TESTIMONY OF

SHARON POWERS SIVERTSEN
ASSISTANT GENERAL COUNSEL
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

THE FEDERAL DEPOSIT INSURANCE CORPORATION'S USE OF THE D'OENCH DUHME DOCTRINE

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

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Mr. Chairman, and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation about our policies for application of the D'Oench doctrine and section 1823(e) and the impact of S. 648, the D'Oench Duhme Reform Act, on the FDIC.

My testimony will briefly describe the D'Oench doctrine and the requirements of section 1823(e); the steps that the FDIC has taken and is taking to balance the public interest in effective banking supervision, resolution, and liquidation with the public interest in the fair treatment of individuals; the public policies served by D'Oench and section 1823(e); and the potential impact of the proposed D'Oench Duhme Reform Act on those public interests.

BACKGROUND ON THE D'OENCH DOCTRINE AND SECTION 1823(e)

What is commonly referred to as the "D'Oench doctrine" is essentially an estoppel doctrine applied by the courts to bar enforcement of secret agreements against the receiver of a failed financial institution. In effect, the doctrine bars reliance upon any secret agreement or arrangement that may tend to mislead financial institution examiners. The D'Oench doctrine arises from a 1942 United States Supreme Court decision, D'Oench Duhme & Co. v. FDIC, 315 U.S. 447 (1942), in which a borrower signed promissory notes to a bank with a secret side agreement that the notes would never have to be repaid. The Court held that the

debtor was estopped from asserting the oral side agreement as a defense. It stated that the FDIC must be able to rely on the institution's books and records to determine the institution's true condition and that allowing the debtor to avoid liability based on an agreement outside the books and records would tend to deceive the regulators.

The related statute, section 1823(e), was enacted as part of the Federal Deposit Insurance Act (FDI Act) in 1950. It specifies four requirements that must be met for agreements to be binding against the FDIC if a financial institution subsequently fails. The statute requires that any agreement be in writing, be executed by the borrower and the institution contemporaneous with the acquisition of the asset, be approved by the board of directors or loan committee, and continuously be an official record of the institution.

In essence, the D'Oench doctrine and section 1823(e) serve to ensure that all agreements or arrangements affecting the depository institution's financial condition must be recorded and available for review by regulators and receivers so that they can accurately assess the true financial condition of the institution. This public policy lies at the center of the ability of the FDIC and other regulators to supervise open institutions and to resolve failing ones. The ability to rely upon the records of an institution in order to evaluate its

assets and liabilities supports key public policy goals and related statutory requirements such as prompt corrective action, the "least cost" test, and the protection of the deposit insurance funds.

Of course, these important public policies must be balanced with the public interest in fairness to individuals. The FDIC has recently taken additional significant steps to ensure that the D'Oench doctrine and section 1823(e) are applied fairly and consistently with their public purposes. The FDIC remains willing to work with Congress to achieve an optimal balancing of the competing public interests in any amendments to section 1823(e). We are committed to finding ways to satisfy our statutory mandates with regard to supervising open financial institutions, resolving failing institutions, and liquidating failed institutions while also preventing a potentially adverse impact on individuals.

EFFORTS BY THE FDIC TO ENSURE FAIRNESS

Although the D'Oench doctrine and section 1823(e) promote critical public policy goals, the FDIC recognizes that the application of these legal principles requires a balancing of those goals with the public interest that individuals be treated

fairly. This balancing of interests has been the subject of debate since the earliest days of the D'Oench doctrine and section 1823(e). Attachment A summarizes the debate surrounding the passage of section 1823(e) in 1950.

Questions about the application of D'Oench or section 1823(e) were raised during Chairman Helfer's confirmation process and during testimony by Vice Chairman Hove last year. Chairman Helfer and the FDIC have followed through on their commitment to reexamine the FDIC's use of D'Oench and section 1823(e) and have implemented new guidelines to govern the circumstances under which these powers will be authorized by the FDIC.

During March 1994, an inter-divisional working group was established at the FDIC to discuss an appropriate response to concerns about the application of the D'Oench doctrine and section 1823(e) and to prepare recommendations to present to the new Chairman. The working group was made up of representatives of all affected groups within the FDIC, including those parts of the FDIC responsible for supervision of open financial institutions, resolution of failing institutions, and disposition of the assets and payment of claims against failed institutions.

As a result of the working group's efforts, new guidelines were implemented during November 1994. All FDIC staff, outside law firms, and asset servicing contractors are now subject to the

guidelines in all cases involving D'Oench and section 1823(e). Since adoption of the guidelines, the FDIC has conducted intensive training in their application for its staff across the country. This training has been conducted nationally as well as regionally to ensure that the guidelines are understood and followed.

