)), which lifted controls on interest paid, did banks gain the power to pay interest.

tional funding, but does not explain the many other special bank insolvency rules described in Part I. Over time, the distinctions between banks and other corporations have eroded significantly, with non-banks today often reliant on short-term financing similar to deposits.[119] In addition, recent scholarship has cast doubt on the traditional understanding of bank runs exemplified by the Kansas court's description.[120] The crucial empirical issue related to bank runs is how likely it is that a run on a particular bank will become a generalized run on many banks. If this likelihood is low, the macroeconomic effects of an individual bank run will be trivial, as depositors will simply transfer their funds to a solvent bank, which will continue to finance commercial activities. If, however, this likelihood is high, the macroeconomic effects of an individual bank run could be substantial—lower business activity and reduced money supply.

George Kaufman has recently presented evidence that the macroeconomic effects of bank runs have been exaggerated, and that nationwide bank contagion probably occurred only in 1893 and during the Great Depression.[121] If the risk of contagion is indeed low—a conclusion not shared by regulators and others[122]—then the historical reasons for special bank insolvency rules become much less important.

This Article does not attempt to answer the debate about the true risks of bank runs. The greater these risks, the greater the

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119. For instance, a growing share of life insurance company assets can now be quickly called in by investors, such as the accrued value of policies, loans available against policies, and guaranteed investment contracts. The effect of these changes was evident in the run in July 1991 on Mutual Benefit Life Insurance Companies. Eric N. Berg, *Rater to Add Policyholder Panic Factor*, N.Y. TIMES, Aug. 2, 1991, at D1.

Many other corporations have become dependent for financing on commercial paper, which are securities issued by the corporation, often for only 60 or 90 days. Such corporations are subject to the functional equivalent of runs whenever they are unable to roll over their commercial paper debt into new issues.

120. *See supra* text accompanying note 104.

121. George G. Kaufman, *Bank Runs: Causes, Benefits, and Costs*, 7 CATO J. 559, 566 (1988).

122. For instance, Comptroller of the Currency C. Todd Conover defended the government rescue of Continental Illinois in 1984, arguing that "had Continental failed and been treated in a way in which depositors and creditors were not made whole, we could very well have seen a national, if not an international, financial crisis the dimensions of which were difficult to imagine." *Inquiry into Continental Illinois Corp. and Continental Illinois National Bank: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 98th Cong., 2d Sess. 288 (1984) (statement of C. Todd Conover).

benefits of special insolvency rules, such as deposit insurance, which reduce the costs of bank runs. These benefits were likely substantial in the period after 1933, when creation of deposit insurance drastically reduced the number of bank failures by reducing the likelihood of runs.[123] Over time, however, these benefits of deposit insurance have carried with them an increasing cost—the cost to the taxpayers of paying for higher numbers of failures. One major source of these failures is "moral hazard," or the incentive for banks covered by insurance to act differently because of that insurance.[124] Institutions have taken advantage of freely available and underpriced deposit insurance, and have taken on excessive risk secure in the knowledge that they would profit from the upside and the insurance fund would pay for the downside. Deposit insurance thus has reduced costs of depositor runs, but has increased costs of excessive risk taken on by institutions.

C. *Implications of Deposit Insurance for Bank Insolvency Rules*

Resolving the tension between reducing runs and reducing deposit insurance payouts is beyond the scope of this Article. At present, deposit insurance remains in place. Trying to reduce the costs of payout from the insurance system has become a major reason for broad regulatory powers both before and after insolvency. The next question is *which* powers are explained or justified by the presence of deposit insurance.

1. *"Saving the Fund" as a Source of Special Rules.* Perhaps the simplest argument for special powers for the FDIC is the "save the fund" argument: The FDIC insurance fund pays the cost of failures covered by deposit insurance;[125] rather than having taxpayers suffer the losses, those connected to the bank failures ought to pay.[126] Under this argument, the rules should favor protection

123. From 1925 to 1932, the number of national and state banks which suspended operations averaged 1,021 per year, and never fell below 479 in any year. From 1934 to 1939, the average number of banks which suspended operations averaged 49 per year, and never exceeded 59 in any year. FDIC ANNUAL REPORT 206 (1939).

124. *See* Fischel et al., *supra* note 3, at 314–16.

125. More precisely, there are now two funds managed by the FDIC, kept separate for accounting purposes: The Savings Association Insurance Fund (SAIF) insures thrift deposits, for essentially those institutions that were covered before FIRREA by the FSLIC; the Bank Insurance Fund (BIF) insures deposits in commercial banks and many savings banks.

126. An initial objection to the "save the fund" argument has often been voiced by

of the deposit insurance fund, and perhaps on close legal issues some benefit of the doubt should be given to the FDIC. I conclude that although it deserves some weight, the argument by itself does not justify anything like the long list of current superpowers.

a. Reasons supporting the "save the fund" argument. The structure of deposit insurance, equitable considerations, and special difficulties facing government collection efforts all may support the "save the fund" argument.

The structure of deposit insurance puts greater burdens on government than on a similar private insurer, and thus may justify certain benefits for government in being reimbursed. Because termination of deposit insurance is considered the equivalent of a death penalty for banks, that penalty is rarely used.[127] The FDIC insurance fund has thus become a sort of "assigned risk" pool, with the government required as sole insurer to take on all the bad risks.

Not only has the FDIC had to insure the bad risks with the good, but it has been saddled by statute with a product that no private insurer would tolerate. The deposit insurance program is in the form of a limitless guarantee—insolvent institutions place their full negative net worth into the insurer's hands. By contrast, liabili-

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the banking industry: Deposit insurance is funded, not by taxpayer dollars, but by assessments on deposits. Therefore, goes the argument, whatever the benefits or burdens accompanying a government-financed scheme, they should not apply to the deposit insurance fund. Furthermore, some might add, the FDIC is a government corporation, and is not considered an agency for many purposes. The argument would conclude that special rules that are justified by the use of taxpayer dollars thus should not apply in bank insolvency.

The distinction between funding by taxpayers or by deposit assessments does not stand up to scrutiny. First, the economic literature suggests that deposit insurance may have been underpriced for most or all of its history from an actuarial standpoint (although any such underpricing has eroded or disappeared due to recent assessment hikes). There thus may well have been an ongoing taxpayer subsidy of the program. Second, the distinction ignores the teaching of modern options theory. Even if deposit assessments had been priced in an actuarially sound way, insured depositors have benefitted from a put option from the Treasury—the option has required the Treasury to pay an unlimited amount in case the fund became insolvent. This option has bolstered confidence in banks enormously, and thus has been very valuable to the industry. Third, taxpayers are explicitly paying now for the thrift deposit fund, and FDICIA creates funding mechanisms that make it quite possible that taxpayer dollars will be used for the bank insurance fund. *See* Michael J. DeVito, *Time to Acknowledge Truth About Bank Fund*, AM. BANKER, Jan. 31, 1992, at 4, 4.

127. *See* FDIC ANNUAL REPORT 29 (1990) (average of 3 terminations per year between 1988 and 1990).

ty in private insurance contracts is carefully capped. The rules governing rights of private creditors thus may not be appropriate for determining the rights of the government when it seeks reimbursement for its extraordinary guarantee.

The unlimited federal guarantee creates moral hazard in a more acute form than would be created in a private insurance market. Banks can take on a limitless amount of insured deposits. Moreover, as discussed below in Part III, private-sector monitoring is less effective for banks than for other corporations, in part due to the presence of government monitoring. Finally, the usual private-sector protections of the insurer, such as deductibles or co-payments by the insured, do not apply in FDIC insurance. The FDIC is now beginning to set premiums based on the riskiness of the bank,[128] which may be a helpful first step toward mimicking private-sector mechanisms that limit moral hazard. But as long as government effectively lacks the private sector's ability to terminate a bad risk's insurance, the FDIC will be worse off than a private insurer. Banks will continue to take on risk to the extent that they can escape detection by heavily burdened regulators.

The unlimited guarantee, combined with acute moral hazard, suggests that the deposit insurance fund is more vulnerable to large losses than analogous private insurers. Yet the disadvantages of the current system, such as the limitless nature of the guarantee and the absence of deductibles and co-payments, are precisely the features that best assure depositor confidence in the banking system. The government thus can make a sort of "sweet with the bitter" argument for special protections when the insurance fund pays out on failed banks.

Another reason the government may deserve special rules in insolvency is that equity may favor it over the third parties with whom it is competing for assets. Imagine, for instance, that the other creditors are mostly insiders who have received fraudulent transfers from the bank before insolvency. Such a situation might justify special rules for fraudulent conveyance in bank insolvency, favoring the insurance fund. More generally, as discussed in Part III, special rules may be appropriate to the extent there is evi-

128. *See* Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 302, 105 Stat. 2236, 2345-49 (to be codified at 12 U.S.C. § 1817(b)) (effective the earlier of 180 days after promulgation of final rules, or January 1, 1994).

dence that the government is equitably in a stronger position than insiders who may have acted abusively.

There may also be characteristic difficulties that face government more than private creditors. Special rules in insolvency may balance out these government disadvantages. One disadvantage is that government agencies may, on average, be less successful at collecting assets than private creditors. Private creditors often have direct financial stakes in realizing on amounts due, while government employees may have a different set of incentives less clearly tied to recovering money.[129] There is also less reason to think that government invests efficiently in collecting amounts due. Whereas a private creditor should invest in collection until the marginal cost from collection efforts equals the marginal return, the level of government collection efforts may be driven by other considerations, such as budgetary rules that limit the number of employees, contracting rules that make it costly for the agencies to adjust the level of collection effort, and political concern that the government appear aggressive in collection efforts.

An additional disadvantage is that the government will often be the last of the creditors to be preferred when the debtor has discretion about making partial payments. A debtor facing bankruptcy, including a bank manager, has an incentive to favor creditors who can be of benefit post-insolvency. There is no similar incentive to favor the government, which is unlikely to show favoritism post-insolvency.[130] This government disadvantage may justify special rules to compensate for situations where other creditors are favored pre-insolvency. More important, this disadvantage is a

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129. Senior agency officials may be oriented, for instance, to avoiding criticism from Congress, which has conducted numerous oversight hearings concerning agency closures of banks and thrifts. *See, e.g., Closure of 45 Privately-Insured Financial Institutions in Rhode Island: Hearing Before the Subcomm. on General Oversight and Investigations of the House Comm. on Banking, Finance and Urban Affairs*, 102d Cong., 1st Sess. 42 (1992) (testimony of Paul G. Fritts, Exec. Dir. for Supervision and Resolutions, FDIC, complaining that the federal regulators are overworked). Although maximizing recovery to the insurance fund is now an important goal of these agency officials, as discussed in Part IV, the avoidance of scandal and other political considerations do limit their focus on recovering assets.

130. An excellent example is given in Theodore Dreiser's novel *The Financier*, in which the business magnate Cowperwood defrauds the city government just before insolvency in order to pay his main backer, the Girard National Bank. Not only does the President of Girard testify favorably at Cowperwood's trial, but Girard later finances Cowperwood in his return to millionaire status. THEODORE DREISER, THE FINANCIER (Harper 1940) (1912).

good description of how deposit insurance works generally—banks and their managers may choose to benefit anyone else before worrying about incremental losses to the deposit insurance fund. The fund may thus deserve special protection in bank insolvencies.

b. Reasons for rejecting the "save the fund" argument. One strong reason for restricting the "save the fund" argument is that it is too open-ended. If the actual goal is to maximize recovery by the FDIC on bank assets, then quite extraordinary measures might be considered. For instance, the FDIC might be able to defeat all claims against the bank except those of insured depositors, with the fund recovering all remaining money. Or, all defenses against collection by the FDIC might be disallowed. (The *D'Oench* powers move far in that direction.) Bank managers or employees might be made to disgorge some or all of their compensation in the year before insolvency, and so on. But it cannot be the case that the mere fact that the government pays means it can do whatever it wants. Additional considerations must be brought to bear on the decision of how far the "save the fund" argument should go.

A second limit on the argument is that it makes little sense when analyzed as tax policy. The costs of the deposit insurance system are spread over a wide base, with the assessments directly made on deposits, and backup funding coming from taxpayers. All depositors and taxpayers receive the macroeconomic benefits of a smoothly functioning banking system. By contrast, special rules that favor the government come at the expense of an unknown group of private parties. The rules thus operate as a sort of random tax on parties unlucky enough to be caught by the special rule.[131] Absent some showing that the losing parties deserve to be singled out for such taxation, the better tax policy would seem to be to spread the cost over the full range of beneficiaries of the deposit insurance system.[132]

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131. Similar concerns about random, substantial taxes on individuals underlie the just compensation provision of the Fifth Amendment, which limits the "government's power to isolate particular individuals for sacrifice to the general good." LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW § 9–6, at 605 (2d ed. 1988).

132. The problem of random taxation is particularly acute during a transition period where parties do not make their bargains with the special rules already in place. *See* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 650 (3d ed. 1988) (criticizing federal "holder in due course" rule as applying a tax to "a random and

The equitable position of the government is not nearly as strong as suggested above. Government agencies have pervasive control over banks, and their intervention in bank management often intensifies as the bank nears insolvency.[133] The general rule is that a creditor having dominion and control over the debtor is in a *weaker* position than other creditors.[134] The government, because it is in a position to control the bank, equitably should come behind other creditors who do not have the benefits of similar control. The equitable position of the government has thus weakened as bank regulators have gained sweeping new powers in recent years.

A related challenge to the government's equitable position comes from the "creditors' bargain" model. As discussed above, Jackson and Baird are critical of special distributional rules in bankruptcy because of the possibility that a creditor might force bankruptcy to take advantage of such rules.[135] Because of its monopoly on bank closure, only the government would similarly be in a position to take advantage of rules in bank insolvency. To the extent that special rules give the government an incentive to alter its decision on whether to close a bank, other creditors are disadvantaged, and thus in an equitably superior position to the government. This risk of the government advantaging itself has become greater under the new early closure rules. The government will now close banks sooner to ensure higher recovery on insured deposits—to the detriment of shareholders and others who lose

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indiscriminately-selected group of debtors, instead of putting the burden on the taxpayers as a whole who presumably are those who principally profit from deposit insurance"). The tax problem may, however, cure itself to some degree over time. The parties most affected by FDIC superpowers are generally not consumers, but instead are sophisticated business actors who can be fairly charged with taking existing superpowers into account in future contracts. Some of the costs of the "random taxation" would thus be passed along eventually to banks and their customers.

133. For instance, especially after the early closure rules enacted in 1991, regulators of weak banks may require submission of capital and business plans, put limits on growth of assets, help select new management, approve or disapprove of proposed new activities, and decide whether the bank can be sold to particular buyers. As discussed above, regulators also have the sole power to decide when a bank is insolvent and must be closed. *See supra* note 37.

134. The legal concern with a creditor's control continues to flourish. Lender liability claims have proliferated in recent years on the theory that the bank as lender/creditor was exercising dominion and control over the borrower. *See, e.g.*, United States v. Fleet Factors Corp., 901 F.2d 1550 (11th Cir. 1990), *cert. denied*, 111 S. Ct. 752 (1991).

135. *See supra* notes 115–16 and accompanying text.

value when a still-solvent bank is declared insolvent. Part V explains how this loss to shareholders and others may, in the long run, actually result in more failures and greater eventual costs to the government.

c. Assessing the "save the fund" argument. On close inspection, it is far from clear that there should be a general presumption in favor of the government and against other parties affected by a bank's insolvency. Although the government has special difficulties in collecting on receivership assets, limits must be set on the powers that the government can claim in order to save the fund. Although the government has plausible equitable claims, so do many third parties. Part III examines further how to analyze these equitable claims, which are linked to the suspicion that bank failures are caused by insider abuse. Part IV discusses a sharper reason for being suspicious of the "save the fund" argument. Both the FDIC and Congress have strong political incentives to err on the side of saving the fund, and placing costs on third parties. These political incentives, rather than sound public policy, may be the strongest explanation for many of the recent special insolvency rules favoring the fund.

2. *FDIC Expertise as a Source of Special Rules.* The presence of deposit insurance may justify special insolvency powers for the FDIC, in addition to whatever powers it deserves in order to save the insurance fund.[136] The FDIC is systematically different from the ordinary creditor in a bankruptcy case. In every bank insolvency the agency becomes the dominant creditor when it takes over the claims of insured depositors, typically having over ninety percent of total claims against the receivership.[137] In order to save the fund, therefore, the agency has good incentive to get substantial recovery on the bank's assets. The agency also is in the unusual position of being a pervasive, repeat player—*every* modern bank insolvency has the FDIC as receiver.

Three sorts of reasons support special FDIC insolvency powers in light of its unique role as dominant creditor in each of the many bank insolvencies. First, and most generally, the FDIC can

136. The argument in this section applies equally to the RTC, but only the FDIC is mentioned for expositional convenience.

