

Redistributing Bank Insolvency Risks: Challenges to Limited Liability in the Bank Holding Company Structure

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INTRODUCTION

Until recently, the risk of a bank's insolvency was borne primarily by its shareholders and the Federal Deposit Insurance Corporation (FDIC).¹ Shareholder liability was limited, however, to the amount of shareholder investment in the bank, with the FDIC responsible for all losses in excess of that amount. Insured depositors bore none of a bank's insolvency loss, and uninsured depositors and other bank creditors, although potentially subject to loss upon a bank's insolvency, were usually made whole in the course of the FDIC's resolution of the insolvent bank.² As a result of this risk distribution, there was little market discipline to quell the moral hazards created by limited shareholder liability and federal deposit insurance.³

Although shareholders have an incentive to regulate the riskiness of activities undertaken by bank managers so that they do not lose their investment upon the bank's insolvency, the vigor of their discipline decreases as the bank approaches insolvency.⁴ Once a bank is insolvent, its shareholders have nothing further to lose and are indifferent to the amount of negative net worth that a bank, unsuccessfully gambling for a return to profit, might accrue.⁵ Their only hope to return some value to their investment is for the bank to remain open and to take risks which if successful will return value to the bank's shareholders, and if unsuccessful will be borne by the FDIC.⁶

Absent much meaningful market discipline of bank insolvency risk, it is no wonder that bank shareholders have gambled with FDIC funds and that bank insolvencies resulting from unsuccessful gambles have exhausted FDIC reserves. With a deficit estimated at over five billion dollars, the FDIC's portion of bank

¹ See *infra* notes 24-52 and accompanying text (explaining history of limited liability and its effect in the context of bank insolvency).

² See *infra* notes 35-48 and accompanying text (discussing effects of FDIC resolution methods).

³ See *infra* notes 66-72 and accompanying text (noting lack of market discipline to limit effects of moral hazard).

⁴ See *infra* notes 54-58 and accompanying text (explaining moral hazard problem).

⁵ See *infra* notes 56-58, 74 and accompanying text (explaining shareholder behavior that leads to moral hazard problem).

⁶ See *infra* notes 74-76 and accompanying text (noting that FDIC resolution methods increase likelihood of moral hazard problem).

insolvency risks is shared with federal taxpayers who must fund interest payments on the federal deficit.⁷

Congress has recently addressed the problems of mounting bank insolvency losses and the resulting strain on the federal deposit insurance system. In its efforts, however, Congress failed to enact proposals to increase depositor discipline of bank managers.⁸ This failure makes its efforts to increase shareholder discipline even more significant as the best available tool to reduce the risk of bank insolvency.⁹ Shareholder discipline is increased by modifying the concept of limited liability and corporate separateness when the insolvent bank is owned by a bank holding company. The most recent statute, which became effective December 1992, requires a bank holding company to guarantee the capital restoration plan submitted to the FDIC by an undercapitalized subsidiary bank (the "controlling company guarantee").¹⁰ A 1989 statute imposed liability for FDIC bank insolvency losses on commonly controlled depository institutions (the "cross-guarantee").¹¹ This statutory redistribution places more risk on the bank holding company parent of an insolvent bank and gives it a greater stake in reducing bank insolvency risk. Although Congressional initiatives to redistribute bank insolvency risks affect only bank holding company shareholders of banks and not individual bank shareholders, the bank holding companies that are directly affected control over ninety percent of all bank assets.¹²

This Article evaluates these statutory changes and concludes that they are efficient because redistributing more bank insolvency risk to the bank holding company shareholder should result in an overall reduction of risk. The moral hazard associated with limited liability should be reduced, market discipline should

⁷ See *infra* notes 50-52 and accompanying text (discussing effect of FDIC resolutions of failed institutions).

⁸ See *infra* notes 91-92 and accompanying text (noting that Congress failed to adopt changes to increase creditor discipline).