The guidelines provide a structure for the FDIC to promote the exercise of sound discretion in the application of D'Oench and section 1823(e) by requiring prior Washington management approval in seven specific categories of factual circumstances. Critical to the guidelines is a recognition that hard and fast rules will not permit the "case by case" review necessary to protect against unfairness while ensuring that secret agreements remain barred. As a result, the guidelines require FDIC attorneys, outside attorneys, asset servicing contractors, and other staff to obtain approval from FDIC Headquarters in Washington before asserting D'Oench or Section 1823(e) in any case within the seven categories.

The seven categories include, among other things: claims by pre-closing vendors; claims or defenses asserted where an authorized bank officer signed the agreement, but it was not included in the bank records; claims or defenses based on the bank's violation of some part of a written agreement; and claims where there is no loan transaction involved in the dispute. In

these and the other categories of cases, D'Oench or section 1823(e) cannot be asserted without specific prior approval from FDIC headquarters in Washington. Thus, the guidelines are designed to ensure the consistent and appropriate application of D'Oench and section 1823(e). A copy of the guidelines is attached to this testimony as Attachment B.

One of the few clear-cut examples where application of D'Oench and section 1823(e) generally is prohibited by the guidelines involves claims by pre-receivership sellers or providers of goods and services to the failed financial institution. Under the guidelines, D'Oench and section 1823(e) will not be asserted to bar those claims where the goods or services were actually received by the institution regardless of the existence of a written agreement. For example, as long as there is evidence that the service was performed, section 1823(e) cannot be used to refuse payment for services provided by a local nursery that planted flowers around an institution's premises prior to its failure, regardless of whether the nursery had a written contract to perform those services.

We believe that the requirement of prior review and approval under the guidelines is promoting a consistent approach to application of these powers. In addition, the flexibility contained in the proposed guidelines permits a careful examination of the unique facts of all proposed cases.

It should be noted that the protections of D'Oench have been interpreted by the courts as extending to parties that purchase or receive assets from the FDIC. Once these assets are sold or transferred to another party, they are neither owned nor controlled by the FDIC. Any attempt to control the use of D'Oench by such asset purchasers or transferees would be difficult because the FDIC generally would not be a party to such actions and would have no advance notice that these legal principles would be asserted. The guidelines, therefore, do not apply directly to purchasers or subsequent transferees of FDIC receivership assets. The FDIC is continuing to examine this issue.

In summary, the guidelines preserve the FDIC's flexibility in addressing the specific facts of individual cases, but provide additional safeguards against any expansive application of D'Oench and section 1823(e). At the same time, the guidelines continue to assist the FDIC in preserving the important public policy underlying these powers -- that regulators must be able to rely on the records of financial institutions in evaluating open institutions and in resolving failed ones.

PUBLIC POLICIES SERVED BY D'OENCH AND SECTION 1823(e)

There are three public policy goals accomplished by the D'Oench doctrine and section 1823(e). First, the D'Oench doctrine ensures that regulators can rely on a financial

institution's records for supervisory purposes and in order to protect the deposit insurance funds they administer. This goal encompasses the supervision of open institutions, the determination of the least cost resolution of failing institutions, and the efficient disposition of assets and payment of creditors of failed institutions. Second, the D'Oench doctrine promotes careful consideration of lending practices, assures proper recordation of various financial activities and protects against collusive or erroneous structuring or restructuring of terms, especially just before the institution fails. Third, the D'Oench doctrine protects the innocent depositors and creditors of a failed institution, including the FDIC, from absorbing the losses resulting from agreements that do not appear in the records and books of the institution and helps to facilitate the quick return of a failed institution's assets to the community.

While the D'Oench doctrine and section 1823(e) have always played a role in the supervision and liquidation of financial institutions, they have become more significant since the enactment of FDICIA in 1991. One of the key provisions crafted by this Committee in FDICIA was the requirement of least cost resolutions.

If a financial institution fails, FDICIA requires the FDIC to determine how to "satisfy the Corporation's obligations to an

institution's insured depositors at the least possible cost to the deposit insurance fund" and to document that analysis. This means that the FDIC must be able to rely on the institution's records at the time of the closing to identify and establish the value of its assets and liabilities. If the assets are worth less or the liabilities more extensive than evidenced in the institution's records due to the existence of undocumented agreements, the FDIC may not be able to determine accurately the least cost method of resolution. In addition, the receiver of the failed bank may have difficulty in structuring a resolution without providing additional rights to acquiring institutions to return assets or obtain indemnification from any costs because neither the receiver nor the acquirer can know what unrecorded agreements might exist that subsequently may affect the value of the failed institution's assets.