137. *See* ZISMAN, *supra* note 3, § 19.02[4].

make a plausible claim to expertise. With high volume comes a variety of economies of scale—procedures are instituted, manuals are developed, and specialized skills are developed. In short, the FDIC can claim the advantages of a bureaucracy devoted to a repetitive task. Second, the FDIC can seek consistency among cases. Its central role in repeated insolvencies means that it can aspire to the goal of distributive justice, of treating like cases alike while making justified distinctions. Third, the FDIC can seek a logical development of the law consistent with public policy. Because the agency is involved in so many cases, it can choose appropriate instances to test principles and develop precedent. The FDIC's cases are heard in federal courts, where there is opportunity to develop law oriented toward a broad range of legal concerns; by contrast, bankruptcy courts are likely more oriented toward the adjustment of the rights of a particular set of debtor and creditors.

These possible advantages may justify the FDIC's unusual combination of the powers of a bankruptcy judge, creditor, and trustee. The advantages of bureaucracy and expertise may justify the FDIC's power to adjudicate claims against the receivership.[138] As creditor, the FDIC insurance fund appropriately receives high priority on recovery of the bank's assets. And as receiver, the FDIC may deserve its range of powers, such as the ability to repudiate contracts and to seek collection in federal court.

Although the FDIC's justifications are forceful, there is reason to be cautious about approving the full range of current powers. The central concern is how well the FDIC will employ its enormous discretion. The range of its discretion is easily illustrated: what means to use in resolving a failed bank;[139] whether to issue a policy statement that certain categories of contracts will not be repudiated;[140] whether to grant an exception to the cross-guarantees power; what sorts of *D'Oench* powers to apply; and, more

138. Agency adjudication of claims is subject to a variety of procedural checks, including the availability of judicial review and the requirement of speedy determination as set forth by the Supreme Court in Coit Independence Joint Venture v. FSLIC, 489 U.S. 561 (1989). For a discussion of the relevant procedural and constitutional issues, see Baxter, *supra* note 3.

139. For instance, a purchase and assumption agreement will transfer uninsured deposits to the acquiring institution, while a liquidation will leave those deposits to recover against the receivership.

140. *E.g.*, Statement of Policy on Foreclosure Consent and Redemption Rights, 57 Fed. Reg. 29,491 (1992).

generally, when to seek penalties against individuals and institutions for alleged violations of banking law.

The unique role of the FDIC as dominant creditor and repeat player offers a possible explanation and justification for broad discretionary powers for the agency in bank insolvencies. Judging these powers, however, requires a difficult empirical estimate. If the FDIC generally uses its discretion well, then bank insolvency will be marked by expert administration, distributive justice, and orderly development of desirable law. If that discretion is abused, however, then bank insolvency can descend into arbitrary administration, favoritism or vindictiveness, and a cynical and selective prosecution of cases in violation of public policy. Agency discretion also creates uncertainty for third parties, which, as discussed further in Part V, can have a chilling effect on those doing business with banks. As our experience with modern bank insolvency grows, Congress, the courts, and the agencies should look for appropriate opportunities to confine FDIC discretion, such as through more rulemakings and agency statements of policy.

D. *Summary*

The existence of special bank insolvency rules was founded on the perceived problem of bank runs and depositors' need to have immediate access to transaction accounts. Whether or not the costs of bank runs are as great as commonly believed, the current deposit insurance system was created as a means of stopping runs. It has largely succeeded in that goal, but has subjected taxpayers in recent years to the enormous costs of the bailout, due in part to the extra risks taken by institutions covered by insurance. If something like the current system is maintained, then its very existence creates arguments for special bank insolvency rules based on "saving the fund" and agency expertise. Although these arguments have some force, they are overbroad, and do not explain just when the fund should be saved or the agency given discretion. Moreover, the arguments for special bank insolvency rules are subject to strong counter-arguments, considered further below.

III. THE PREVALENCE OF INSIDER ABUSE AND SPECIAL BANK INSOLVENCY RULES

Many of the special bank insolvency rules can be explained, and perhaps justified, by the peculiar likelihood that a bank failure

is caused by the misdeeds of insiders. Imagine at the extreme that every bank failure is caused by "insider abuse." "Insider abuse," as the term is used here, refers to two distinct sorts of behavior by insiders, who are management and any shareholders who play an intimate role in directing the corporation. The first sort is fraud or self-dealing—insiders taking advantage of their position to benefit themselves in unpermitted ways. In corporate law terms, this behavior is likely to violate the duty of loyalty to the corporation.[141] The second sort of behavior is severe mismanagement, which means behavior reckless or stupid enough to be second-guessed by courts, even under the generous deference of the business judgment rule.[142]

By contrast, imagine that every failure of a non-bank is the result of stiff competition in a competitive market. In these failures, there is no severe mismanagement or violation of the duty of loyalty. Instead, management's decision was reasonable *ex ante*. At the time of the decision, there was a probability distribution of results, and the expected value of this distribution exceeded the expected value of the alternatives that were open to management. Sadly enough, the corporation experienced the negative tail of the distribution, and therefore failed. More generally, failure might result from any management decision that was good enough to survive scrutiny under the business judgment rule.

This Part argues, as a descriptive matter, that current insolvency law has been strongly influenced by the "model of insider abuse" for banks and thrifts (and sometimes other financial institutions) and by the "model of stiff competition" for other corporations. In particular, many of the strict rules enacted in 1989, 1990, and 1991 conform to the "model of insider abuse."

Although this model helps explain the recent passage of strict rules, it has become dated. The available evidence suggests that banks and thrifts today face much stiffer competition than in years past, so that current failures are more likely to be due to competition rather than abuse. Nonetheless, from a theoretical perspective, there continue to be factors which make insider abuse more likely

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141. *See* Danny Clearman, *FDIC and FSLIC Pursuit of Claims Against Officers, Directors and Others Involved with Failed Lenders*, 58 MISS. L.J. 89, 105 (1988).

142. *See* International Ins. Co. v. Johns, 874 F.2d 1447 (11th Cir. 1989).

An example of severe mismanagement comes from the movie *It's A Wonderful Life*, where Uncle Billy places the thrift in jeopardy by literally mislaying thousands of dollars in the hands of the evil town banker.

in banks than in industrial corporations, including the relative ease of doing fraudulent transactions and the relative weakness of monitoring of banks by the private sector. To the extent that it is demonstrated that certain forms of insider abuse are especially likely in the banking context, some special rules for bank insolvency may be justified. But the volume of recent legislation raises the strong possibility that more rules have been passed than can be so justified.

A. *The Historical Basis for the "Model of Insider Abuse"*

The history of banks and thrifts since the adoption of deposit insurance suggests that the "model of insider abuse" described bank and thrift failures fairly well from the creation of deposit insurance in 1933 until about 1980. Numerous rules limited competition and the risk of insolvency.[143] Glass-Steagall[144] and other restrictions forced institutions to specialize by product—banks, thrifts, securities firms, and insurance companies were kept off of each other's turf. Banks faced pervasive limits on geographic expansion. For instance, branching within a state, or even within a county, was often prohibited.[145] Entry to banking was carefully controlled by regulators who denied many charter applications. Finally, rate regulation strictly controlled the interest banks and thrifts could offer on savings accounts, and forbade altogether interest on checking accounts.[146] Local banks thus enjoyed substantial monopoly power, free from the worry of price competition or new entry.

With the protection afforded by these rules, it often took fraud or severe mismanagement for a bank to fail—and thus the "model of insider abuse" appears to have been a good fit until about 1980. In 1976, when much of the monopoly system of regulation was still in place, Robert Clark reported on the relative frequency of insider abuse in banks and non-banks.[147] The FDIC

143. For a fuller historical account, see Peter P. Swire, *Good Old Days Disappear in Banking Regulation*, 16 VA. L. SCH. REP., Summer 1991, at 21, 21–22.

144. Glass-Steagall Act, ch. 58, 47 Stat. 56 (1932) (codified as amended at 12 U.S.C. §§ 347a–347b, 412 (1988)).

145. Swire, *supra* note 143, at 21.

146. "As long as thrifts competed primarily with banks for deposits, this arrangement provided monopoly-like pricing and profitability for both thrifts and banks in garnering deposits . . . ." BRUMBAUGH, *supra* note 8, at 39.

147. Clark, *supra* note 2, at 12. Clark's conclusions were consistent with those of oth-

reported to Clark that for the 80 insured bank failures between 1960 and 1975, the basic causes of failure were insider loans in 42 cases (52.5%) and insider misappropriation in 24 cases (30%).[148] The remaining failures were attributed to managerial weaknesses. None of the failures were attributed primarily to business downturns or other market-based causes.[149] By contrast, Clark reported that "only a negligible proportion of the business failures of ordinary industrial corporations is due to fraudulent and self-dealing conduct."[150]

The hundreds of thrift failures of the 1980s have been portrayed popularly, and in Congress, as due to a new wave of insider abuse. On this account, when the thrift industry blamed overregulation for the losses of the late 1970s and early 1980s, Congress responded by granting thrifts broad new powers and raising the insured amount from $40,000 to $100,000 per account.[151] Expanded powers, combined with a simultaneous sharp reduction in thrift supervision, opened opportunities for abuse. The moral hazard created by deposit insurance, and newly fed by brokered deposits, meant that thrift operators could bet enormous sums on a "heads I win, tails the government pays" strategy. Adverse selection also occurred, as sharp operators entered the business to take advantage of the chance to gamble large amounts of other people's money. For example, Charles Keating was allowed to buy a thrift even though he had a cease-and-desist order outstanding from the SEC for previous bank-related abuses.[152]

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er contemporary observers. Economist Joseph Sinkey reported: "The major causes of bank failures have been dishonest and/or inept bank managers." Joseph F. Sinkey, *Identifying Large Problem/Failed Banks: The Case of Franklin National Bank of New York*, 12 J. FIN. & QUANTITATIVE ANALYSIS 779, 782 (1977).

148. Clark, *supra* note 2, at 12 n.46. "Insider misappropriation" included defalcation, embezzlement, or manipulation. *Id.*

149. *Id.* For other financial institutions, Clark also reported relatively high rates of insider abuse, finding that dishonest employees accounted for 77% of life insurance insolvencies between 1963 and 1972, and 40% of property-liability insolvencies (where underwriting risks were quite great). *Id.*

150. *Id.* at 13. Clark estimated for one period that 0.9% of industrial failures were due to fraud. *Id.* at 13 n.48. Clark did not report on the number of industrial business failures that were due to mismanagement severe enough to be condemned under the business judgment rule.

151. *See* BRUMBAUGH, *supra* note 8, at 36–49.

152. Benjamin J. Stein, *What Investors Never Knew: Ugly Facts About Charles Keating Were Not Disclosed*, BARRON'S, Apr. 16, 1990, at 6, 7.

The flamboyant scandals surrounding thrift owners such as Keating and David Paul[153] gave Congress a plausible basis for acting on the perception that thrift failures were due to insider abuse. FIRREA, the Crime Control Act of 1990, and FDICIA had numerous strict provisions that can be understood as attempts to attack "S&L kingpins."[154] These laws, such as innovative ways to prevent institution-affiliated parties from transferring funds away from regulators, make a good deal of sense if bank and thrift failures indeed systematically arise from insider abuse.

Ironically, however, the strict laws of recent vintage have been passed just as the "model of stiff competition" has become a much stronger general explanation for bank and thrift failures. In the 1980s, the old monopoly system broke down. Insurance companies, securities firms, thrifts, banks, and "non-bank banks" invaded each other's turf. Branching rules were relaxed. New entry increased as regulators became more likely to approve charter and merger applications.[155] And rate regulation was abandoned in response to high interest rates and the development of money market mutual funds as an attractive alternative to bank and thrift deposits. In short, banks and thrifts since the early 1980s have faced sharply increased competition, as well as the strain of high and volatile interest rates and deep regional recessions.

As monopoly profits eroded, banks and thrifts lost their previously enormous margin for error. In their newly competitive markets, a few bad management decisions can be enough to result in failure. These more challenging external conditions have, like a low tide, left more and more institutions stranded in agency hands. The recent history suggests that many, and perhaps most, bank and thrift failures have been attributable to stiff competition.[156] In

153. *See* Mark Sell, *Cooking the Books? Thrift Regulators Under Fire for Masking Losses*, LEGAL TIMES, Nov. 26, 1990, at 2 (describing Paul scandal).

154. For instance, the Crime Control Act of 1990 includes mandatory minimum sentences for certain crimes and a possible term of life in prison for "S&L kingpins." Crime Control Act of 1990, 18 U.S.C. § 225 (Supp. III 1991); *see* John R. Cranford, *Scandal Gives Parties a Chance to Fire Away at Each Other*, 48 CONG. Q. 2204, 2205 (1990) (discussing debate on the provision).

155. *See* MACEY & MILLER, *supra* note 6, at 95–96 (describing Comptroller's increased willingness to grant charters). At the same time, antitrust standards were loosening for banks as well as for other industries, making it less likely that a merger would be considered noncompetitive. Entry by aggressive, out-of-town companies by merger could increase competition in local markets.

156. A large study of thrifts in the southeastern United States found little evidence

the future, the strict new criminal and civil enforcement rules should further deter insider abuse, while making failure for business reasons relatively more likely.[157] It has become anachronistic to assume that failures are due to insider abuse.

B. *The Continuing Tendency of Insider Abuse in Bank Failures*

Although bank failures are today less likely to be due to insider abuse, such abuse is still more likely to occur in banks than industrial corporations. A maxim has it that the best way to rob a bank is to own one. Fraud is easy to conduct; information for controlling fraud is difficult to come by; and usual means of monitoring are weaker than for industrial companies.

1. *Fraud and the Nature of Banking Transactions.* Banking involves transactions that are (1) numerous, (2) in highly liquid form, (3) easily forgeable, and (4) involve large amounts of money which (5) often cross jurisdictional boundaries. Each of these factors make it easier for insiders to steal. First, a large volume of transactions, such as the mortgages and commercial loans that flood through a bank office, is harder to monitor than a small number. It is easier to get away with an occasional fraudulent deal set amidst a large number of legitimate ones. A large number of transactions can also make detection difficult, such as when assets are shuttled through numerous dummy corporations in a series of complex transactions. Second, liquidity is of great help to a thief—it is far easier to fence stolen dollars than a stolen machine press.[158] Third, financial transactions, such as loans, are easily

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that most insolvencies were linked with risky behavior or insider abuse. The insider abuse seemed to have occurred in a small number of cases, which were the most expensive to resolve. George J. Benston et al., *The Failure and Survival of Thrifts: Evidence from the Southeast, in* FINANCIAL MARKETS AND FINANCIAL CRISES 305, 379 (R. Glenn Hubbard ed., 1991).

157. *See infra* text accompanying notes 289–300 (describing reasons why strict rules can cause additional failures for non-abuse reasons).

158. Milton Friedman similarly has observed that fraud is "peculiarly difficult to prevent" in banking transactions:

> The very performance of its central function requires money to be generally acceptable and to pass from hand to hand. As a result, individuals may be led to enter into contracts with persons far removed in space and acquaintance, and a long period may elapse between the issue of a promise and the demand for its fulfillment. In fraud as in other activities, opportunities for profit are not likely to go unexploited.

forged or otherwise included in fraudulent schemes—it is easier to find a taker for fake loan documents than for fake machine presses. Fourth, significant fraud is better done in large transactions. An illicit $10,000 is more easily hidden in a huge real estate loan than in a used car loan. Fifth, crossing between jurisdictions often means that no one can adequately perceive the true recipient of the funds.[159]

These five factors can have a synergistic effect. The 1991 failure of the Bank of Credit and Commerce International (BCCI) is a type case of a huge insider fraud that escaped detection for years.[160] The "bank within a bank" manufactured a great number of transactions, involving liquid assets, that were both readily forgeable and for large sums of money, and shuttled among separate corporations in as many countries as possible. BCCI is an extreme case, but it remains plausible that insider fraud on a large scale is much more likely to occur in banks and similar financial intermediaries than in industrial corporations.

Although there has been little attention in the theoretical literature to explaining the special propensity for insider abuse in financial institutions, the legal system has long recognized the problem. In a variety of contexts, courts have placed a heightened duty on the officers and directors of financial institutions,[161] and have based this duty on the increased likelihood of fraud. The likelihood of insider abuse helps to explain the specialized regulatory regimes that have developed for all major categories of financial institutions, including pensions, investment companies, insurance companies, and securities firms.[162]

MILTON H. FRIEDMAN, A PROGRAM FOR MONETARY STABILITY 6–7 (1959), *quoted in* CHARLES A.E. GOODHART, THE EVOLUTION OF CENTRAL BANKS 61 (1988).

159. An additional source of fraud is the information asymmetry between bank insiders and often-unknowledgeable consumers of banking services. This asymmetry is discussed below in the discussion of the difficulty of monitoring bank solvency. *See infra* text accompanying notes 163–69.

160. *Bank of Credit and Commerce International (BCCI) Investigation: Hearings Before the House Comm. on Banking, Finance and Urban Affairs*, 102d Cong., 1st Sess., pt. 2, at 69 (1991) (testimony of Virgil J. Mattingly, General Counsel for Board of Governors of the Federal Reserve System).

161. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 211 (proposed final draft 1992); *see* Jameson v. FDIC, 931 F.2d 290 (5th Cir. 1991) (extending FDIC power to sanction director or other institution-affiliated party for six years after termination of the affiliation); *see also infra* note 185.