⁹ Jonathan R. Macey, *The Political Science of Regulating Bank Risk*, 49 OHIO ST. L.J. 1277, 1277 (1989) ("The leading edge issue in banking law today is . . . risk.").

¹⁰ See *infra* notes 105-21 and accompanying text (discussing 1991 controlling company guarantee provision).

¹¹ See *infra* notes 96-104 and accompanying text (explaining 1989 cross-guarantee provision).

¹² Bank holding companies control 92.7% of all bank assets. Federal Reserve Board (Banking Structure and Assets as of Dec. 31, 1991).

increase, and a bank holding company should endeavor to close an insolvent bank before significant negative net worth accrues to minimize its own loss, which will in turn minimize the FDIC's loss.¹³ Bank holding companies are in control of their bank subsidiaries and thus are in a better position to monitor risk and reduce the risk of activities undertaken by bank managers than the FDIC whose supervision, examination and enforcement efforts must be spread among all insured banks in the country.¹⁴

Moreover, the risk redistribution is equitable as well as efficient. Bank holding companies benefit from profitable risky activities undertaken by their bank subsidiaries, as well as from operational efficiencies and tax advantages that may be achieved from the bank holding company structure.¹⁵ As the beneficiaries of bank risk and the bank holding company form of operation, it is more equitable for bank holding companies and their shareholders to bear the losses from bank risk than the FDIC (and while it is insolvent, federal taxpayers).¹⁶

Although the new risk redistribution statutes provide substantial benefits over the prior risk distribution scheme, the statutes are not likely to operate in a manner that will maximize these benefits. Opportunities exist to avoid application of the statutes, so that insolvency risk distribution will remain unchanged.¹⁷ Even when applied, the statutes themselves contain limits on the liability of the bank holding company that may continue many of the moral hazard problems associated with the previous risk distribution scheme.¹⁸ This Article concludes by proposing an alternative liability scheme making the bank holding company family responsible for losses of an insolvent bank subsidiary in such a manner

¹³ See *infra* notes 126-51 and accompanying text (arguing that statutory changes decrease bank insolvency risks).

¹⁴ See *infra* notes 152-66 and accompanying text (proposing that bank holding company should bear proportionately more risk than FDIC).

¹⁵ See *infra* notes 172-73, 177-78 and accompanying text (explaining benefits to bank holding companies of subsidiaries' risk-taking activities).

¹⁶ See *infra* notes 167-86 and accompanying text (arguing that risk redistribution to bank holding companies is equitable).

¹⁷ See *infra* notes 218-30 and accompanying text (noting weaknesses in statutory changes).

¹⁸ See *infra* notes 231-36 and accompanying text (explaining that statutory changes do not eliminate moral hazard problem).

as to maximize the possibilities for meaningful reduction of bank insolvency risk.¹⁹

Part I sets forth the risk distribution schemes in effect prior to and following the enactment of the redistribution statutes in 1989 and 1991.²⁰ Part II sets forth the benefits of the 1989 and 1991 redistribution statutes and suggests that this scheme should result in an overall reduction of bank insolvency risk.²¹ In Part III, the new statutory scheme is nevertheless criticized for being less than optimally efficient by continuing to limit bank holding company liability in many respects and by presenting opportunities by which the risk redistribution may be avoided.²² An alternative statutory scheme is proposed that attempts to eliminate the defects of the new statutory scheme and maximize its benefits.²³

I. DISTRIBUTION OF BANK INSOLVENCY RISKS

From the institution of a system of federal deposit insurance in 1933 until statutory changes beginning in 1989, the distribution of bank insolvency risks was controlled by three factors: limited liability of bank shareholders, federal deposit insurance, and the FDIC's practices in resolving insolvent banks. The following section discusses how each of these factors affects the distribution of bank insolvency risks, imposing the risk of bank insolvency primarily on bank shareholders and the FDIC, while limiting the risk imposed on bank shareholders to the amount of their investment in the bank. This risk division is criticized because it creates a substantial "moral hazard" that encourages risk-taking on the part of bank managers that is not otherwise disciplined by the market, and leaves only the FDIC with an incentive to close an insolvent bank before any substantial negative net worth accumulates. The section then describes statutes passed in 1989 and 1991 which redistribute bank insolvency risks from the FDIC to the bank holding company as shareholder of an insolvent bank and other commonly-controlled depository institutions.