The failure of a financial institution can be very harmful to a community, especially a small community that does not have other significant financial resources. Therefore, the efficient resolution of a failed institution and the prompt availability of deposits and advance dividends can be vitally important in a community that otherwise would be devastated by the closure of its primary financial institution. As a result of the FDIC's ability to rely on the financial institution's records, depositors typically have access to their money on the following business day after an institution fails. The FDIC also often

advances funds, known as advance dividends, to uninsured depositors or creditors based on its historical experience regarding the recovery it can anticipate from the liquidation of the institution's assets. Without the ability to rely on the failed institution's books to value the assets, it would be considerably more difficult for the FDIC to achieve prompt resolutions or to pay advance dividends.

Finally, without the D'Oench doctrine and section 1823(e), the FDIC would have difficulty enforcing many valid obligations owed to the failed financial institution because it often cannot rebut allegations of unwritten agreements or arrangements as effectively as the failed institution. After an institution fails, the FDIC often does not have ready access to its officers and employees. In such circumstances, the receiver frequently is unable effectively to counter allegations that the institution entered into unwritten agreements or challenge the terms of such alleged agreements. The ability of the FDIC to enforce the obligations due to the failed institution in reliance upon the written records of loans and other assets prevents fraudulent claims and unnecessary legal expenses.

As the receiver for the failed financial institution, the FDIC has a legal obligation to the other creditors to protect the receivership estate for the benefit of the institution's creditors. If the FDIC as receiver pays unsubstantiated claims,

other claimants and creditors of the receivership estate, such as vendors who provided services to the institution before it failed, will receive less. Creditors will also receive less if the FDIC cannot enforce valid obligations owed to the failed institution. There is a limited pool of assets in each receivership of a failed institution and anything that reduces the value of the assets or increases the number of claimants will reduce the recoveries for creditors.

COMMENTS ON THE PROPOSED D'OENCH DUHME REFORM ACT

On March 30, 1995, Senator Cohen introduced S. 648, the D'Oench Duhme Reform Act, which was cosponsored by you, Mr. Chairman, and Senators Faircloth and Bennett. Since the introduction of S. 648, FDIC staff have met several times with Senator Cohen's staff and the staff of this Committee to discuss the concerns of the FDIC regarding this legislation. As a result of these discussions, we have been able to resolve or narrow many of the differences between the parties.

Last Friday, Senator Cohen provided us with a copy of the most recent version of his legislation (the Cohen substitute). Although the Cohen substitute does not yet reflect a total agreement between the parties, this substitute includes a number of changes from S. 648 that represent a thoughtful balancing of the competing interests. Among their important provisions, S.

648 and the Cohen substitute generally require that any agreement between a financial institution and a claimant be in writing and have been executed in the ordinary course of business by an officer or employee of the institution with the authority to execute such an agreement. By requiring that the alleged agreement be in writing, the Cohen substitute addresses the difficult problems of proof involved with disputes regarding oral agreements and recognizes ordinary commercial practices. The requirement that the agreement also be executed in the ordinary course of business by an employee of the institution with the authority to execute such an agreement prevents the claimant from unilaterally creating a binding agreement simply by sending a letter to the bank "confirming" the terms of an alleged agreement.

The legislation also includes a number of exceptions which significantly limit the application of the general rule requiring a written agreement. Some of the exceptions to the requirement of a written agreement in the Cohen substitute are reasonable. For example, the FDIC supports the provision which permits the enforcement of oral agreements between the failed institution and vendors where the goods or services are actually received by the institution before it fails. This is consistent with current FDIC practice under our D'Oench guidelines.

The FDIC, however, is concerned that some of the exceptions are too broad and introduce new ambiguities into the clear requirements of the current statute that will create additional litigation and costs. The FDIC is particularly concerned about the following exceptions to the general rule requiring a writing agreement: the exception that permits unwritten liabilities; the exception for violations of federal or state law; and the retroactive application of the Cohen substitute.

The Cohen substitute only requires a written agreement for "specific assets." By repealing section 1821(d)(9)(A) which extends the current requirements of section 1823(e) to receivership liabilities, it would create an exception to the general rule that an agreement must be in writing if the oral "agreement" created a liability but never resulted in an actual asset (loan) or if the asset no longer exists. Examples include claims for benefits or indemnification by institution officers and directors, undocumented future loan commitments, and claims arising out of a lending relationship that are asserted after repayment of a loan. No current asset exists in any of these examples. They, however, would impose liabilities on the institution and could affect the regulators' or receivers' evaluation of the financial condition of the institution.

For example, institution officers or directors may claim that the institution orally promised to indemnify them for any

litigation or claims. These claims can be very large and such an indemnification agreement that is not recorded in the institution's books and records can alter the true financial condition of the institution as much as any asset. For example, there is a single indemnity claim against one of the FDIC's receiverships for half a billion dollars based on an unwritten agreement. If the general goal is to permit regulators and receivers to rely on the institution's records to determine its financial condition, there is no logical justification to differentiate between secret agreements that affect assets and ones that create liabilities.