162. For securities brokers, the typical risk of insider abuse seems to explain the spe-

2. *Information Inadequacy and the Likelihood of Insider Abuse.* Problems of information inadequacy, which trouble stakeholders in corporations generally, are especially acute in banking. Following Charles Goodhart's analysis, the crucial problem is how difficult and costly it is for consumers or monitors of financial services to distinguish between banks with more, and banks with less, risky strategies.[163] The usual market signals are inherently ambiguous. A high rate of return may be offered by a bank because of greater efficiency. But it may also be offered because the bank is taking greater risks or practicing insider abuse. This ambiguity is made worse by the fact that a bank's rate of profitability is not a good predictor of future likelihood of failure—high-risk strategies often produce high returns in an early period before leading to spectacular failure later.[164]

The nature of commercial lending also makes it unusually hard to assess the likelihood of insider abuse and future solvency. The securities markets in recent decades have taken over a large fraction of the short-term financing traditionally funded by com-

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cial insolvency rules of that industry. The special risk is that the broker will convert the client's assets to the broker's or firm's account. Such conversion is likely to be fairly easy, because a broker often has possession or control of the securities. The conversion will also be very tempting in times of financial stress.

If the conversion occurs, the client involuntarily becomes a creditor of the firm, and thus subject to loss if the firm becomes insolvent. It may well be unfair or inefficient to expect the client to monitor for the risk of conversion. In such a case, a special insolvency regime may be appropriate to protect clients against the risk of conversion. This is precisely the regime provided by the Securities Investors Protection Corporation. 15 U.S.C. §§ 78aaa–*78lll* (1988). With the risk of insider abuse serving as the policy basis, small premiums are assessed on securities brokers to create a fund to pay clients the full value of their assets in the event of conversion.

163. GOODHART, *supra* note 158, at 59–61. Goodhart also explains the limited effectiveness of relying on bank reputation. *Id.* at 60.

164. *See id.* at 64 (citing D.A.J. Marais, *A Method of Quantifying Companies' Relative Financial Strength*, BANK OF ENGLAND DISCUSSION PAPER NO. 4 (1979)). The pattern of high early profits followed by enormous losses was characteristic of many of the worst thrift failures. As one thrift official testified in 1989,

> [S]ome very intelligent people, including the current chairman of the Federal Reserve, [Alan Greenspan,] were, quite frankly, fooled by direct investments. It has now been painfully noted, to Mr. Greenspan's chagrin, that of the 17 associations he represented back in 1984, [which were then quite profitable,] 16 of them have failed, and most of them rather spectacularly.

Lincoln Savings & Loan Association: Hearing Before the House Comm. on Banking, Finance and Urban Affairs, 101st Cong., 2d Sess. 11 (1990) (testimony of Kevin O'Connell, Deputy Director for Special Cases, Office of Thrift Supervision).

mercial banks.[165] The remaining commercial loans are predominantly to "middle-market" or small companies, or for other projects that are not readily financed by securities.[166] Middle-market loans are often complex, nonstandard contracts, embedded in a broader business relationship and difficult to price accurately. A variety of technical difficulties have thus far frustrated all attempts by regulators to compel banks to mark their loan portfolios to market.[167] Without mark-to-market, the value of a bank's loan portfolio is difficult for outsiders to evaluate, creating uncertainty about the ability of the bank to remain solvent in the face of market risks. More complete disclosure by banks of their loan portfolio would also compromise the confidentiality of information provided to the bank, one of the traditional advantages of borrowing from a bank.[168] Robert Clark has noted an additional source of information inadequacy: the relatively great ability of banks and similar financial institutions to shift their corporate strategy without notice to shareholders or bondholders.[169]

3. *The Relative Weakness of Bank Monitoring.* The increased likelihood of fraud and problems arising from information inadequacy would exist even in a deregulated banking system. These possibilities of insider abuse are compounded by the weakness in the usual types of monitoring compared with public, indus-

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165. Short-term commercial paper, from a negligible base in the 1960s, grew by January 1992 to a total of $533 billion outstanding, which was 87% of total commercial and industrial loans of $608 billion. Fed. Res. Bull. A17, A23 (May 1992).

166. Of $600 billion outstanding commercial loans in the United States, approximately $450 billion (75%) are middle-market loans with no market pricing. Christopher L. Snyder, Jr., *Let's Not Compel Commercial Lenders to Mark to Market*, AM. BANKER, Aug. 14, 1991, at 6.

167. *See id.* (mark-to-market would require complex new rules for yield calculation, credit ratings, loan pricing, and loan documentation).

168. Loss of confidentiality could produce a deadweight loss compared to the current regime. Certain borrowers can only make best use of funds if confidential business information is not disclosed to the public and its competitors. If changed reporting requirements lead to disclosure of this confidential information, these borrowers will lose the opportunity to finance themselves through the currently most efficient means, bank borrowing.

169. Clark, *supra* note 2, at 14. The ability of banks to shift strategies is due to the greater liquidity of bank assets when compared to the assets of typical industrial corporations. Banks, for instance, invested heavily in highly leveraged transactions in the late 1980s, without the need for prior notice to debt and equity holders.

trial corporations. Government monitoring is far more detailed with respect to banks, but still has characteristic weaknesses.

a. Depositor monitoring. The current deposit insurance system makes significant monitoring by depositors highly unlikely. Insured depositors have little reason to invest in monitoring the solvency of banks. After all, they are fully insured, and the FDIC has made a strict policy of making insured deposits available immediately in the event of bank failures.[170] Uninsured depositors have had little more reason to invest significant resources in monitoring. Most large bank failures have been handled through a purchase and assumption transaction, in which insured deposits are simply transferred to the acquiring bank.[171] In addition, the bulk of uninsured deposits are held in banks considered "too big to fail." Thus uninsured depositors are fairly confident that they will be protected by the FDIC's resolution of the failure; they are even more confident that they will be able to spot a potential large failure in time to move uninsured deposits to another bank.[172]

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170. An exception exists for insured depositors with favorable interest rates locked in by contract, such as above-market certificates of deposit. These contracts may be repudiated by the FDIC or RTC upon insolvency, with the interest rate reset to the lower market level. *See infra* Part V (discussing contract repudiation).

171. Under FDICIA, which requires the FDIC to choose the least-cost option for resolution, the role of purchase and assumption transactions will likely decline. 12 U.S.C.A. § 1823(c)(4)(A)(ii) (Supp. III 1991). It is too soon to tell whether this and other FDICIA amendments will create any significant depositor monitoring.

172. Recent history confirms that there are very low levels of uninsured deposits at the time that banks are declared insolvent. *See* Sam Zuckerman, *Uninsured Depositors Said to Stage "Silent" Runs*, AM. BANKER, Feb. 19, 1991, at 1, 1. Uninsured depositors can cheaply monitor for well-known signals of a bank that is likely to become insolvent, such as heavy borrowing from the Federal Reserve discount window. These depositors can then move the uninsured deposits well before insolveney is declared.

Note that uninsured depositors can generally protect themselves close to failure, and need not devote significant resources to monitoring solvency at earlier stages of a bank's difficulties. Uninsured depositors who place longer-term deposits, such as six-month certificates of deposits, would need to monitor earlier. Even in such a case, the difficulties of major banks have typically been known far enough in advance that there is time to remove uninsured deposits before the bank is closed, although perhaps at some penalty. *See* Robert M. Garsson, *Reform Bills Would Limit Fed Largesse*, AM. BANKER, Aug. 9, 1991, at 1, 9 ($5 billion in uninsured deposits left Bank of New England while the Federal Reserve supplied support). Many uninsured depositors also benefit from depositor preference statutes, which give depositors priority ahead of general creditors. *See Bank Board Adopts Final Rule Governing Depositor Preference in S&L Receiverships*, 51 BANKING REP. (BNA) 266, 266–67 (Sept. 15, 1988).

Much has been written on the role of depositor monitoring were deposit insurance to be abolished or substantially modified.[173] Advocates of market discipline have suggested that private institutions would develop to constrain bank risk-taking. If so, there would be less reason to suspect that bank failures arose from insider abuse. Opponents of market discipline have emphasized the cost of depositor monitoring, the increased risk of bank runs, and the disproportionate costs to less sophisticated depositors. In this Article, I do not choose sides in the debate over how to reform deposit insurance; thus far, major reform has been stymied. I note, however, that shifting large losses to depositors would reduce the stake of the insurance funds in bank failure, and consequently weaken "save the fund" rationales for special rules in bank insolvency.

b. Stockholder monitoring. The stock market likely plays a less effective role in monitoring management in banks than in industrial corporations. Outside bank shareholders suffer from the same information inadequacies as depositors. Bank shareholders also are likely disadvantaged by the special regime of bank securities regulation. The bank regulatory agencies, rather than the Securities and Exchange Commission, oversee bank securities issues, and there is evidence of less strict enforcement and less disclosure of potentially useful information.[174]

Nor has the market for corporate control operated as effectively with respect to banks. Hostile takeovers have been rare among banks and thrifts, with the Bank of New York's takeover of Irving Trust in 1989 the one notable exception.[175] Such take-

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173. *See* MACEY & MILLER, *supra* note 6, at 267–75 (citing sources).

174. *See* Michael P. Malloy, *The 12(i)'ed Monster: Administration of the Securities Exchange Act of 1934 by the Federal Bank Regulatory Agencies*, 19 HOFSTRA L. REV. 269, 281 n.66 (1990). A prime example of incomplete disclosure is the practice of not requiring a bank holding company to give detailed financial information on its subsidiary banks. Because depositors have a direct call only on the assets of the bank, and not on the holding company, this omission makes it especially difficult for shareholders and depositors to evaluate the ability of the individual banks to meet their obligations. Investors also may not have information about which assets are held by banks, and are thus subject to cross-guarantees, and which are held by non-bank affiliates, which are not subject to cross-guarantees.

175. *See* Donald G. Simonson, *Are U.S. Banks Undervalued?*, U.S. BANKER, Nov. 1989, at 63 (describing low threat of hostile takeovers). The general limits on geographic expansion by banks have precluded many possible takeovers. In addition, a special and

overs can serve as an incentive for investors to discover badly managed banks; and the threat of takeover acts as a goad for managers to avoid being uncovered as bad managers. Without the threat of hostile takeover, bank management has historically been more free to engage in insider abuse, secure in the knowledge that bad management or fraud would not trigger an attempt by investors to select new management.[176]

c. Monitoring by secured creditors. An important body of theoretical literature has emphasized the leading role that secured creditors (often banks) can play in monitoring behavior by secured debtors.[177] Banks are free from this sort of monitoring. Their dominant source of secured credit is in the form of sophisticated securities transactions that take place in large, impersonal markets, rather than in relationships in which creditors monitor debtors.

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strict antitrust regime, which effectively required clearance both by the Federal Reserve and the Department of Justice, prevented many mergers from occurring. *See* 12 U.S.C. §§ 1828(c), 1842(c) (1988); *see also* United States v. Philadelphia Nat'l Bank, 374 U.S. 321 (1963) (upholding Justice Department authority over bank mergers under strict "cluster market" analysis, with result that competition from thrifts and other non-banks was not considered). This highly regulated setting and strict antitrust enforcement created a great risk of not securing regulatory approvals, thus discouraging hostile bids. *See generally* Edward D. Herlihy et al., *Hostile Takeovers and Bank Regulatory Policy: A Primer*, 8 Banking Expansion Rep. 1 (Nov. 6, 1989).

176. Many of the thrifts in the 1980s that suffered from insider abuse were closely held, so that the stock market would not have served as an effective check on management. These closely-held corporations, however, suffered from an analogous monitoring failure when the FHLBB relaxed its scrutiny of the character of thrift owners. Just as hostile takeovers can stop bad managers from continuing in place, enforcement of laws such as the Change in Control Act could have stopped at least some abusive managers from taking control in the first place. *See* Stein, *supra* note 152, at 6–7, 18.

It is interesting to note that mutual thrifts, owned by depositors and not shareholders, do not appear to have been the source of especially significant insider abuse, despite management's insulation from outside challenge. In the 1980s, mutuals were disadvantaged at raising capital publicly, and were not the target of high-risk managers such as Keating. They thus did not grow nearly as rapidly as stock thrifts, and did not change their traditional business practices as much in the ways that were eventually correlated with insider abuse.

177. *See* Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982); Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986).

d. Bondholder monitoring. Many corporations face significant monitoring from the owners of their debt, and bond covenants are an important way to control corporate risk-taking.[178] Bond covenants are not, however, an important way to monitor and control bank risk. Despite proposals to require banks to issue bonds,[179] banks currently issue only a small amount of them, in part because most bonds do not count toward a bank's required capital.[180] Unless market conditions or regulatory requirements change drastically, bondholders will continue to be far less important in the monitoring of behavior in banks than in industrial corporations.

e. Government monitoring. In light of the systematic weaknesses of private monitoring, government agencies have been assigned the major role in preventing insider abuse in banks and thrifts. (The existence of government monitoring may also have prevented effective private monitoring from developing.) Today, there is reason to believe that government monitoring is a better deterrent against major insider abuse than it was previously.

Over time, publicized incidents of abuse have led to agency requests for additional enforcement powers, which have eventually been granted. Examples of this pattern include the Financial Institutions Supervisory Act of 1966,[181] the Garn-St. Germain Depository Institutions Act of 1982,[182] FIRREA in 1989,[183] and the Crime Control Act of 1990.[184] The arsenal possessed by regulators today is truly formidable. For instance, fines of $1 million per day and the agencies' ability to freeze the assets of alleged wrongdoers

178. Macey & Miller, *supra* note 3, at 1164 n.33.

179. *See, e.g.*, Larry D. Wall, *A Plan for Reducing Future Deposit Insurance Losses: Puttable Subordinated Debt*, FED. RES. ATLANTA ECON. REV., July/Aug. 1989, at 2, 2–3. The major advantage of such a requirement would be the market pricing of the bonds, giving the private sector an incentive to invest in bank monitoring. Regulators could then use price declines as early warning of possible trouble in banks who issue the bonds.

180. For conditions bonds must meet to be included in capital for national banks, see 12 C.F.R. § 3.100 & App. A (1992).

181. Pub. L. No. 89–695, 80 Stat. 1028 (codified in scattered sections of 12 U.S.C.).

182. Pub. L. No. 97–320, 96 Stat. 1469 (codified as amended in scattered sections of 11, 12, 15, 20, 42 U.S.C.).

183. Pub. L. No. 101–73, 103 Stat. 183 (codified as amended in scattered sections throughout U.S.C.).

184. Pub. L. No. 101–647, 104 Stat. 4789 (codified in scattered sections of 11, 12, 18, 28 U.S.C.).

should prove an effective deterrent to insider abuse. These new powers are accompanied by much stricter agency supervision than financial institutions, especially thrifts, received in the early 1980s. Indeed, as discussed below in Part V, the new agency powers may have become so strong as to chill legitimate banking activity. An important risk today is that over-strict insolvency rules will reduce the capital flowing into banking, thereby shrinking the size of the banking industry, increasing the likelihood of marginal banks failing for reasons unrelated to abuse, and increasing ultimate costs to the insurance fund. Although there can be many sorts of doubts about the effectiveness of government regulation, it seems unlikely today that any ineffectiveness would be due to lack of enforcement weapons.

C. *Implications of Insider Abuse for a Special Bank Insolvency Regime*

General bankruptcy law recognizes the possibility of insider abuse, and addresses the problem primarily through the law of fraudulent conveyances and preferences, and the law of equitable subordination. This bankruptcy law operates through standards, usually with a rebuttable presumption that a transaction was done in good faith. Those wishing to challenge the transaction must then come forward with evidence tending to show that insider abuse indeed occurred. This presumption fits well with the evidence that insider abuse is not an important cause of most industrial insolvencies.

If insider abuse is prevalent enough, however, then the default rule should shift. That shift may place the burden of proof on the insider to show that abuse did not occur. Or, the standard could move all the way to a rule conclusively presuming abuse. In corporate law, courts apply greater supervision to certain categories of transactions having a high risk of abuse.[185] At the extreme, such as where an agent makes use of a principal's property without

185. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (heightened scrutiny of mergers "freezing out" minority shareholders); Cookies Food Prods. v. Lakes Warehouse, 430 N.W.2d 447 (Iowa 1988) (strict common law standards applied to transaction involving interested director); *see also* 3 MICHAEL DOOLEY, CORPORATION LAW: THEORY AND PRACTICE IV–58 (preliminary draft 1991) ("In conflict of interest situations, the choice between prohibitory and policing rules and among policing rules of varying degrees of rigor should logically depend upon the rulemaker's perception of the risk of cheating involved in the type of transaction in question.").

authorization, courts apply a conclusive rule against the agent, and will not even inquire into the reasons for the use.[186]

The choice among default rules raises the familiar issues of choosing between rules and standards.[187] As applied to insolvency rules, three factors would seem especially relevant. First are the transaction costs of doing a case-by-case analysis under a standard. As these transaction costs rise, it becomes more desirable to set a firm rule. Second are error costs of finding insider abuse when it did not exist, or no insider abuse when it did. As these error costs rise, a standard becomes more desirable. Third, but perhaps most importantly here, is the likelihood that insider abuse contributed to the insolvency.

Even in the current period, when bank insolvencies can readily happen due to stiff competition, insider abuse probably plays a greater role in the failures of banks and other financial institutions than in failures of industrial corporations. Where a showing is made of the great prevalence or likelihood of abuse, there is a justification for special rules, in or out of insolvency, to deter or compensate for that abuse.