¹⁹ See *infra* notes 237-55 and accompanying text (proposing alternative to minimize risks left after statutory changes).

²⁰ See *infra* notes 24-121 and accompanying text.

²¹ See *infra* notes 122-216 and accompanying text.

²² See *infra* notes 217-36 and accompanying text.

²³ See *infra* notes 237-55 and accompanying text.

A. Factors Relating to Insolvency Risk Distribution

1. Limited Liability

Since the nineteenth century, corporate law has limited the liability of a corporation's shareholders to the amount of capital each shareholder invested in the corporation.²⁴ Prior to the imposition of a federal system of deposit insurance in 1933,²⁵ however, most bank shareholders were subject to a double liability system.²⁶ Upon a bank's insolvency, bank shareholders stood to lose not only the amount of their initial investment in the bank, but also an additional amount up to that stock's par value.²⁷ The purpose of the double liability provision was to provide an extra source of funds with which to protect the claims of bank depositors and to provide shareholders an incentive to monitor the activities of the bank.²⁸ Double liability was phased out by the

²⁴ See MODEL BUSINESS CORP. ACT § 6.22 (1984) (giving limited liability to shareholders). The notion of limited liability is a concept viewed with reverence in corporate law. David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1569 (1991) ("Limited liability is today regarded as a birthright of corporations . . .").

²⁵ Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C. (1988)) [hereafter Banking Act of 1933].

²⁶ See Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31, 35-39 (1992) (giving overview of double liability system); see also John R. Vincens, *On the Demise of Double Liability of Bank Shareholders*, 12 BUS. LAW. 275 (1957) (discussing Banking Act of 1933's effect on double liability system). For examples of the statutes imposing additional liability, see N.Y. CONST. OF 1916, art. VIII, § 7 (repealed 1935) (constitutionally providing for double liability; National Banking Act of 1863, ch. 58, 12 Stat. 665 (repealed 1953) (imposing liability equal to investment plus par value); COLO. REV. STAT. ANN. § 14-1-48 (West 1953) (repealed 1957) (providing for triple liability).

²⁷ National Banking Act of 1863, ch. 58, § 12, 12 Stat. 665, 668 (repealed 1953) ("[E]ach shareholder shall be liable to the amount, at their par value, of the shares held by him in addition to the amount invested in such shares.").

The United Supreme Court held in *Anderson v. Abbott*, 321 U.S. 349 (1944), that double liability should be assessed against the shareholders of a bank holding company when the bank holding company, as the insolvent bank's shareholder, was not financially able to satisfy the double liability obligation. The Court held that bank shareholders would not be permitted to form a poorly capitalized bank holding company and transfer bank stock to it in return for bank holding company stock in a seeming effort to avoid application of the double liability provision. *Id.* at 357.

²⁸ See Macey & Miller, *supra* note 26, at 36 (Senator Sherman described the National Bank Act's double liability provision as providing additional

Banking Act of 1933 which instituted federal deposit insurance,²⁹ presumably because deposit insurance eliminated the need to provide an extra source of funds to satisfy the claims of depositors of a failed bank.³⁰ Bank shareholders were returned to the traditional corporate limited liability regime where each shareholder's loss is limited to the shareholder's portion of the bank's capital.