Similarly, this provision would permit individuals to bring claims based on undocumented oral agreements if they paid off their loan because there is no longer an asset. If the same loan was not paid off, the individual could not bring the claim because the asset would still exist. In essence, this creates an exception for those borrowers fortunate enough to be able to pay off their notes before bringing their claim. Fairness would seem to require that the general rule apply to all claimants equally regardless of their financial resources.

The Cohen substitute also includes an exception for "alleged intentional torts or alleged violation of State or Federal law." While the FDIC has no desire to perpetuate or benefit from inappropriate actions by the failed institution or its employees,

the exception as currently drafted could overwhelm the general rule requiring a written agreement.

The exception requires only an allegation of an "intentional tort" or "violation of State or Federal law." In other words, knowledgeable claimants could still pursue oral agreements if they carefully framed their claim. "Intentional torts" and "State or Federal law" are not defined and the scope of those terms is extremely broad. Indeed, under the current draft there is no requirement that a "violation of State or Federal law" be intentional and it could be wholly regulatory. Virtually any creative litigant can fashion an allegation of some violation of State or Federal law. As a result, fraud, intentional misrepresentation, deceptive acts/practices and similar allegations will probably become routine elements of claims based on oral agreements to avoid the general requirement that they be in writing. Since such charges are inherently fact-intensive, we can expect many such actions to go to trial and increase the litigation expenses of the FDIC. Further, we can expect that the prolonged period that it will take to resolve these factual disputes will delay the termination of receiverships.

The Cohen substitute applies retroactively to "administrative claims brought or pending, and any litigation filed, in progress or on appeal on or after the date of enactment." By applying to all administrative claims at any

stage in the review process and to all litigation pending on or after the stated date, the retroactive application of the Cohen substitute raises issues of implementation and cost to the deposit insurance funds.

Retroactive application of the legislation to claims and lawsuits pending on or after the date of enactment, could impose additional losses on the deposit insurance funds and necessitate the recalculation of distributions from open receiverships. Since the amendment would permit claims or defenses that were barred by prior law, it would impose new and unanticipated expenses and losses on receiverships. If the expenses or losses prove to be substantial in a receivership, the distributions in pre-depositor preference receiverships must be recalculated with a resulting increase in losses both to other innocent creditors and to the deposit insurance funds. Because the FDIC cannot realistically take back dividends already advanced to creditors, the full amount of any claims and additional litigation costs most likely will be borne by the deposit insurance funds.

Using the FDIC's case tracking system, we have identified approximately 750 cases involving D'Oench and section 1823(e) issues that could be affected by the retroactive application of the Cohen substitute. Because we received the new language of the Cohen substitute only within the last several days, we are still attempting to determine the extent of additional exposure

to the deposit insurance funds and additional litigation costs. We will forward this information to the Committee as soon as it is available.

These figures do not include "claims" that were never filed or that were denied based upon the application of D'Oench or section 1823(e) which did not result in any litigation. It is possible that some courts might find that the Cohen substitute would create an opportunity for claimants to file new claims based solely on this new provision. It is our understanding, however, that this is not Senator Cohen's intent.

Although the general rule in the Cohen substitute provides important safeguards to insure fairness for individuals and to prevent secret agreements, it is important to note that it does not require that the agreement be recorded in the institution's books and records and be available for review by the regulator or receiver. The recordation requirement of the current law reflects clearly the difficult balancing of public policy interests inherent in D'Oench and section 1823(e). Some would argue that it is not fair to hold claimants responsible for seeing that their agreements with an institution are maintained in the institution's records when they have no control over the records. On the other hand, Congress and the courts to date have determined, on balance, that it is more important to a safe and sound financial system to require that an agreement be reflected

in an institution's records for the benefit of regulators and that the risk of loss be placed on the party in the best position to avoid the risk -- the claimant dealing with the institution. The Cohen substitute alters this balance.

CONCLUSION

The D'Oench doctrine and section 1823(e) serve important public policy interests in the supervision, resolution and liquidation of banks. Application of these legal principles involves a balancing of the public interest in effective banking supervision, resolution, and liquidation with the public interest in fairness for individuals. The FDIC has taken significant steps to insure that the D'Oench doctrine and section 1823(e) are applied appropriately through the implementation of guidelines designed to ensure consistency and careful consideration of their use. In addition, while we have some concerns about particular provisions of S. 648 and the Cohen substitute, we appreciate the constructive efforts to balance the competing public interests embodied in the D'Oench doctrine and will continue to work with the Congress on these important issues.

Mr. Chairman, this concludes my testimony. I would be pleased to respond to any questions that the Committee might have.