The systemic effects described in Part II, including the arguments for saving the fund or deferring to FDIC expertise, give an undifferentiated basis for agency victory over *any* competing claim. The "model of insider abuse" provides a more discriminating basis for special insolvency rules: Where there is a high enough likelihood that a transaction or failure was due to abuse, then the rules shift against the party who likely participated in the abuse.

The "model of insider abuse" thus provides a plausible policy basis for passage of many of the recent bank insolvency rules. As discussed below in Part V, both cross-guarantees and *D'Oench* powers can be explained as ways to address insider abuse, and cross-guarantees with more validity. Other rules linked to insider abuse include: strict rules concerning repudiation of contracts and leases, broadened definitions of fraudulent conveyance, asset freezes, FDIC discretion to adjust priority among creditors of the failed bank, unique agency enforcement powers, and priority of

186. *See* Diamond v. Oreamuno, 24 N.Y.2d 494 (1969); RESTATEMENT (SECOND) OF AGENCY § 388 cmt. c.

187. *See generally* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J 557 (1992).

the FDIC over certain bankruptcy rules.[188] Any of these rules might be justified if a strong empirical basis is shown for believing that these transactions or insiders are especially likely to be involved with abuse. As discussed in the next Part, however, the political needs of the FDIC and Congress, rather than public policy analysis, likely created an excessive number of strict rules. Ironically, the presumption of insider abuse led to passage of new rules just as a far greater proportion of failures was caused by stiff competition.

IV. PUBLIC CHOICE AND SPECIAL BANK INSOLVENCY RULES

The Article up to this point has essentially explored whether the special regime in bank insolvency has evolved for good public policy reasons. Reducing the systemic effects of bank failures and preventing insider abuse are policy goals that can gather widespread support, and both goals can be used to justify as well as explain special rules in bank insolvency.

Public choice theory offers a quite different approach to explaining the special bank insolvency regime. Concerned with the rational analysis of the means and ends of political actors and institutions, public choice theory can help explain and predict political behavior.[189] Public choice theory can also assist in evaluation of public policies. In particular, when public choice offers a strong explanation for why an outcome is in the interest of some particular set of institutions, the result can be to cast doubt on whether the proffered public policy rationales are in fact being sought or achieved.

This Part presents a public choice analysis of the special bank insolvency regime. In short, the FDIC can be seen as an agency trying to expand its power and protect the insurance fund. Members of Congress, meanwhile, have been concerned since the passage of FIRREA with avoiding voter backlash for the bailout. With the interests of the FDIC and Congress thus aligned, the result has been a "strict" approach to bank and thrift failures, expressed as the grant of extraordinary new powers to the FDIC. The temptation for the agency and Congress is to push costs of

188. *See supra* Section I(B) (describing special bank insolvency rules).

189. "Public choice can be defined as the economic study of nonmarket decisionmaking, or simply the application of economics to political science." DENNIS C. MUELLER, PUBLIC CHOICE 1 (1979).

the bailout off-budget and onto third parties. These incentives to be strict lead to the suspicion that the recent flurry of bank insolvency laws have been based more on politics than on accurate public policy.

A. *The FDIC and the Public Choice of Bank Insolvency*

Identifying the goals of the FDIC will help us to understand recent developments in bank insolvency law. A recent article by Ronald Cass and Clayton Gillette canvasses the public choice explanations of bureaucratic objectives.[190] Starting from William Niskanen's hypothesis that agencies maximize their budgets,[191] Cass and Gillette also examine such goals as furthering agency programs, providing service to clients, and advancing the careers of bureaucrats.

In understanding the recent behavior of the FDIC, I suggest that special attention should be paid to its unique goal of protecting the deposit insurance fund. Historically, the FDIC fund for insuring bank deposits grew each year from 1933 to 1988.[192] During this period, banks were the key FDIC constituency. Banks paid higher insurance premiums than the FDIC used in any year, and then received annual rebates. The FDIC could please the key banking constituency by assuring rebates and allowing the fund to grow slowly. After 1988, however, the rebates stopped.[193] As the insurance fund began to decline, taxpayers and especially the Congress became the key constituents. They began to fear, with justification, that general government revenues would be needed to protect the insurance fund.[194]

I propose that in the stressful period since 1988, when losses from bank failures became significant, a key goal of the FDIC has been to maximize the insurance fund. If this hypothesis is correct,

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190. Ronald A. Cass & Clayton P. Gillette, *The Government Contractor Defense: Contractual Allocation of Public Risk*, 77 VA. L. REV. 257, 320–35 (1991).

191. WILLIAM A. NISKANEN, JR., BUREAUCRACY AND REPRESENTATIVE GOVERNMENT 36–41 (1971).

192. FDIC, THE FEDERAL DEPOSIT INSURANCE CORPORATION: THE FIRST FIFTY YEARS 68 (1984) (showing fund balances 1934–1982); FDIC ANNUAL REPORT 24 (1985) (1983 & 1984 fund balances); FDIC ANNUAL REPORT 38 (1987) (1985 & 1986 fund balances); FDIC ANNUAL REPORT 43 (1989) (showing first decline).

193. *See* STEPHEN K. HUBER, BANK OFFICER'S HANDBOOK OF GOVERNMENT REGULATION ¶ 17.03[1] (2d ed. 1989).

194. *See supra* note 125 (discussing possible need for general revenues).

then many agency actions should be correctly predicted or explained by reference to their tendency to maximize the fund.[195] In contrast to Niskanen's general model of public agencies, where there is no clear measure of agency output,[196] the amount in the deposit insurance fund serves as a public, objective measure of agency performance.[197] The agency would both try to increase the balance of the fund, and rebut any information suggesting that the fund was at risk.[198]

The FDIC has witnessed an unusually apt bureaucratic lesson about why it should be concerned with the size of the insurance fund. The failure of FSLIC to maintain its insurance fund resulted in that rarest of Washington events—the death penalty for an entire agency. As the thrift crisis deepened, a great deal of public attention focussed on the ever-larger projections of the FSLIC deficit. FHLBB Chairman M. Danny Wall suffered withering criticism for his failure to acknowledge the magnitude of the problem.[199] In FIRREA, the FHLBB was abolished, and its insur-

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195. The strongest incentives to maximize the fund occur under current circumstances, where the fund is negative or only slightly positive. In this range, political attention is especially focused on the size of the fund because of the reality that taxpayer dollars are needed (if the fund is negative) or the risk that they will soon be needed (if the fund is slightly positive).

196. NISKANEN, *supra* note 191, at 26–27.

197. It might be objected that the balance of the deposit insurance fund is an imperfect measure of the quality of the agency effort, because there is no information about what the balance would have been with better or worse agency effort. The chief response is that the identical problem exists in the private sector, as to whether management should have had even higher profits. In terms of the FDIC's actual goals, the presence of a public, numerical measuring stick can itself be a reason to optimize with respect to the measuring stick, whether or not the stick measures the correct thing. *Cf.* Laurence H. Tribe, *Technology Assessment and the Fourth Discontinuity: The Limits of Instrumental Rationality*, 46 S. CAL. L. REV. 617 (1973) (describing "dwarfing of soft variables" and exaggeration of hard numbers in cost/benefit analysis).

198. The hypothesis that the FDIC seeks to maximize the deposit insurance fund is analytically distinct from the discussion, *supra* notes 127–30 and accompanying text, about the public policy justifications for saving the fund. The latter primarily involves normative evaluation of when it is appropriate to consider saving the fund. A positive aspect of that discussion is the possibility that bank insolvency rules have developed to save the fund *because* of the force of the normative arguments. As Farber and Frickey would put it, the development of law that saves the fund might be better explained by "ideology"—a belief by political actors that the rules serve the public interest—than by public choice analysis of what an entity self-interestedly maximizes. DANIEL A. FARBER & PHILLIP P. FRICKEY, LAW AND PUBLIC CHOICE 21–33 (1991).

199. *See Wall Resigns Post as Director of Office of Thrift Supervision*, 53 Banking Rep. (BNA) 885 (Dec. 11, 1989); Jerry Knight, *A Bottom-Line Question in the S&L Crisis: Why Shouldn't Wall Be Fired?*, WASH. POST, Mar. 28, 1989, at E3.

ance fund was placed under the control of the FDIC.[200] Faced with the lessons of FSLIC, FDIC administrators and employees have an excellent incentive to protect today's insurance funds.

Recent actions by the FDIC seem to fit the hypothesis that the agency is seeking to maximize the insurance fund, rather than the traditional Niskanen hypothesis that the agency is seeking to maximize its budget. If the agency were trying to maximize its budget, then one would expect significant discussion about its tendency to hold on to properties rather than to dispose of them quickly.[201] But my own reading in the trade press has yielded no reason to think that the agency is trying to manage an enormous real estate empire in order to increase its own budget.

Other qualitative evidence supports the idea that the FDIC is seeking to maximize the insurance fund. FDIC Chairman William Seidman responded harshly to a 1990 report by three economists who estimated that the bank insurance fund was insolvent at that time on an actuarial basis.[202] In light of Seidman's political astuteness, the vehemence of his response is a good indication of the seriousness he attached to public perceptions of the fund's solvency. Furthermore, the FDIC has lobbied vigorously for discretion to set the level of assessments that the banks pay into the insurance fund.[203] Such discretion is important to agency calibration of how best to maximize the fund over time. Finally, and most broadly, the FDIC has adopted long-range litigation and lobbying strategies to maximize the flow of closed-bank assets into the fund.[204] These

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200. 12 U.S.C. §§ 1437, 1821 (Supp. III 1991).

201. Holding onto properties brought under FDIC receivership or conservatorship would require more agency personnel and a larger budget than would quick sale of the properties.

202. Jerry Knight, *FDIC Head Says Fund Is Under Stress*, WASH. POST, July 16, 1990, at A1.

203. This discretion was granted for the first time in FIRREA, the first opportunity to change deposit insurance regulation after it became apparent that FHLBB Chairman Wall had underreported the size of the FSLIC deficit. *See* 12 U.S.C. § 1817(b) (Supp. III 1991). Previously, the assessment was set by statute.

204. Parker Interview, *supra* note 15. For instance, the FDIC pursued innovative legal strategies to gain assets of affiliated banks in a number of the major Texas failures in 1986 and 1987, such as MCorp. *E.g.*, MCorp Financial v. Board of Governors, 900 F.2d 852 (5th Cir. 1990), *rev'd in part on other grounds*, 112 S. Ct. 459 (1991). While these cases were proceeding, the FDIC gained essentially similar powers in the cross-guarantees powers that were included in FIRREA. 12 U.S.C. § 1815(e) (Supp. III 1991).

The RTC's regular funding requests to Congress form a measure similar to the size of the FDIC insurance fund, giving a similar incentive for the RTC to minimize cost of

efforts have resulted, for instance, in expanded *D'Oench* and cross-guarantee powers. By contrast, there is little reason to think that the FDIC is holding on to failed bank assets, rather than selling them, in order to increase the size of its budget or the empire under its control.

Inter-agency politics has encouraged the FDIC to focus on protecting the insurance fund. At least until FDICIA in 1991, the Federal Reserve and the Office of the Comptroller of the Currency effectively protected their existing powers to regulate the important solvent banks.[205] The FDIC's power as insurer to control solvent banks has remained limited.[206] The chief outlet for the FDIC's legislative efforts has thus been the law of bank insolvency.

In pursuing its goal of maximizing the insurance fund, the FDIC has some systematic advantages in Congress. The bank and thrift industries may be at a particular disadvantage in lobbying for less strict rules in insolvency. In opposing a rule aimed at insider abuse, the bank and thrift industries have to explain why it is better to be "soft" on persons or institutions that are costing taxpayers large sums of money. The internal politics of the industries also weaken lobbying efforts on insolvency issues. The strong banks and thrifts place little priority on insolvency law, while the weak banks and thrifts have constrained resources and suffer from the suspicion that they are trying to escape the consequences of their own fraud or mismanagement. A related advantage for the FDIC is that it has been able to pursue its legislative goals repeatedly, in each of the banking statutes in recent years, while its natural opponents on insolvency law have been the shifting set of institutions that in a given year were strong enough to lobby but weak enough to be concerned about insolvency.[207]

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the bailout. Because the clear trend has been to have thrift rules copy bank rules, *see supra* note 7, the goals of the FDIC have played the leading role in developing insolvency statutes.

205. The Federal Reserve supervises state-chartered banks that are members of the Fed, which includes most important state banks, and bank holding companies. The OCC supervises national banks. FDICIA for the first time gave significant powers to the FDIC over solvent banks. *See supra* note 42.

206. The FDIC's power to suspend deposit insurance has been seen as such a draconian power that it has rarely been used. *See supra* note 42.

207. *See* Marc Galanter, *Why the "Haves" Come Out Ahead: Speculation on the Limits of Legal Change*, 9 LAW & SOC'Y REV. 95 (1974) (explaining advantages to group pursuing an agenda over time when opposed by one-time opponents).

The models developed by James Q. Wilson[208] and Michael Hayes[209] are helpful in understanding descriptively where the FDIC has been most likely to achieve its legislative goals. The FDIC has sought a variety of legislation that gives it "concentrated" benefits, that is, benefits that flow primarily or exclusively to the FDIC and are designed to achieve the major FDIC goal of maximizing the fund. Where the concentrated benefits to the FDIC are paired with "diffuse" costs to others, the FDIC success is greatest. Part V argues that the FDIC's expansion of the *D'Oench* powers has been aided by an extremely diffuse distribution of costs. By contrast, where the concentrated benefits to the FDIC are paired with concentrated costs to another group, the FDIC has encountered much stiffer opposition. The best example of this is the loss which the FDIC suffered in FIRREA on recovering on many large directors' and officers' insurance contracts. On this issue, the agency was unable to defeat a coalition of large directors' and officers' insurers and solvent banks that wanted the insurance.[210] From a normative standpoint, there is great reason for concern about a particular insolvency rule where the concentrated benefits to the FDIC are clear, but the political opposition diffuse and thus unlikely to serve as an effective check.

B. *Congress and the Public Choice of Bank Insolvency*

The above discussion of the FDIC's legislative goals and achievements draws on the interest group branch of public choice theory, which analyzes the factors contributing to the legislative success or failure of organized political entities. A complementary branch of public choice theory focuses on the goals and actions of the legislators themselves, and usually emphasizes the legislators' goal of getting reelected.[211]

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208. JAMES Q. WILSON, POLITICAL ORGANIZATIONS (1973).

209. MICHAEL T. HAYES, LOBBYISTS AND LEGISLATORS (1981).

210. The relevant language is codified at 12 U.S.C. § 1821(e)(12)(A) (Supp. III 1991); *see, e.g.*, St. Paul Fire & Marine Ins. Co. v. FDIC, 968 F.2d 695, 702 (8th Cir. 1992) (construing same).

211. The classic exposition of this thesis is given in DAVID R. MAYHEW, CONGRESS: THE ELECTORAL CONNECTION (1974). The analysis here does not depend on accepting a strong form of the thesis, that legislators *only* seek to maximize their chance of reelection. Other political scientists have made convincing arguments that legislators also pursue other goals, such as enacting their own visions of good public policy or achieving influence within Congress. *See, e.g.*, RICHARD F. FENNO, JR., CONGRESSMEN IN COMMITTEES

A recent book by R. Douglas Arnold, *The Logic of Congressional Action*,[212] provides an excellent framework for explaining how members of Congress have acted with respect to bank and thrift insolvency. Arnold stresses that in seeking reelection representatives predict the "potential preferences" of their constituents on issues that may become the subject of future political campaigns. Representatives are especially concerned with the subset of issues that are "traceable" to the incumbents, and adopt strategies to minimize the risk that these traceable issues will be contrary to the preferences that voters will have come Election Day.

Arnold persuasively sets forth three conditions that must be met to make an effect traceable to a representative, and thus the basis for a vote against the incumbent: "a perceptible effect, an identifiable governmental action, and a legislator's visible contribution."[213] Bank and thrift insolvencies meet these criteria precisely. The "perceptible effect" for voters would be the enormous cost of the bailout, which has been reported by the press to be between $100 billion and $1 trillion. Individual voters might readily interpret such sums as a significant personal burden, expressed as increased future taxes or higher costs for servicing the budget deficit. The "identifiable government action" would be the repeated bills passed by Congress to fund the bailout, coupled with earlier legislation deregulating the thrifts and arguably causing the crisis. The "legislator's visible contribution" is the roll call vote by the incumbent in favor of providing money to resolve the insolvencies. Some members have made even more visible contributions, such as heading a banking committee or making headlines in a thrift-related scandal.

Recent elections show that voters have indeed become disposed to punish their incumbent representatives for the bailout. In the House, several members seem to have been defeated on the thrift issue in 1990, and many more were attacked on it during campaigns.[214] In the Senate, the Keating scandal caused great em-

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(1973). As discussed in Part V, *infra*, no clear conception of the dangers of an over-strict insolvency regime has previously been advanced. Legislators have thus been free to believe that the strict rules that favored their reelection were also good public policy.

212. R. DOUGLAS ARNOLD, THE LOGIC OF CONGRESSIONAL ACTION (1990).

213. *Id.* at 47.