2. Deposit Insurance

Federal deposit insurance is intended to ensure customer confidence in banks and thereby eliminate destabilizing runs on troubled banks by their depositors, and to ensure the safety of the investments of small depositors who do not have the wherewithal to investigate bank safety on their own.³¹ Two aspects of deposit insurance affect the distribution of bank insolvency risks. First, depositors are explicitly protected by deposit insurance for deposits of up to \$100,000 in the event of a bank failure.³² Most bank depositors—approximately seventy-five percent—are fully protected by this deposit insurance guarantee and suffer no loss

security for bank creditors and as tending to prevent bank shareholders and directors from “engaging in hazardous operations.”) (quoting CONG. GLOBE, 38th Cong., 1st Sess., pt. 2, at 1069 (1864)); Susan Woodward, *A Transaction Cost Analysis of Banking Activity and Deposit Insurance*, 7 CATO J. 683, 689 (1988) (“[T]he willingness of bank owners to assume personal liability for their bank’s soundness doubtless increased depositor confidence and reduced incentives for bank risk-taking.”).

Furthermore, there was little evidence during the period that double liability was in force that it discouraged capital investment in banks, as many scholars have since assumed. PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: TORT, CONTRACT, AND OTHER COMMON LAW PROBLEMS IN THE SUBSTANTIVE LAW OF PARENT AND SUBSIDIARY CORPORATIONS* § 2.01 (1987).

²⁹ See Banking Act of 1933, *supra* note 25, § 22, 48 Stat. at 189 (repealed 1959) (discontinuing double liability for newly-issued national bank shares). It was not until 1953 that double liability was totally phased out for national banks. See Macey & Miller, *supra* note 26, at 38-39. Similarly, states began to eliminate their own double liability systems and by 1944, 31 states had abolished double liability. *Id.* at 39.

³⁰ See Macey & Miller, *supra* note 26, at 38 (stating that deposit insurance believed to be more effective than double liability system).

³¹ CONGRESSIONAL BUDGET OFFICE, *REFORMING FEDERAL DEPOSIT INSURANCE* 4 (1990) [hereafter *REFORMING FEDERAL DEPOSIT INSURANCE*].

³² 12 U.S.C. § 1821(a)(1)(B) (Supp. III 1991) (providing insurance up to \$100,000 for all deposits maintained by depositor in insured depository institution).

as a result of a bank's failure.³³ The second important aspect of deposit insurance is that until recently, insurance premiums were assessed on a flat percentage of a bank's deposits and did not reflect the risk of the bank's activities.³⁴ Because the insurance assessment was not related to the bank's risk of insolvency, the bank and its shareholders did not pay for any increased risk of insolvency in the form of increased deposit insurance premiums.

3. FDIC Resolution Methods

A bank's primary regulator is authorized to close it upon insolvency, and to appoint the FDIC as conservator or receiver to resolve the failed institution.³⁵ During the twenty-year period from the mid-1960s to the mid-1980s, bank failures were resolved so that "all general creditors were, in practice, afforded 100 percent insurance."³⁶ The two resolution methods most often employed by the FDIC are a liquidation of the insolvent institution and a purchase and assumption transaction³⁷ in which

³³ DEPARTMENT OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS Table 1, after XVI-2 (1991) [hereafter MODERNIZING THE FINANCIAL SYSTEM]; Woodward, *supra* note 28, at 693 ("Deposit insurance transfers the risk of losses on the bank's portfolio (in excess of the bank's equity) from the depositors to the deposit insurer.').

³⁴ 12 U.S.C. § 1817(b) (Supp. III 1991). Deposit insurance assessments were 23 cents per \$100 of deposits. 57 Fed. Reg. 21,617 (1992). During 1993 (a transitional year in the implementation of a risk-based premium system), risk-adjusted deposit insurance premiums will range from 23 cents per \$100 of deposits for the banks in the lowest risk category to 31 cents per \$100 of deposits for banks in the highest risk category. *Id.* at 45,284-85 (to be codified at 12 C.F.R. 327.3(d),(e) (1992)). Effective January 1, 1993, premiums are assessed based on the capitalization of and the level of supervisory concern associated with a particular institution. 57 Fed. Reg. 62,502, at 62,503 (1992) (proposed Dec. 31, 1992) (proposing permanent risk-based assessment system to become effective Jan. 1, 1994).

³⁵ Bank closure policy was traditionally vested in the chartering agency (the Office of the Comptroller of Currency for a national bank and the state banking regulator for a state-chartered bank). JONATHAN R. MACEY & GEOFFREY P. MILLER, BANKING LAW AND REGULATION 631 (1992). A bank may be closed when it is insolvent. 12 U.S.C. § 1821(c)(5) (Supp. III 1991).

³⁶ REFORMING FEDERAL DEPOSIT INSURANCE, *supra* note 31, at 63 (footnote omitted).

³⁷ 12 U.S.C. § 1821(d)(2)(E), (G) (Supp. III 1991). See generally John F. Bovenzi & Maureen Muldoon, *Failure-Resolution Methods and Policy Considerations*, 3 FDIC BANKING REV. 1 (1990) (reviewing FDIC methods to deal with failing institutions).

another bank agrees to purchase the assets and assume the liabilities of the failed bank.³⁸ Approximately seventy-five percent of insolvent banks have been resolved by a purchase and assumption transaction.³⁹ In the past, all liabilities—including uninsured deposits, nondeposit claims, and contingent claims—were assumed by the institution purchasing the failed bank's assets so that the claims of all creditors were honored by the purchasing institution and bank creditors lost nothing as the result of extending credit to a bank that became insolvent.⁴⁰ In more recent purchase and assumption transactions, the liabilities of nondeposit creditors have not been assumed,⁴¹ although all deposit liabilities (including uninsured deposits) have been assumed by the asset purchaser.⁴² A purchase and assumption transaction in which uninsured deposits are assumed shifts "losses from uninsured depositors to the FDIC."⁴³ Thus, bank depositors bear none of the consequences of the bank's insolvency.

To illustrate the distribution of the risks of a bank's insolvency among its shareholders and the FDIC, consider the following example. A bank holding company owns 100% of the outstanding stock of Bank A and Bank B. It has invested \$100,000 in each bank. The bank holding company is owned by five shareholders, each of whom has invested \$100,000 in the bank holding company for a total investment in the bank holding company of \$500,000, \$200,000 of which has been invested in Banks A and B. Assume for illustration a simplified balance sheet for Bank A in which it has \$1,900,000 in insured deposits (recorded as liabilities

³⁸ MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at I-30.

³⁹ *Id.* Table 1, after I-30; *cf.* John L. Douglas, *Marketplace Discipline is Reintroduced*, NAT'L L.J., Feb. 17, 1992, at 22 (finding that about 80% of all bank failures have been handled by purchase and assumption transactions and that such transactions have, in the aggregate, accounted for well over 95% of assets of all banks that have failed since 1985).

⁴⁰ MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at I-41.

⁴¹ *Id.* at I-42. Nondeposit creditors have been given receivership certificates representing their pro rata share of the receivership's collections. *Id.* Subordinated debtholders have generally received little, if any, recovery. *Id.*

⁴² *Id.* at 8 (stating that between 1985 and 1990, over 99% of uninsured deposits were fully protected). Recently, however, deposits held by entities affiliated by common bank holding company ownership have not been fully paid. *Id.* at I-39; *see also* Bovenzi & Muldoon, *supra* note 37, at 3 (noting only specific situations in which depositors receive full payment on claims).

⁴³ MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at 8.

on the balance sheet), which along with its \$100,000 in capital are invested in \$2,000,000 in loans (recorded as assets on the balance sheet). The balance sheet balances as the assets of \$2,000,000 equal the liabilities of \$1,900,000 plus the capital of \$100,000. If Bank A writes off \$250,000 in bad loans, this reduces its \$2,000,000 in assets to \$1,750,000. Its liabilities (deposits) presumably remain the same, and therefore, to keep the balance sheet in balance, the \$250,000 loss must be charged against Bank A's capital account, reducing it from its \$100,000 beginning balance to a negative position of \$150,000, and rendering the bank insolvent.