214. "Public outrage over the increasingly expensive bailout of failed savings and loan institutions zapped some of the [House] losers." Dave Kaplan, *The Tally: Democrats, Up Nine; Republicans, Down Eight*, 48 CONG. Q. 3801, 3802 (1990) (listing five defeated in-

barrassment for five Senators, and contributed to Senator Alan Cranston's decision not to seek reelection.[215]

Members of Congress have responded to this traceable issue with strategies that respond to each of the three conditions identified by Arnold.[216] Congress can combat the "perceptible effect" of the bailout cost by adopting what might be called a "strict" strategy for reducing the bailout cost. A large number of recent enactments fit within the "strict" strategy.[217] For instance, FIRREA raised fines for bank-related violations to up to $1 million per day, and numerous insolvency provisions have made it easier for the agencies to recover assets that arguably belonged to the insured institution, and thus to the insurance fund.[218] The 1991 amendments calling for mandatory early closure of weak banks also demonstrates a strict approach for reducing future losses.[219] In addition, Congress's decision to split the cost of the bailout into several separate bills may aim to reduce the "perceptible effect" of the bailout—voters might remember the most recent $25 billion authorization rather than aggregate the full cost of hundreds of billions of dollars.

Congress can try to avoid blame for "identifiable government action" either by justifying the government actions or by shifting

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cumbents). Representative Jim Leach called the thrift crisis " 'a congressional Watergate,' " and said: " 'This is the best issue for all challengers of all parties.' " John R. Cranford, *Partisan Knives Are Drawn as Thrift Crisis Builds*, 48 CONG. Q. 1937, 1938 (1990).

215. Bob Benenson, *Cranston's Retirement Decision Ensures Spirited 1992 Races*, 48 CONG. Q. 3832, 3832 (1990).

216. Arnold, *supra* note 212, at 47. Arnold does not expect many members actually to be defeated due to their actions on traceable issues: "My intent is to show how legislators' fear of this form of retrospective voting affects their behavior in Washington, not to establish how frequently they miscalculate citizens' preferences or potential preferences." *Id.* at 46. Arnold's contribution is to define the universe of traceable issues, and explain how members' desire to be reelected will lead to defensive strategies on precisely those issues.

217. "Perhaps the most visible sign of member concern about voters' reaction to the thrift scandal was the rush to pass new penalties for bank fraud and provide the Justice Department with more resources to investigate thrift crimes." John R. Cranford, *Scandal Gives Parties a Chance to Fire Away at Each Other*, 48 CONG. Q. 2204, 2205 (1990). Lame duck Senator William Armstrong opposed an amendment to the Crime Control Act as " 'a smoke screen to shift the culpability for the S&L mess from the Congress and onto a few unscrupulous businessmen.' " *Id.*

218. *See supra* notes 12–13 and accompanying text (listing provisions of FIRREA and Crime Control Act).

219. *See supra* text accompanying notes 92–93.

the blame to others. Members can articulate a public policy basis for the bailout costs, namely that deposit insurance exists to protect the money of ordinary depositors. The strategy is to maintain the still-popular system of deposit insurance, while demonstrating a "strict" approach of punishing thrift kingpins.

Shifting blame onto the President and the agencies can also reduce the chance that voters will identify incumbents as worthy of electoral punishment. There has been no shortage of hearings criticizing bank and thrift regulators for causing bank and thrift problems.[220] The Senate's 1991 refusal to confirm the renomination of Robert Clarke as Comptroller of the Currency[221] is a clear example of blaming the President and the agencies. Clarke was the senior bank regulator directly responsible to the President, and Clarke was severely criticized by Democrats, led by Senator Donald Riegle, in part for laxness in the regulation of national banks.[222] Indeed, such blame-shifting may explain the more general outlines of recent insolvency law—Congress can give broad powers to the FDIC and RTC, and then criticize the agencies for their inevitable failure to solve bank and thrift problems.

Arnold's third condition of a traceable issue, a "legislator's visible contribution," has also been the subject of defensive action by Congress. The strict strategy has allowed incumbents to show visible support for being "tough on S&L kingpins."[223] Particular legislators who were vulnerable to charges of being responsible for the thrift crisis have taken vigorous steps to show their toughness on the issue.[224] Most striking is the escalating reluctance of Con-

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220. *See, e.g., When Are the Savings and Loan Crooks Going to Jail?: Hearing Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 2d Sess. (1990).

221. Robert Clarke, the former Comptroller, should not be confused with Robert Clark, Dean of Harvard Law School, who is quoted *supra* at text accompanying note 2 and *passim*.

222. *See Senate Banking Committee Votes 12-9 to Reject Clarke for Second OCC Term*, 57 Banking Rep. (BNA) 758 (Nov. 11, 1991).

223. For instance, a representative who supported deregulating the thrifts in the Garn-St. Germain Depository Institutions Act of 1982 could later vote for the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990, contained within the Crime Control Act.

224. Two examples are Senator Donald Riegle, Chairman of the Senate Banking Committee, and Representative Frank Annunzio, former Chairman of the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance. Senator Riegle was a target of the "Keating Five" ethics investigation, and has since shown his strictness, for instance, by criticizing regulatory laxness and leading the attacks on the renomination of

gress to authorize funding for the bailout. The House approved the November 1991 authorization of $25 billion for the RTC on a voice vote, apparently to avoid members having to go on record as supporting the bailout.[225] When the RTC's temporary authorization to close thrifts expired in April 1992, the House completely refused to vote for continued spending, despite estimated costs of delay ranging up to $1.4 billion.[226] Such unwillingness to allow needed spending is a remarkable sign of legislators' avoiding a "visible contribution" to the thrift bailout.[227]

C. *Summary*

Congress's strict strategy has beautifully complemented the FDIC's institutional desires to increase agency turf and protect the insurance fund.[228] Both the FDIC and Congress prefer to have third parties shoulder the costs, rather than pay from the insurance funds. The list of third-party payors has become impressive: state and local governments deprived of taxes; borrowers and others affected by *D'Oench*; almost any bank insider with deep pockets; lawyers and accountants unlucky enough to be near the scene of a failure; and so on. In light of the public choice conclusions, the

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Comptroller Clarke. Representative Annunzio suffered political attack in 1988 and 1990 for being overly friendly with thrifts, and subsequently took very public positions in favor of strict treatment of insolvent thrifts. *Compare* Kathleen Day, *When Hell Sleazes Over: Judgment Day for S&L Slimeballs*, NEW REPUBLIC, Mar. 20, 1989, at 26, 30 (criticizing Representative Annunzio for wanting to preserve the S&L industry virtually without change) *with* Barbara A. Rehm, *RTC Bulk Deal with Investor Group Draws Fire in Bank Panel Report*, AM. BANKER, Jan. 3, 1992, at 14, 14 (Representative Annunzio criticizes RTC bulk sales). These strict actions may well reflect the members' sincere beliefs, but they also provide a defense to accusations that the members visibly contributed to the thrift crisis.

225. Robert M. Garsson, *Taylor Blasts Proposal to Phase in FDIC Recap*, AM. BANKER, Nov. 26, 1991, at 1, 1.

226. Bill Atkinson, *Bush Urges House to Pass Bailout Bill*, AM. BANKER, July 30, 1992, at 1, 1.

227. Representative Wylie made this precise point: " 'There are some members who don't want their thumbprint on RTC funding.' " *Id.* at 8.

228. The public choice account offered here highlights two major differences that exist between bank insolvency and bankruptcy: the existence of the FDIC as the concentrated beneficiary of special insolvency rules, and the recent political importance of bank insolvency issues as traceable, and thus of strong interest to incumbent representatives. Bank insolvency has thus had two important political engines, absent in bankruptcy, for creating different rules pre- and post-insolvency.

question then becomes how to assess normatively the strict system that has developed.

V. APPLICATION TO CURRENT BANK INSOLVENCY PROBLEMS

The previous Parts have developed three accounts that explain the development of special bank insolvency law: the public policy stories based on the systemic effects of bank failure and the problems of insider abuse, and the public choice story of the goals of Congress and the FDIC. These three accounts show how a special confluence of public policy and public choice occurred in 1989, when the decisive statutory shift occurred in FIRREA. FIRREA came at the time of the first really substantial taxpayer funding of the thrift insurance fund,[229] and at a new height of publicity about the exploits of Charles Keating and other thrift insiders. Meanwhile, the bank insurance fund seemed solvent, with its major losses readily explicable.[230] In this setting, the FDIC and its popular Chairman, William Seidman, became an attractive "white knight" for solving the thrift crisis. The FDIC took over the thrift insurance fund and became manager of the RTC's cleanup efforts. To do this tough job, the FDIC sought and received broad special powers in insolvency, increasing its turf and gaining tools for protecting the insurance fund. Congress could feel comfortable with its actions in the insolvency area: FIRREA was consistent with strong public policy arguments; it was "strict" on thrift kingpins (helping politically on a "traceable" political issue); and it delegated power to the best available agency (accomplishing policy goals while reserving Congress's ability to blame the agency if things did not work out).

The three accounts developed in this Article thus combine to give a good account of how the FDIC has gained its extraordinary range of special powers in bank insolvency. All the major forces have pushed in the same direction, toward a greater divergence of pre- and post-insolvency law. A remaining task is assessing wheth-

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229. CEBA in 1987 provided carefully limited funding to FSLIC of $10.825 billion. Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 302(e)(i), 101 Stat. 552, 590 (codified at 12 U.S.C. § 1441(e)(1) (1988)). FIRREA, by contrast, contemplated funding of losses with a present value of over $90 billion, and there was by then a known risk that the final bill might be much higher. H.R. REP. NO. 54, *supra* note 94, at 502, *reprinted in* 1989 U.S.C.C.A.N. at 297.

230. *See infra* notes 231–33 and accompanying text (discussing need for cross-guarantees powers to combat insider abuse in Texas holding companies).

er the current rules are normatively desirable. I conclude that there is often reason for concern that current superpowers are an overreaction to the problems that justified some special rules in bank insolvency. When all three accounts push the same way, where are the brakes? The danger of overreaction is greatest where there are no effective political checks on the incentives of Congress and the FDIC to be strict.

In this Part, particular aspects of bank insolvency law are first examined, to understand how the three accounts together can justify or explain two notable areas of bank insolvency law—FIRREA's cross-guarantees provision and the *D'Oench* powers. Second, a more global assessment is made, focusing on the costly consequences of having too large a gap between pre- and post-insolvency banking law. The most important consequence is what I term the "black hole" effect, in which weak but solvent banks may be pulled inexorably down into insolvency.

A. *Assessing and Explaining Particular Aspects of Bank Insolvency Law*

1. *Cross-Guarantees.* For a normative assessment of the cross-guarantees provision, a key question is whether there is enough risk of insider abuse to justify the extraordinary FDIC powers. The systemic account is only weakly related to cross-guarantees, much as any rule that helps save the insurance fund. From the public choice perspective, passage of cross-guarantees is consistent with the goals of Congress and the FDIC, while the banks on whom the costs are concentrated seem to retain some potential to check agency overreaching.

a. Cross-guarantees and the "model of insider abuse." As described above,[231] FIRREA's cross-guarantees provision allows the FDIC to charge affiliated banks and thrifts (but not the holding company or non-bank affiliates) for the costs of a failure, and subordinates the claims of shareholders and non-bank affiliates to the FDIC claim. This provision arose from the FDIC's experience with large Texas bank holding companies, including MCorp and Texas American Bankshares. These holding companies had set up numerous separately incorporated banks in order to comply

231. *See supra* subsection I(B)(1).

with strict state laws against branching. In the FDIC's opinion, these holding companies employed a strategy of dumping liabilities into a few of their banks, which became deeply insolvent, while retaining assets and shareholder worth in other banks. When some banks neared insolvency, the holding companies and solvent banks refused regulators' demands to support the weak banks.[232] The FDIC and the Federal Reserve then attempted novel legal means, with limited success, for gaining the value in the holding company and solvent affiliates.[233] Meanwhile, the FDIC sought and received from Congress the cross-guarantees powers, to avoid similar problems in the future.

In assessing cross-guarantees, first imagine, consistent with the "model of insider abuse," that many bank failures were accompanied by systematic transfer of assets to an affiliated, solvent bank. Bank owners could use deposit insurance as a convenient way to dump losses, while retaining all profits. Would cross-guarantees be desirable in such circumstances? Probably so. Consider the alternatives.[234] Relying on fraudulent conveyance law would likely fail to capture much of the fraud and would have enormous transaction costs. Routine transactions between affiliated banks can be incredibly numerous, especially in the Texas model where one or more "lead banks" serve as a conduit for most loans or other investment in assets outside of the holding company. Such a corporate

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232. Indeed, directors and officers of the holding company and solvent affiliates would have been sued for wasting corporate assets if they had transferred their assets to the failing banks, especially because those assets were apparently insufficient to protect the weak banks from failure. *See* MCorp Financial v. Board of Governors, 900 F.2d 852 (5th Cir. 1990), *rev'd in part on other grounds*, 112 S. Ct. 459 (1991).

233. *See id.* at 855–64 (ruling that Federal Reserve Board did not have authority under either the Bank Holding Company Act or under 12 U.S.C. § 1818(b) (unsafe or unsound practices) to require bank holding company to transfer assets to troubled subsidiary).

234. One possible alternative has been impossible politically. If state branching restrictions were abandoned, or preempted by federal law, then many current bank affiliates could be consolidated to take advantage of efficiencies, such as reducing costly formalities and avoiding duplication of costly boards of directors. In that event, the need for cross-guarantees would be less, because there would be fewer commonly controlled depository institutions. Proposals to eliminate branching restrictions, however, have encountered ferocious opposition.

A second alternative would be to strengthen the substance or procedure of the Federal Reserve rules governing intra-holding company transactions. 12 U.S.C. § 371a (1988). Stopping fraud through such enforcement is difficult pre-insolvency in light of the enormous number of transactions that may routinely take place between affiliated banks, and the difficulty of detecting a small fraction that may be part of a fraudulent scheme.

structure makes it terribly difficult to distinguish a routine transaction from part of a fraudulent scheme.

More promising would be an FDIC power to take advantage of the doctrine of equitable subordination, as creditors can do in bankruptcy. Under this approach, the FDIC would prove in federal court that a pattern of insider domination should justify subordinating the insiders' claims to those of bona fide outside creditors.[235] Robert Clark has shown that equitable subordination is a desirable substitute for fraudulent conveyance law in highly complex cases where it would be costly or impossible to make findings as to the fraudulent nature of each transaction.[236] The chief advantage of equitable subordination, compared with cross-guarantees, would be remedial precision—insider claims would be subordinated only to the extent an abusive scheme was shown, and would not be presumed except where abuse is evident. A second advantage would be the increased likelihood of debt financing to the troubled bank by holding companies and non-bank affiliates, thereby reducing the likelihood of insolvency and costs to the FDIC.[237]

In a world of pervasive abuse, these advantages would have little weight. First, a rule assuming abuse would have greater accuracy and lower transaction costs, and thus be preferable to a standard where the creditor has to come forward with evidence of abuse. Second, funding by other insiders would deserve equity

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235. Clark, *supra* note 46, at 517–18.

236. *Id.* at 530. Clark also analyzed a then-pending proposal of the Commission on the Bankruptcy Laws of the United States to adopt a general rule automatically subordinating any claim of controlling shareholders to those of other creditors. *Id.* at 536–40. The proposal was not adopted. The proposal was similar to the FDIC's powers in that it gave automatic, lower priority to claims of certain insiders. 12 U.S.C. § 1815(e)(2)(C) (Supp. III 1991). The FDIC's powers go even further, however, because the agency is permitted to assess affiliate banks and thrifts for losses incurred by the insolvent institution.

237. Under cross-guarantees, debt financing is reduced because the insider investor is automatically subordinated to outside creditors, including the FDIC, and is thus treated as an equity holder.

The question of funding by the holding company is also implicated by the Federal Reserve's position that holding companies should serve as a "source of strength" for their weakly-capitalized banks. For purposes of this Article, it is sufficient to note that cross-guarantees and source of strength serve largely overlapping functions. They both seek to assure that shareholders do not retain value while dumping losses into the insurance fund. Assessing the relative merits of cross-guarantees and source of strength is a complex issue that goes beyond the scope of this Article.

treatment under the rules of equitable subordination, and cross-guarantees would again have the advantage of simplicity and lower transaction costs. As abuse becomes less pervasive, these same arguments would apply, but with lesser weight. The key normative question would be whether abuse was pervasive enough to justify the strict rule.

Even assuming that abuse is less pervasive, an automatic rule such as cross-guarantees may be justified as a means to prevent abuse from occurring.[238] The bright-line nature of cross-guarantees may make it relatively hard to evade the purpose of the rule and dump liabilities onto the fund while preserving value to shareholders.[239] If the rule is difficult to evade, then it will seldom have to be used to address fraud; potential wrongdoers will realize the pointlessness of fraudulently transferring assets to affiliated banks.[240]

b. Cross-guarantees and systemic effects. On first impression, the mere existence of deposit insurance would seem to give little reason for special rules for handling transfers with affiliates. To the extent that cross-guarantees allow the FDIC to grab affiliate assets in the event of an insolvency, there is the general temptation to save the fund by favoring the FDIC. But something more should be shown in order to favor a rule, especially in light of the possibility that cross-guarantees may discourage debt financing of the banks and thus ultimately increase the likelihood of insolvencies and the cost to the fund.

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238. In a similar context, Clark has noted that an automatic, preventive rule may be justified "by the decision to sacrifice analytical and remedial precision for the certainty and ease of preventive rules." Clark, *supra* note 46, at 540 (discussing bankruptcy proposal).

239. The obvious way to avoid cross-guarantees is to transfer assets to entities not covered by the guarantees, notably the holding company or non-bank affiliates. Two factors limit the likely success of such a strategy. First, all such transfers remain subject to the limits of sections 23A and 23B of the Federal Reserve Act, which govern affiliated transactions. 12 U.S.C. §§ 371c, 371c-1 (1988). Violation of these rules can carry stiff fines and other penalties. Second, large and illegitimate transfers to non-bank entities are likely to be easier to detect than transfers among banks, where ordinary business may involve numerous legitimate transactions as a cover for some illegitimate ones. *See supra* Part III (discussing special likelihood of fraud in banks).

240. The effectiveness of the rule is a plausible explanation for why cross-guarantees has only rarely been invoked since 1989, even though the FDIC believed that questionable transfers among affiliated banks were common before FIRREA.

A somewhat stronger systemic argument focuses on how the FDIC is to sell the insolvent bank. The clear priority rules embodied in the cross-guarantees allow an acquiror to price a bank or its assets quickly, without speculating on the nature of the claims of bank affiliates or the likelihood of creditors eventually making out a case for equitable subordination. A rule fostering speedy sale helps the fund, because the value of bank assets deteriorates steadily the longer they are held by the government receiver.[241] Because of the special problems the government seems to experience in maintaining the value of a receivership, a special rule fostering speedy sale may be justified.[242]

A related systemic argument looks to the going concern value of the affiliated banks. The FDIC may wish to sell all affiliated banks as a package, in order to preserve the business advantages that existed from their joint operation. Precisely this rationale was given for using cross-guarantees against the Maine affiliate of the Bank of New England.[243] Preserving going concern value may well be more a more efficient use of the banking assets than splitting control between the FDIC and the holding company. This efficiency point is bolstered by the usual equitable arguments that favor saving the fund, rather than leaving value in the hands of the holding company that allowed the bank to fail.

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241. *See* Charles M. Horn, *"Early Intervention" Monster Needs Taming*, AM. BANKER, Dec. 24, 1991, at 4, 4.

242. One reason for the deterioration is the strict rule that generally bars prior officers from continuing in place after insolvency. 12 U.S.C. § 1831o(f)(2)(F)(ii) (Supp. III 1991). Banks and thrifts in receivership or conservatorship are thus typically run by persons lacking knowledge and business contacts possessed by prior management. The rule against officers remaining is consistent with the model of insider abuse, but is less appropriate where failure occurs due to strict competition. In the latter case, the costs of losing prior officers' firm-specific investment may outweigh the benefits of deterring officers from allowing the firm to fail. In the bankruptcy context, the modern trend is to allow management to remain in place, at least during the early stages of a reorganization.

243. The FDIC used the cross-guarantees to

> fail the Maine National Bank which was otherwise in sound financial condition. This was done in order to bring all the banks under our control at one time, thereby allowing us to preserve franchise value, to stabilize the entire system and to be able to sell the entire Bank of New England holding company banks to one purchaser . . . .

The Failure of the Bank of New England: Hearing Before the Senate Banking, Housing, and Urban Affairs Comm., 102d Cong., 1st Sess. (1991) (statement of William Seidman, Chairman, FDIC); *see also For FDIC, Bolstering the Economy Was Key*, AM. BANKER, Jan. 8, 1991, at 1, 1 (reporting federal regulators' intent to use government control to stabilize the financial situation in the area, and not to impose "market discipline" on the economy).

c. Cross-guarantees and public choice. The cross-guarantees power fits well into the public choice perspective developed in Part IV. The new powers furthered the FDIC's goals of increasing its turf and protecting the deposit insurance fund. Its turf was increased by the strong new power, coupled with the ability to waive the cross-guarantees at the agency's discretion. The insurance fund was protected by the FDIC ability to take assets from affiliated banks, and by the prophylactic effect of preventing future sequestering of assets. The cross-guarantees provision also met Congress's goal of protecting itself on a traceable issue. Members could now proudly show that they "did something" to prevent abuses of the fund as allegedly occurred in MCorp.

A modest puzzle is why the banking industry failed to defeat the cross-guarantees provision. The costs of the provision would seem to be concentrated fairly directly on bank shareholders, who now lose value when any bank affiliate fails, and bank officers, who will lose their jobs when an affiliate's insolvency triggers their own bank's insolvency.[244] Why wasn't this provision defeated by industry?

Several factors explain the political inability of the banks to defeat cross-guarantees. The bank lobby lacked strong allies on this issue.[245] Publicity surrounding MCorp and other Texas insolvencies made a solid political and policy case for a prophylactic rule such as cross-guarantees. In addition, the major burden of the provision occurs only when a bank becomes insolvent; and, as explained above,[246] banks concerned about insolvency are in an especially weak position on both policy and public choice grounds. Finally, the FDIC, during consideration of FIRREA, agreed to material amendments to the cross-guarantees proposal in ways that addressed the concerns of solvent banks while meeting FDIC goals.[247]

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244. The effect may also fall on the shareholders and officers of the bank holding company, which is more likely to fail in the presence of cross-guarantees because one insolvency among its subsidiaries will likely trigger multiple insolvencies.

245. By contrast, elements of the insurance industry lobbied effectively with banks to defeat the FDIC's proposals regarding directors' and officers' liability insurance. *See* Sherry R. Sontag, *Law Puts FDIC's Claims in Peril*, 14 NAT'L L.J., Feb. 24, 1992, at 1.

246. *See supra* text accompanying note 207 (describing systematic political disadvantages facing banks concerned with insolvency rules).

247. Notably, the priority rules were amended to place subordinated debt ahead of the FDIC and insider creditors. *Compare* S. 413 (Administration draft) *with* 12 U.S.C. § 1815(e)(2)(C) (Supp. III 1991) (cross-guarantees provision as passed in FIRREA). This

d. Assessing cross-guarantees. Application of the three accounts developed in this Article suggest that there is a reasonably strong normative basis for the cross-guarantees power of the FDIC. The "model of insider abuse" suggests that it is especially easy to shift value among affiliated banks[248] but very difficult to unravel the transactions in time to facilitate the resale of the insolvent bank and its assets. If these transactions cannot be quickly unraveled through either the law of fraudulent conveyance or equitable subordination, then systemic concerns suggest the desirability of the FDIC having power to sell the affiliated banks together to retain going concern value. Equity also favors protecting the insurance fund compared with protecting shareholders or affiliate shareholders who may have contributed to the insolvency. From a public choice perspective, the existence of a concentrated group that absorbs the cost of the cross-guarantees provision suggests a potentially important political check on excesses in the area.[249] The combination of plausible policy rationales and potential political checks on the FDIC gives a fairly strong justification for current cross-guarantees law.

2. D'Oench *Powers.* The FDIC and thrift agencies have invoked both systemic effects and insider abuse as justifications for expansive *D'Oench* powers. Although these justifications seem strong for the core example of regulators defrauded by secret agreements, *D'Oench* powers have been extended to new cases where the justifications are less strong, and where the agencies have not yet clearly come forward with supporting rationales.[250]

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change furthered the FDIC policy of encouraging banks to use subordinated debt while reducing the costs to the solvent banks that rely on such debt.

248. This conclusion rests on the plausible empirical assumption either that a significant amount of such insider transactions took place, such as in Texas, or that the prophylactic rule prevents significant transactions that would have taken place in its absence. *See supra* notes 231–40.

249. The banking industry was successful in having an expanded version of the cross-guarantees power deleted from the 1991 banking legislation. The expanded version would have, *inter alia*, required non-bank affiliates to guarantee the FDIC for up to 5% of losses incurred by affiliated banks. *Senate Banking Starts Marking up Major Banking Bill; Action Very Slow*, 57 Banking Rep. (BNA) 205, 206 (Aug. 5, 1991).

250. *See supra* text accompanying notes 50–69 (listing numerous categories of claims or defenses barred by *D'Oench* powers).

a. D'Oench *powers and systemic effects.* Banking agencies have invoked a number of systemic reasons for broad *D'Oench* powers. Most importantly, the entire system of deposit insurance depends on the ability of regulators to assess a bank's books. Strict rules against unwritten agreements can thus be justified in order to allow regulators to supervise lawful behavior in solvent institutions and to decide when to declare insolvency. In turn, accurate decisionmaking by regulators should reduce costs to the insurance fund.

Institutional factors also argue for strong *D'Oench* powers. *D'Oench* powers are similar to cross-guarantees in that they help the FDIC speedily determine the value of an insolvent bank. The FDIC has argued that this speedy determination helps it meet its statutory obligation of choosing the least-cost means of resolving the institution.[251] There is also an unusual difficulty in getting reliable testimony from the bank employee, often an officer, who took action prior to insolvency that forms the basis for the third party's claim or defense.[252] On the one hand, the employee has typically been fired, has no particular loyalty to the receiver, and may have more loyalty to the other party to the agreement. Therefore, the employee may not testify as helpfully to the bank as would a current employee. On the other hand, the employee may be facing an enforcement proceeding for actions that contributed to the insolvency. Therefore, the employee may have incentive to testify even more helpfully to the government than truth would warrant. In light of these conflicting impulses, a clear *D'Oench* rule preventing the use of such testimony may be desirable.

The strength of these systemic arguments, however, is far from clear. As to the reliability of employee testimony, the legal system faces innumerable factual settings where witnesses have incentives to distort the truth. Nevertheless, testing truth through

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251. Until 1991, the FDIC had the obligation to liquidate the institution unless another means would be less costly to the fund. 12 U.S.C. § 1823(c)(4)(A) (1988). The Supreme Court found that this obligation was a crucial factor in its decision to give a very expansive interpretation to § 1823(e). Langley v. FDIC, 484 U.S. 86, 91–92 (1987). FDICIA now requires the FDIC to choose the least-cost means of resolution, and not merely to find that its preferred means is less costly than liquidation. 12 U.S.C. § 1823(c)(4)(A)(ii) (Supp. III 1991).

252. The difficulty will be even greater in the event that the employee is no longer readily available to testify. Thanks to Saul Levmore for pointing out the incentives facing these employees.

cross-examination is usually considered superior to excluding entire categories of claims from the courtroom (although more nuanced rules could be developed where the risk of inaccurate testimony is greatest). And the fears of inaccurate testimony must be great to justify defeating otherwise valid claims of third parties, individual claims which range into the millions of dollars.[253] Moreover, similar incentives can exist for former employees of an ordinary corporation in bankruptcy, yet there is no similar rule barring oral claims and defenses in bankruptcy.

The systemic advantages of speedy bank valuation are even more dubious. The available empirical evidence suggests that *D'Oench* factors have not historically been important to the agencies' decision of whether to liquidate.[254] Indeed, it is difficult to understand how the agency could make a loan-by-loan assessment of a bank's balance sheet in time to make its determination as to the least-cost means of resolution.[255] Furthermore, contractual means are well known for selling a bank quickly even when uncertainty exists as to its value, so that *D'Oench* powers do not materially speed the ability of the agency to sell the institution.[256]

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253. *E.g.*, *Langley*, 484 U.S. at 86 (claim of over $5 million defeated by § 1823(e)).

254. *See* James R. Barth et al., *The Cost of Liquidating Versus Selling Failed Thrift Institutions: Presentation at the Annual Meetings of the Eastern Finance Association* (Apr. 1990), *reprinted in Transactions to Resolve Failed Depository Institutions, 1990: Hearing Before the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 2d Sess. 620 (1990). This study performed a regression analysis on 26 liquidations and 179 sales of thrifts for 1988 failures. *Id.* at 622. The two key determinants of whether to liquidate were the amounts of core deposits and tax benefits. *Id.* at 632. *D'Oench* issues were apparently subsumed within a less important factor labelled "bad assets," a broad category defined as "including acquisition, development and construction loans, real estate owned and direct investments." *Id.* at 630. Nothing in the study suggests that the amount of assets protected by *D'Oench* powers was important to the FDIC's decision whether to liquidate—contrary to the position put forward by the FDIC and accepted by the Supreme Court in *Langley*. *See* 484 U.S. at 91.

The study was conducted under the assumption of current *D'Oench* law. In the absence of the FDIC's *D'Oench* powers, it is therefore possible that the decision whether to liquidate would be affected by the level of assets for which the FDIC could no longer take advantage of *D'Oench* powers. However, this hypothesis seems implausible given the study's conclusion that the total level of *all* bad assets was not central to the FDIC's decision. *See* Barth et al., *supra*, at 632.

255. *See* Gunter v. Hutcheson, 674 F.2d 862, 865 (11th Cir. 1982) (noting that "a purchase and assumption must be consummated with great speed, usually overnight"), *cert. denied*, 459 U.S. 826 (1982); *see also* Flint, *supra* note 3, at 504 (arguing that least-cost test as a reason for broad *D'Oench* powers is "a perversion of the truth").

256. The agencies have faced precisely that problem when insolvent banks have had large and uncertain amounts of bad loans. In such circumstances, the agencies have

Even if *D'Oench* powers do not clearly offer systemic advantages, they may be justified as doing little or no harm in the long term. Persons doing business with banks in the future should conform their conduct to the *D'Oench* rules. For instance, borrowers will insist that contracts and contract modifications meet the strict conditions of section 1823(e). To the extent that borrowers cannot control how the bank keeps its written records, they will place a risk premium on transactions with banks.[257]

This story of the market smoothly adjusting may be too rosy, however. From an equitable point of view, agency superpowers unfairly harm those who are ignorant of the intricacies of *D'Oench* doctrine, such as consumer borrowers. The superpowers are unfair during the transitional period when bank insolvency is becoming more common and *D'Oench* powers more expansive—good-faith transactions will be vitiated by *D'Oench* powers, and bank receivers will recover more value than the amount for which the bank had originally bargained. From an efficiency point of view, expansive *D'Oench* powers may also have significant costs. Contracting around the new *D'Oench* rules will be costly, such as when a mere contract modification might require an entirely new loan origination in order to meet the strict terms of section 1823(e).[258] Bor-

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sometimes sold the bank subject to the buyer keeping a put option for bad loans. The agencies have also sometimes sold banks for a given price, with the insurance fund and buyer then sharing in recovery of bad loans. *See* John W. Milligan, *The Man Selling America's Busted Banks*, INSTITUTIONAL INVESTOR, Jan. 1992, at 39, 39 (describing FDIC strategies). Similarly, the agencies could sell banks with put options or profit-sharing related to the level of successful claims that would have been unsuccessful in the presence of *D'Oench* powers. Alternatively, the agencies could develop information about the typical level of *D'Oench* problems in various categories of banks, so that buyers could estimate likely costs.

Note that these pricing mechanisms for handling uncertainty are likely to be less helpful in handling payments from affiliated banks and thrifts. The systemic arguments for cross-guarantees thus seem stronger than for broad *D'Oench* powers. Cross-guarantees help assure going concern value, unlike *D'Oench* powers. *See supra* text accompanying notes 241–43. Cross-guarantees also regulate the often-enormous flows among entities in a holding company; by contrast, sums involved in otherwise valid claims that are defeated by the *D'Oench* powers are much smaller. *See supra* note 254 (describing limited size of *D'Oench* claims compared with total bank assets).

257. That is, a borrower seeking financing either from a bank or a non-bank finance company will, *ceteris paribus*, require a lower interest rate from the bank due to the risk that the borrower's valid position will be defeated by the *D'Oench* power if the bank goes insolvent.

258. Reorigination may be necessary in order to meet the requirement that the writing in the bank records be "contemporaneous" with approval by the board of directors.

rowers may have to engage in costly monitoring of bank records in order to assure that defenses are maintained. Moreover, borrowers may engage in costly monitoring of the solvency of their bank in order to minimize the risk that *D'Oench* powers will be invoked in insolvency. Nevertheless, there is little reason to think that bank borrowers will be efficient monitors of bank solvency, in light of the common assumption that borrowers rely on their banks for financial expertise.[259] Finally, as discussed further below, expansive *D'Oench* powers likely have harmful effects on the banking system when combined with the numerous other superpowers.

b. D'Oench *powers and the "model of insider abuse."* The *D'Oench* case itself involved a "secret agreement" between bank and borrower, so that the bank's books became inaccurate and regulators could not properly assess the bank's solvency. From the perspective of insider abuse, strict rules against secret agreements are a natural protection against and cure for this sort of fraudulent behavior. Oral agreements and other schemes that are not fully reflected in a bank's records provide a ripe opportunity for third parties to take advantage of a bank, at the ultimate expense of the insurance fund. If "secret agreements" are the dominant sort of activity defeated by the *D'Oench* doctrine, then the current strict rules would have the signal advantage of saving litigation costs compared to requiring the receiver to litigate each claim or defense on the merits.[260]

From the perspective of insider abuse, the key empirical question is whether agreements affected by *D'Oench* powers are usually abusive. If most affected claims or defenses arise from ordinary business transactions, then it is hard to justify rules that defeat claims and defenses that would have won outside of insolvency.[261]

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259. *See supra* note 177 (secured credit literature on the role of expert lenders, often banks).