If the FDIC elects to resolve the insolvent institution by arranging a purchase and assumption transaction, the FDIC will have to pay the institution that purchases the \$1,750,000 in assets and assumes the \$1,900,000 in liabilities, the difference between the two—\$150,000.⁴⁴ The greater Bank A's negative net worth, the greater the difference between the value of its assets and liabilities, and the greater the cost to the FDIC to resolve insolvent Bank A. Thus, the bank holding company, as Bank A's shareholder, will lose its \$100,000 investment in Bank A,⁴⁵ and the FDIC will bear the remaining \$150,000 loss. Bank B continues to operate with its \$100,000 of capital intact.

An alternative resolution method is liquidation of the failed bank.⁴⁶ The FDIC pays the insured depositors, sells the assets of the bank, and distributes the proceeds to satisfy the claims of uninsured depositors, nondeposit creditors, and itself for the amounts it paid to insured depositors.⁴⁷ When the FDIC selects

⁴⁴ A cash payment from the FDIC to the acquirer, reduced by any premium the acquirer agrees to pay for the franchise value of the failed bank, covers the difference between the value of the acquired assets and assumed liabilities. Any assets the FDIC retains are liquidated and used to reimburse the FDIC. GEORGE J. BENSTON ET AL., *PERSPECTIVES ON SAFE & SOUND BANKING: PAST PRESENT AND FUTURE* 94-95 (1986); *MODERNIZING THE FINANCIAL SYSTEM*, *supra* note 33, at I-14.

⁴⁵ This loss represents a decline in the value of each shareholder's investment in the bank holding company by \$20,000.

⁴⁶ MACEY & MILLER, *supra* note 35, at 644-45. Another resolution method that is sometimes utilized is an insured deposit transfer, in which the failed bank's insured deposits are transferred to another institution that compensates the FDIC for the value of the deposit base. *Id.* at 645.

⁴⁷ 12 U.S.C. § 1821(g) (Supp. III 1991) (FDIC becomes general creditor for amounts paid to insured depositors); *MODERNIZING THE FINANCIAL SYSTEM*, *supra* note 33, at I-30; BENSTON ET AL., *supra* note 44, at 94.

liquidation as the resolution method, the risk of the bank's insolvency is borne in part by uninsured depositors and nondeposit creditors who may sometimes receive only a portion of their claims.⁴⁸

The three factors described above combine to impose the loss resulting from a bank's insolvency primarily on bank shareholders and the FDIC. Although the shareholders' loss is limited to the amount of the bank's capital,⁴⁹ the remaining loss—no matter how large—is borne by the FDIC. FDIC losses resulting from the dramatic increase in bank failures in the last decade have placed a tremendous strain on FDIC resources. Deposit insurance assessments have not kept pace with FDIC expenditures in resolving failed banks since 1988.⁵⁰ As the result of spending more than it is taking in, the FDIC has exhausted its reserves and is now itself insolvent with a deficit estimated at over five billion dollars.⁵¹

⁴⁸ If the FDIC elects to liquidate the failed bank, the difference between the amount realized by sale of the bank's assets and the payments the FDIC makes to the bank's insured depositors is the FDIC's cost of liquidation. If the bank's assets may be liquidated for their balance sheet value of \$1,750,000, this money is available to satisfy the claims of the bank's insured depositors. If the entire \$1,900,000 of deposits are insured, it will cost the FDIC \$150,000 to resolve the bank by a liquidation—the same cost as a purchase and assumption transaction. If, however, only \$1,000,000 of the deposits are insured, then the FDIC should incur no cost in a liquidation resolution. After paying \$1,000,000 to satisfy the claims of insured depositors, the remaining \$750,000 received from liquidation of the bank's assets will be used to help satisfy the claims of the uninsured depositors who will obviously not receive their entire \$900,000 in uninsured deposits. In this scenario, the \$150,000 of negative net worth is a cost borne by the uninsured depositors, rather than the FDIC. See Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1192 (1988) (stating that uninsured depositors get 99.5% of their claims in liquidation).