260. *See* Langley v. FDIC, 484 U.S. 86, 92 (1987) (noting that requirements of § 1823(e) "prevent fraudulent insertion of new terms, with the collusion of bank employees, when a bank appears headed for failure").

261. James J. White and Robert S. Summers apparently believe that many current *D'Oench* cases are of this good-faith variety, when they state that "the effect of these decisions is to place the loss resulting from bank failure on the backs of *a random and indiscriminately-selected group* of debtors, instead of putting the burden on the taxpayers as a whole who presumably are those who principally profit from deposit insurance."

It is difficult to assess whether the bulk of *D'Oench* cases involve insider abuse. Government attorneys believe that they do.[262] But as the fact patterns depart more and more from secret agreements to defraud regulators, the "model of insider abuse" offers less justification for expansion of *D'Oench* powers. For instance, the "model of insider abuse" offers no reason to defeat a borrower's usury defense when the FDIC seeks to collect as receiver. The borrower was the victim of an illegal loan, not the collaborator on a scheme to defraud the bank or its regulators. Yet courts have granted the FDIC summary judgment on just such cases.[263] It is similarly unclear why *D'Oench* policies should trump many other contractual and statutory rights that would otherwise win against the bank.[264]

The rationale of insider abuse is further weakened in light of the many other powers that banking agencies have recently gained. Since FIRREA, banking agencies have a broad array of enforcement powers against solvent banks that should detect, deter, and punish a large portion of abusive agreements. Even if the abusive agreements remain undetected until insolvency, the receiver takes over the books of the bank and gains the ability to bring lawsuits in the bank's name for breaches of duty against the bank. After insolvency, the primary banking regulator can still institute enforcement actions, and the receiver can pursue the institution-affiliated party with superpowers such as the ability to freeze the party's assets. The sum of these agency powers makes it less likely that there will be abusive agreements, and more likely that sufficient recourse can be had, apart from *D'Oench* powers, in the event such agreements occur.

c. D'Oench *powers and public choice.* At least in the first instance, the concentrated benefits to the FDIC of easy collection of assets are paired with a very diffuse affected group—primarily, borrowers who receive loans from banks that

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WHITE & SUMMERS, *supra* note 132, at 650 (emphasis added). By contrast, if *D'Oench* rules are invoked in cases of pervasive abuse, then the affected debtors are anything but "a random and indiscriminately-selected group."

262. Parker Interview, *supra* note 15.

263. FDIC v. Claycomb, 945 F.2d 853, 861 (5th Cir. 1991), *cert. denied*, 112 S. Ct. 2301 (1992).

264. For a listing of the types of claims defeated by *D'Oench*, see *supra* text accompanying notes 50–69.

later become insolvent.[265] These borrowers are generally smaller corporations, which do not have permanent legislative staff in Washington.[266] Except for the little-known intricacies of the *D'Oench* rules, these relatively small companies have no common basis or preexisting institutional forum for mobilizing politically. Furthermore, at the time *D'Oench* powers were expanded in 1987 and 1989, it is likely these companies individually did not know the legislation affected them.[267] In the absence of effective political checks on the FDIC, there is thus special reason to fear that *D'Oench* powers have been extended beyond their justifiable scope.

d. Assessing D'Oench *powers.* The case for *D'Oench* superpowers is strongest in its original application to secret agreements, which involve both insider abuse and systemic harm to regulators' ability to police the banking system. As the scope of *D'Oench* powers has expanded, however, the equitable and effi-

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265. As is often the case, the actual incidence of costs is less clearly identifiable. As *D'Oench* powers become more widely known, borrowers will attach a risk premium to (expect a discount on the loan rate for) dealing with a bank as it nears insolvency. In addition, borrowers will demand elaborate and costly written approval for all changes in loan contracts, as an imperfect hedge against the possibility of lender insolvency. Banks that are at risk of insolvency will thus share the burden of *D'Oench* powers with their borrowers. The public choice question then becomes how effective potentially insolvent banks would be at lobbying against the FDIC on the issue. I suggest that the costs remain diffuse, and the FDIC would thus remain at a considerable advantage. First, as discussed above, nearly insolvent banks generally face important obstacles to achieving political goals. *See supra* text accompanying note 207. Second, the number of potentially insolvent banks is itself quite large, although not so large as the number of those banks' borrowers, and not historically organized in a separate political organization. Third, potentially insolvent banks, to the extent they are organized, likely would place a higher priority on issues that most directly affect current management and shareholders. The political focus would be on keeping incumbent management in place, not on affecting legal doctrines that apply to third parties, only in insolvency, and after management is removed.

266. The largest, most creditworthy corporations typically raise their short-term capital by issuing securities in the commercial paper market. *See supra* note 119.

267. The timing of the agencies' *D'Oench* victories is itself explicable in public choice terms. As failures mounted, first among thrifts, and then among banks, it became a higher priority of the relevant agencies to have strong and systematic *D'Oench* powers, because the powers were becoming more important to maximizing the insurance fund. As a higher priority, the issue would receive a greater share of the agency's scarce lobbying resources. In fact, the FHLBB won significant expansion of *D'Oench* powers in 1987, as part of the first infusion of money into the thrift fund. As bank and thrift failures continued to mount through 1989, the FDIC was able to systematize and expand *D'Oench* powers in FIRREA. *See generally* ZISMAN, *supra* note 3, § 25.04–.07 (describing the scope and operation of the *D'Oench* doctrine).

ciency arguments of the agencies have become weaker. The recent rounds of agency legislative victories, coupled with the lack of effective political checks, give strong reason for concern that the superpowers have gone too far.[268]

B. *Assessing the Overall Effects of the Special Bank Insolvency Regime*

The three accounts developed in this Article suggest that cross-guarantees are probably good policy, but that the *D'Oench* powers have likely been extended too far.[269] The next question is whether the overall regime of bank insolvency is normatively desirable.

Under the "creditors' bargain" model of bankruptcy, a central reason for having the same rules in and out of insolvency is to prevent strategic behavior by the subset of creditors who would benefit by causing insolvency. As discussed below, the FDIC and the purchasers of insolvent banks can benefit substantially from special bank insolvency rules. But many others doing business with a weak or failed bank will lose. To avoid such losses, these third

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268. One way to address this concern is to give less deference to the policies behind *D'Oench* powers where there is a conflict with statutes or other sources of law. A few courts recently have ruled against the FDIC's motions for pre-trial judgment where *D'Oench* arguments have conflicted with other legal provisions. *E.g.*, Bateman v. FDIC, 970 F.2d 924 (1st Cir. 1992) (applying state mechanics lien law); Centex-Simpson Constr. Co. v. Fidelity & Deposit Co. of Md., 795 F. Supp. 35 (D. Me. 1992) (applying Miller Act, 40 U.S.C. § 270(a)); *In re* NBW Commercial Paper Litigation, No. 90-1755 (RCL), 1992 WL 73135 (D.D.C. Mar. 11, 1992) (applying § 12(1) of the Securities Act of 1933, 15 U.S.C. § 77*l*(1)). These cases involve the interpretation of two areas of law that developed largely independently, such as *D'Oench* powers and the securities laws. Congress never revealed its intent as to how to read these statutes together. As *D'Oench* powers expand beyond their original application to secret agreements, there may thus be strong arguments in favor of allowing the other laws, such as the securities laws, to apply.

269. It should be clarified how these normative assessments mesh with the descriptions of how the special insolvency rules developed. In Part II, the Article took no position on the disputed issue of how dangerous bank runs are to the macroeconomy. That dispute is not relevant to the assessments of cross-guarantees and *D'Oench* powers. The presence or absence of the superpowers would not seem important to whether contagious runs develop. In Part III, the Article suggested that current and future failures are increasingly likely to be due to stiff competition rather than insider abuse. The analysis in Part V suggests that cross-guarantees are likely a well-targeted approach for limiting insider abuse that would continue to exist in the absence of the superpower. By contrast, the numerous extensions of *D'Oench* powers have likely been based on an outmoded presumption that failures are caused only or primarily by insider abuse.

parties have an incentive to "run" from the bank, with costly consequences for the banking system.

1. *An Example: Effects of Special Bank Insolvency Rules on a Nearly Insolvent Bank.* A helpful way to understand this modern form of bank run is to think concretely about a particular bank that is nearing insolvency. Banks are subject to a general capital requirement of eight percent of assets, of which at least half (four percent) must be "Tier 1" (primarily, equity) capital.[270] The "prompt corrective action" rules, enacted in 1991 and scheduled to take full effect in 1993, subject banks to increasingly tight restrictions as their total capital drops toward two percent. When capital falls to two percent, the law ordinarily requires the regulator to declare the bank insolvent within ninety days, and to appoint a receiver.[271] The analysis here will focus on a bank under the early closure rules that has three-percent capital, and examine the effects of the special insolvency rules on that bank's situation.[272]

Those doing business with a three-percent-capital bank face the risk of numerous special insolvency rules if capital falls to two percent. A partial list of such rules includes: cross-guarantees; *D'Oench* powers affecting bank borrowers and others; broad fraudulent conveyance rules; strong rules for breaking burdensome contracts and leases; powers to seek and freeze assets related to the insolvency; and the early closure rules themselves, shifting the usual point of insolvency from zero-percent to two-percent capital. Although no empirical studies exist on the effects of the insolven-

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270. 12 C.F.R. pt. 3 app. A § 4(b)(1) (1992) (OCC final rule); 12 C.F.R. pt. 208 app. A, part IV.A. (1992) (Federal Reserve final rule); 12 C.F.R. pt. 325 app. A, part III.A. (1992) (FDIC final rule); *see also* 53 Fed. Reg. 8550, 8551 (1988) (joint proposed rule on risk-based capital standards).

271. 12 U.S.C. § 1831o (Supp. III 1991).

272. A large number of banks and thrifts are currently far below the required minimum levels. As of the summer of 1991, the OTS had identified "378 savings and loans with $261 billion in assets as troubled institutions with poor earnings and low capital," many already scheduled to be turned over to the RTC. *The Structure of the Savings and Loan Bailout: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 102d Cong., 1st Sess. 48, 51–52 (1991) (statement of James R. Barth, Lowder Eminent Scholar in Finance, Auburn University). As of March 1992, the FDIC reported $607 billion in assets for 1,051 institutions on its "problem list," up from $409 billion at the end of 1990. FDIC Q. Banking Profile 11 (1st Quarter, 1992 and 4th Quarter, 1991).

cy rules, informed judgments suggest that the combined effect of the rules is substantial.[273]

Special insolvency rules will affect many of the groups that have business dealings with a nearly insolvent bank: equity holders; debt holders; other creditors, such as trade creditors, landlords, and depositors; borrowers; and bank personnel, including directors and officers. The effects of special insolvency rules on each of these groups will be examined in turn.

a. Equity holders. A major effect of strict insolvency rules will be to discourage investment in banks, especially nearly insolvent banks. This basic conclusion applies to efforts by a nearly insolvent bank either to be taken over by another bank or to raise capital itself through issue of stock. The obstacles such banks face in raising capital mean that strict insolvency rules are in tension with the major regulatory goal of encouraging banks to have higher capital.

A crucial factor is that an acquiror will prefer a bank that has gone through insolvency to a bank that is nearly insolvent. A number of reasons support this preference. First, the advantages of *D'Oench* rules will usually accrue to whomever purchases the insolvent bank from the receiver.[274] The acquiror thus takes the bank free from secret agreements, oral contracts, and all other legal claims and defenses that are defeated by today's expansive *D'Oench* rules. Second, the acquiror will take advantage of the power to break disadvantageous contracts and leases. Notably, this power allows the acquiror to cancel above-market certificates of deposit, which can be a major saving if interest rates have declined.[275] In declining real estate markets, the ability to cancel above-market leases can also be important. Third, the agency may offer protection to the acquiror of an insolvent bank concerning

273. Harrison Young, Director of the FDIC Division of Resolutions, has stated that "closed bank protections are important, and will be a drawback to early resolution" of banks, where the banks do not first go through insolvency. Speech at Prentice-Hall Conference on Contracting, Litigating and Dealing with the RTC and FDIC (Oct. 29, 1991); *see* William Isaac, *Praise for Ryan—and Some Advice*, AM. BANKER, Apr. 9, 1992, at 4, 4 (noting that insolvency needed to rid many weak institutions of "extensive leases or other obligations that no acquiror would want to assume").

274. *See* ZISMAN *supra* note 3, § 25.06[5] (collecting cases).

275. *See* Alan Greenspan, Statement to Senate Comm. on Banking, Housing and Urban Affairs (Feb. 25, 1992), *in* 78 Fed. Res. Bull. 264 (1992).

bad loans, which are often difficult to value at the time of sale.[276] By contrast, the acquiror of a nearly insolvent bank must bear the risk of bad loans. Fourth, the acquiror will typically take over the assets of the insolvent bank freed from the risk of cross-guarantees.[277] By contrast, an acquiror of a nearly insolvent bank is putting its current banks and thrifts at risk for subsequent losses to the insurance fund. Fifth, other insolvency rules, such as the fraudulent conveyance rules and the rules allowing freezing of assets, will help the acquiror marshal assets.[278]

The net result of these factors is that a potential acquiror has strong reason to wait for a nearly insolvent bank to be declared insolvent. Declaration of insolvency acts as a sort of "magic wand" that increases the value of the target to the acquiror. This "magical" transformation unambiguously comes at the expense of various groups that have previously done business with the bank, such as borrowers, depositors, and others who have existing contracts. When an acquiror waits until after insolvency, the effect on the insurance fund is generally worse than if the acquisition had taken place pre-insolvency. The fund is benefitted by superpowers that allow it to collect assets more easily. But the fund is hurt by the consequences of the failure occurring, such as taking on the risk of bad loans and losing the protection of cross-guarantees. Once failure occurs, the fund takes on the risk in the amount that insured deposits exceed recovery on assets.[279]

Equity holders in the nearly insolvent bank are clearly hurt by the combined effect of special insolvency rules. No matter what

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276. The FDIC has in the past accepted arrangements for sharing the risk of non-collection, or allowed acquirors for a specified period to put bad loans back to the FDIC. *See supra* text accompanying notes 127–28.

277. The FDIC has adopted an informal, but regularly followed, policy of waiving the application of cross-guarantees to acquirors of insolvent banks. By contrast, acquirors of nearly insolvent banks face considerable uncertainty as to whether they will be granted a discretionary waiver of cross-guarantees under 12 U.S.C. § 1815(e)(5) (Supp. III 1991). In order to encourage acquisitions before insolvency, the FDIC could consider clarifying its criteria for granting waivers, in, say, a rulemaking or public policy statement.

278. The ability of the acquiror to take advantage of these superpowers depends on the terms of its purchase from the receiver. The FDIC or RTC may retain the power to marshal assets in these ways. If the agencies do so, the superpowers still increase the total worth of the insolvent bank to be divided between the agency and the acquiror.

279. The insurance fund may benefit in the long run from the effect that strict insolvency rules play in deterring banks from falling to three percent capital. This issue is discussed below. The fund could also benefit if the costs post-insolvency are less than FDIC costs of assisting an acquisition pre-insolvency.

level of capital a bank has initially, the insolvency rules create greater risk, requiring a higher return for investors, and less investment in the banking industry. The "magic wand" effect means that insolvency is more likely than it would be in the absence of special insolvency rules—the FDIC will be tempted to accelerate a closure in order to find a willing buyer. Making the standard assumption that a corporation faces a distribution of probable results from its business strategy, bad results can occur even for initially well-capitalized banks. Bad business luck or decisions could send capital down toward three percent, causing acute difficulties in raising capital at that point.[280]

At the risk of badly mixing metaphors, one might thus conclude that the "magic wand" for the acquiror will seem instead to be a "black hole" for current equity holders. The special insolvency rules will mean that new equity will be increasingly difficult to raise as a bank gets sucked down toward the vortex of the two-percent-capital level. The only available means of raising capital may be retained earnings, and, as discussed below, those too may be difficult to find.

b. Debt holders. Special insolvency rules will have similar effects on equity holders and those who hold bank debt raised in capital markets.[281] Most generally, the increased likelihood of insolvency caused by insolvency rules means there is greater default risk on debt, thereby increasing required return and decreasing supply of capital. More specifically, the cross-guarantees provision will reduce the supply of funds for bank debt. The holding company and its non-bank subsidiaries do not themselves have to pay the cross-guarantees; however, they will be reluctant to supply debt to an affiliated bank because in the event of insolvency, payments on that debt will be subordinated to the FDIC and all other claimants.[282] The bank with three-percent capital will thus likely

280. This result could occur, for instance, if real estate values and business activity in the bank's region fall sharply, a not improbable scenario.

281. Effects of insolvency rules on depositors and general creditors, who are debt holders in the broadest sense of the term, are discussed below.

282. A provision in the early closure rules will also somewhat reduce the supply of subordinated debt. Under FDICIA, no payment of principal or interest on subordinated debt can be made beginning 60 days after an institution becomes "critically undercapitalized." 12 U.S.C. § 1831o(h)(2)(A) (Supp. III 1991). Section 1831o(h)(3)(A)(i) provides that a receiver will be appointed for the critically undercapitalized institution within 90

have great difficulty getting debt financing either from the capital markets or from its affiliated entities.

c. Other creditors. For purposes of bank insolvency rules, a trade creditor, a landlord, and a depositor are quite similar. If the three-percent-capital bank becomes insolvent, each will have a contract (or lease) that is subject to the receiver's superpowers. Favorable contracts will be terminated. Unwritten terms in the contracts, such as modifications excusing some performance by a trade creditor, will be unenforceable due to *D'Oench* powers. Past transactions will be subject to scrutiny under the strict fraudulent conveyance provisions, which have a special five-year statute of limitations. Non-deposit creditors will be subject in an increasing number of states to "depositor preference" statutes, which place depositors ahead of other general creditors. Because deposits typically make up such a large fraction of total bank liabilities, other claimants will often receive only a small fraction of the par value of their claim.

In the face of such risks, these contract beneficiaries will have an incentive to grab assets before insolvency, to reduce the amount of credit extended to nearly insolvent banks, or to place a growing risk premium on doing business with the bank as it nears insolvency. These actions will hurt a bank's earnings, further increasing the likelihood of insolvency. Contract beneficiaries will thus contribute to the "black hole" phenomenon of a nearly insolvent bank becoming insolvent. Even many insured depositors will prefer to do business with a well-capitalized bank, in order to reduce the interest rate risk associated with the possible cancellation of an insolvent bank's certificates of deposit.

d. Borrowers. Borrowers will be in a position similar to the contract beneficiaries, and will seek to withdraw their business as the bank nears insolvency. *D'Oench* powers, especially the strict list of requirements of section 1823(e), create a significant risk that valid defenses to collection will be barred in insolvency.

The possibility of insolvency is itself a reason for borrowers to seek alternative funding. Loans are unlikely to be renewed once

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days, so the special subordinated debt provision is likely to have only an incremental effect. Both § 1831o(h)(2) and § 1831o(h)(3) are subject to a limited power of the FDIC to allow exceptions.

the bank enters receivership, and loan officers who approved the existing loan may well lose their jobs. Because borrowers will perceive the "black hole" phenomenon, they will have reason to move their business. The best borrowers will leave first, saddling the nearly insolvent bank with a growing proportion of riskier loans that cannot get alternative financing. Profits on lending will thus become difficult to achieve at just the time that the three-percent-capital bank has few other sources of funding.

e. Bank personnel. Bank personnel in a nearly insolvent bank, especially directors and officers, will have great reason for worry.[283] Their personal assets will be subject to extraordinary rules, including readily available freezes, and strict rules against dischargeability of their bank-related debts in bankruptcy. The FDIC has won the early rounds of litigation aimed at making some directors and officers of insolvent banks subject to a negligence standard of liability, rather than the gross negligence standard applied to ordinary corporations.[284] When the bank becomes insolvent, as it is likely to do once three-percent capital is reached, directors and officers will typically lose their jobs.[285] The remarkable enforcement powers of bank regulators apply both before and after insolvency, and authorize fines of up to $1 million per day for violations of banking regulations. A new pitfall is that the compensation paid to officers can be the basis of an enforcement action: Critically undercapitalized banks are forbidden from "[p]aying excessive compensation or bonuses,"[286] whatever that vague phrase turns out to mean.

Faced with such an array of sanctions, qualified persons might well decide not to accept the privilege of being directors or officers of weakly capitalized banks. The complexity of modern bank regulation makes it quite possible to violate one rule or another

283. An especially pessimistic view for bank personnel is given in Timothy D. Naegele, *Rabid Regulators Want Your Hide*, AM. BANKER, May 27, 1992, at 4, 4 ("Why should any employee feel safe under these circumstances? The answer is that none should . . . .").

284. FDIC v. Canfield, 967 F.2d 443, 445–46 (10th Cir. 1992).

285. This is the clear rule under FDICIA. 12 U.S.C. § 1831o(f)(2)(F)(ii) (Supp. III 1991).

286. 12 U.S.C. § 1831o(i)(2)(F). In addition, § 1831o(f)(4) restricts compensation to senior executive officers for significantly undercapitalized institutions and undercapitalized institutions that fail to submit acceptable capital restoration plans.

inadvertently, with possibly calamitous effects on a person's career and personal finances. Senior bank personnel might fear that enforcement officials will assume insider abuse and thus prosecute vigorously, even when bank failure is caused by competitive pressures.[287]

The result of these risks is that the most qualified persons, those with the greatest opportunity to move to safer jobs, will abandon weakly capitalized banks. These banks as a group will thus suffer from weaker management, further increasing the likelihood of failure.[288]

2. *Assessing the Current Regime.* The example of a bank with three-percent capital shows the result of a large gap in the law applying to banks in and out of insolvency. It will be very difficult for the nearly insolvent bank to raise capital, whether from capital markets, affiliated entities, or retained earnings. There will be monitoring costs on those who do business with banks, such as on insured depositors who risk having their certificates of deposit cancelled. There will be a risk premium on doing business with weakly capitalized banks. Bank personnel who can gain employment elsewhere will leave weakly capitalized banks, depriving the banking system of quality management where it is most needed.

Large differences in pre- and post-insolvency law can thus create the "black hole" effect, by which nearly insolvent banks fall almost inevitably into insolvency. A modern sort of bank run will result, in which those doing business with a bank will attempt to withdraw their business as the bank's capital falls. The likely result

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287. The creation in the Department of Justice of large civil and criminal enforcement staffs, to complement existing agency enforcement staffs, would support the concern that numerous prosecutions will be brought in the area of bank failures. *See* Stanley S. Arkin & Lorraine Massaro, *Thrift Crime: A Target for the Prosecutor's Posse, Part I—Legal Exposure*, N.Y. L.J., Nov. 13, 1990, at 1, 6 (describing "immense machinery being assembled to investigate and prosecute financial fraud").

288. The general contraction of the banking industry may soften the effect of this flight of quality personnel. The shrinking number of banks, and the large layoffs at many existing banks, will create a pool of experienced bank managers who need new jobs. *See* Teresa Carson, *Bankers' New Year Hope: Don't Let the Ax Hit Us; Tens of Thousands of Jobs to Vanish in '92*, AM. BANKER, Jan. 2, 1992, at 1 (1992 banking job losses will number in the tens of thousands, with a 10% to 30% shrinkage predicted by the year 2000). Some of these managers may choose to work for weakly capitalized banks despite the risks.

is that the FDIC and RTC will have to resolve a far higher number of insolvencies than would have occurred in the absence of the superpowers.

An increased number of failures will be expensive.[289] The going concern value of the bank will be destroyed.[290] Previously, the FDIC could capture much of this going concern value in the form of a premium from a willing buyer.[291] In recent years, the size of the premium has shrunk dramatically, due apparently to a glut of failed institutions and the constrained capital positions of possible acquirors.[292]

As hundreds of failures occur, there are large deadweight losses that arise from shuffling so many assets. Christopher James has estimated that administrative and legal expenses associated with bank failures in the 1980s averaged ten percent of the banks' assets.[293] Transaction costs are particularly large for the FDIC and RTC, which face numerous constraints not imposed on private actors.[294] Deadweight losses also occur for those doing business with the bank pre-insolvency, as the higher likelihood of insolvency and the special insolvency rules require increased monitoring costs.

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289. One recent study concluded that "the magnitude of the direct costs associated with bank failures (10 percent of the failed bank assets) suggests that the costs of thrift and bank failures are substantial. Moreover, the direct costs of failure appear to be larger than the direct costs of bankruptcy for nonfinancial firms." Christopher James, *The Losses Realized in Bank Failures*, 46 J. FIN. 1223, 1241 (1991).

290. The going concern value is most strongly associated with the amount of "core" deposits in the bank, defined as total deposit accounts below $100,000. *See id.* at 1237.

291. Economists have presented evidence that going concern values for banks arose principally from barriers to entry in local loan and deposit markets. *See, e.g.*, Stephen A. Buser et al., *Federal Deposit Insurance, Regulatory Policy, and Optimal Bank Capital*, 36 J. FIN. 51 (1981); Alan J. Marcus, *Deregulation and Bank Financial Policy*, 8 J. BANKING & FIN. 557 (1984).

292. Premiums received by the RTC for its first two years of operation averaged 1.4% of deposits, far below traditional levels. *Buyer's Market for Bank Branches*, U.S. BANKER, Jan. 1992, at 28, 28.

293. James, *supra* note 289, at 1225.

294. For instance, the FDIC and RTC are required by Congress to cap the amount of legal work for them by each law firm, which limits development of expertise and economies of scale. Marianne Lavelle, *FDIC/RTC Fees to Outside Counsel Are Up Sharply*, NAT'L L.J., Mar. 9, 1992, at 17. Other strict rules place a high overhead on the hiring of the myriad contractors on which the RTC especially must rely to marshal assets. *See, e.g.*, *RTC Revises Contract Policies on Financial Defaults, Litigation*, 59 Banking Rep. (BNA) 144, 144 (July 27, 1992); *RTC Issues Final Rule Prohibiting Sales to Insiders Who Benefit from Wrongdoing*, 59 Banking Rep. (BNA), 144, 144–45 (July 27, 1992).

There will be allocative effects from the hundreds of billions of dollars of assets flowing through the FDIC and RTC. The agencies' decisions about how to sell these assets, affected by unique bureaucratic rules and political considerations, will have a great effect on the markets for bank assets. In particular, otherwise efficient transactions with nearly insolvent banks, such as takeovers of weakly capitalized banks, may not take place because of the distortions caused by the "black hole" effect.[295]

Most generally, the larger number of failures may well impose a net cost on the insurance funds. The short-term benefits from the superpowers, such as recovery on *D'Oench* cases, may be outweighed by the long-term cost to the insurance fund of the additional failures. Strict insolvency rules, intended to reduce costs to the fund, can instead cause increased costs.

It is worth considering whether these costs of the "black hole" effect are outweighed by benefits from the current regime of bank insolvency law, especially some long-term incentive effects. Those doing business with banks, such as investors, borrowers, and bank officers, should now be on notice of the strict new rules. Over time, these actors may develop efficient ways to limit their exposure to losses from the superpowers, such as by developing new standard-form contracts.[296] Knowing that a three-percent-capital bank will likely become insolvent, insiders will have a powerful incentive against allowing the bank ever to become undercapitalized. This fear of insolvency can sharply limit the moral hazard, and consequent incentive for excessive risk-taking, that deposit insurance otherwise creates for bank owners and managers. Decisions by banks could thus better approximate economically efficient decisions that would occur in the absence of deposit insur-

295. In assessing the overall effects of the superpowers, care should be taken to distinguish the rule shifting the point of insolvency from zero percent to two percent. First, the two-percent-capital rule does not contribute to the "black hole" effect. The early closure rule simply shifts the point of insolvency, without changing the incentives of actors when the bank is, for example, one percent from insolvency. Second, such a rule may be justified by the failure of banks to use market value accounting and the experience of regulators that the point of economic insolvency is likely to be well above zero-percent capital calculated at book value, and sometimes above two-percent capital. The two-percent-capital rule may therefore be a better approximation than a zero-percent-capital rule of the appropriate time to declare insolvency.

296. Discussions with practitioners suggest, for instance, that borrowers are trying to ensure that banks comply with § 1823(e), and creditors are beginning to seek ways to obtain risk premiums as a bank nears insolvency.

ance.[297] Future costs to the insurance fund will be reduced because banks will avoid falling to three-percent capital, whereas previously they could fall to zero percent or even below, before being declared insolvent.[298] Under this optimistic view of the current regime, the risk premiums and monitoring costs for those doing business with banks can be seen as mechanisms for reducing bank failures, rather than as disagreeable costs.

This view, however, is too optimistic for four reasons. First, there are transition costs of moving to the early closure approach. For the hundreds of banks that are already undercapitalized, the "black hole" effect will lead to large costs from additional insolvencies, without concurrent benefits of encouraging better banking. Even well-managed banks have no ready way to avoid the fall into insolvency.

Second, it is not clear whether the strict closure rules will achieve their intended effect of deterring low bank capital. As discussed above, future bank failures are likely to come increasingly from stiff competition rather than insider abuse. The banks' loss of monopoly position, and the pressures for major consolidation of the industry,[299] mean that many banks will likely merge or become insolvent within the next few years, even in the absence of insider abuse. Under the model of stiff competition, failure occurs when the bank experiences the bad end of the probability distribution. Banks experiencing these bad results can thus be somewhat unlucky, and then have the "black hole" effect pull them down into insolvency. This insolvency, in turn, will trigger the deadweight and other losses discussed above.

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297. A related efficiency may arise from the elimination of weakly capitalized banks, who have offered especially high interest rates on deposits in order to gain funding and stave off insolvency. If weakly capitalized banks are closed more quickly, then these high rates will no longer have to be met by other banks, which thereby become more profitable. The size of this effect is questionable, however. Under modern market conditions, consumers can readily use money market mutual funds or other close substitutes for traditional bank deposits. The ability of banks suddenly to gain much higher profits is thus doubtful.

298. During the 1980s, the FSLIC often did not have the resources, not to mention the political will, to close all thrifts whose capital had fallen below zero percent on a GAAP (generally accepted accounting principles) basis. Hundreds of insolvent thrifts thus remained open and in private hands, at an ultimate additional cost to the taxpayers of billions of dollars. *See* BRUMBAUGH, *supra* note 8, at 124.

299. An Arthur Andersen study estimated that the number of U.S. banks would drop by 25% in the next ten years. *Study by Andersen Organization and BAI Views Banking in 2000*, BANKING POL'Y REP., Nov. 18, 1991, at 5.

A third result of the current regime will be to make bank managers more risk averse in order to reduce the likelihood that the bank will fall into the capital range where the "black hole" effect exists. At some difficult-to-determine point, the concern about excessive risk-seeking due to moral hazard transforms into a concern about excessive risk aversion, known commonly as a "credit crunch," due to fear of accelerated insolvency. The "credit crunch" may itself have negative macroeconomic effects when borrowers cannot get loans that would be funded by risk-neutral lenders.[300]

A fourth result of the current regime will be to encourage third parties to shift their business from banks to non-banks, which are not subject to the special insolvency rules. To take one example, a company might wish to borrow from a non-bank finance company, in order to avoid the risks of being subjected to *D'Oench* powers. Strict bank insolvency rules are part of a larger pattern of subjecting banks to much stricter regulation than their non-bank competitors. These stricter regulations, including strict insolvency rules, reduce the flexibility of a bank's business decisions. Saddled with stiff competition from non-banks and reduced flexibility to respond to business challenges, banks become more likely to encounter business difficulty. The "black hole" effect can then take over, leading to additional insolvencies.

In sum, the costs of additional failures are clear. The discussion of the "black hole" effect shows, at a minimum, that there is a compelling reason for concern about over-strict bank insolvency rules. The possible benefits of the current regime are far from proven, and are subject to strong counter-arguments. I conclude that there is likely room to cut back on some of the multiple superpowers that now exist. This action would mitigate the "black hole" effect, while retaining a powerful arsenal for the agencies to employ in settings where insider abuse has actually occurred.

VI. CONCLUSION

Even before federal deposit insurance began in 1933, special bank insolvency rules could be explained as ways to assure deposi-

300. Because many bank loans are made to borrowers who lack access to securities markets, significant risk aversion among banks as a group would make loans unavailable to creditworthy borrowers.

tors access to transaction accounts, prevent bank runs, and reduce insider abuse. With the creation of deposit insurance, additional special rules could be justified in order to save the insurance fund and to take advantage of the FDIC's expertise. The thrift crisis of the 1980s could be seen as new reason for strict rules to save the fund and curb losses caused by insiders.

The Article has thus provided a plausible policy rationale for the remarkable regime of special insolvency rules that now applies to banks and thrifts. But such an optimistic view of this regime is probably not warranted. The rules' empirical assumptions about how to save the fund and curb insider abuse are often questionable. In addition, an alternative explanation of the recent strict rules comes from public choice theory, emphasizing the incentives of Congress and the FDIC to create rules far stricter than public policy requires. For these reasons, more careful attention should be paid to whether a sound empirical and theoretical basis exists for particular special rules. The analysis here suggests that the cross-guarantees powers likely have that sound basis, but that the agencies' *D'Oench* powers may well have been extended beyond their justification.

More generally, the Article set forth for the first time an overall conception of the costs of an over-strict bank insolvency regime. The numerous special rules can create the "black hole" effect, in which a weak bank almost inevitably is sucked down into insolvency. This effect results from a modern sort of bank run, as the special insolvency rules cause those doing business with a bank to withdraw their business as the bank's capital falls.

Ultimately, the numerous strict insolvency rules can thus have the opposite of their intended effect. Rules designed to save the insurance fund can end up encouraging additional bank failures, adding to the fund's eventual costs. In an insolvency regime handling hundreds of billions of dollars of assets, agency and congressional efforts to maintain and increase superpowers should be examined critically. At a minimum, the agencies should be required to make fresh showings that the rules are well tailored to actual problems and are not political efforts to avoid blame for the bailout.