⁴⁹ Any loss that may be imposed on a bank's creditors in a liquidation of a failed bank is also limited in amount and will not exceed the amount of credit extended by the creditor.

⁵⁰ See MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at XVI-3 (stating that FDIC experienced net operating loss for first time in 1988). It is not clear, however, whether deposit insurance funds were ever intended to be self-sustaining. REFORMING FEDERAL DEPOSIT INSURANCE, *supra* note 31, at 20.

⁵¹ See MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, Table 6, after X-15 (table of FDIC bank failure costs); *Commercial Banks Show Record Profits; Negative BIF Balance Improves, FDIC Says*, 59 Banking Rep. (BNA) 330 (Sept. 14, 1992) (stating that FDIC's Bank Insurance Fund (BIF) has deficit of \$5.5 billion). The Bank Insurance Fund reduced its deficit during 1992,

Funding of the FDIC's deficit and its additional expenditures not covered by deposit insurance assessments is a cost imposed on all federal taxpayers whose tax dollars finance interest payments on the federal deficit.⁵²

B. Critique of Insolvency Risk Distribution

The result of the insolvency risk distribution described above is the creation of a "moral hazard" associated with limited liability and deposit insurance that encourages bank managers to undertake riskier activities than would presumably otherwise be consistent with safe and sound operations. Further, there is little market discipline (from shareholders, depositors, or other creditors) exerted on these risk-taking activities. Nor do bank shareholders or creditors have an incentive to act to reduce the amount of the insolvency loss that will be borne by the FDIC. This distortion of private risk-taking incentives is the difficult risk issue in holding company regulation.⁵³

1. Excess Moral Hazard

Under a system of limited liability, shareholders benefit from any risky activities undertaken by the bank while any losses suffered from such risky activities are limited to the amount invested.⁵⁴ Thus, shareholders may encourage bank managers to

beginning the year with a negative balance of \$7 billion. Barbara A. Rehm, *As FDIC'S Problems Ease, '91 Rescue Second-Guessed*, AM. BANKER, Dec. 3, 1992, at 1.

⁵² If the deposit insurance reserve fund cannot handle current losses, then the FDIC is authorized to borrow, within limits, from the Department of the Treasury, in which case federal taxpayers are the ultimate insurers of deposits. REFORMING FEDERAL DEPOSIT INSURANCE, *supra* note 31, at 4; *see also id.* at 20 (stating that backing deposit insurance funds with full faith and credit of United States government exposes taxpayers to deposit insurance losses).

⁵³ *See* H.R. REP. NO. 324, 100th Cong., 1st Sess. 21, 40 (1987) ("A systematic distortion of risk-taking incentives occurs when a bank or its affiliate makes investments or other risky business decisions with the expectation that losses in excess of a certain amount will be paid by the insurance fund."); MACEY & MILLER, *supra* note 35, at 266 (explaining that bank managers are subject to moral hazard of distribution of risks).

⁵⁴ *See* BENSTON ET AL., *supra* note 44, at 19 (stating that depositors need not receive compensation for risk because insurer bears risk); MACEY & MILLER, *supra* note 35, at 268 (explaining that shareholders get most of profit if risk pays off, but only lose investment if things go poorly); Alex M. Azar, II, Note, *FIRREA: Controlling Savings and Loan Association Credit Risk*

undertake excessive risk.⁵⁵ This “moral hazard” created by lim-

Through Capital Standards and Asset Restrictions, 100 YALE L.J. 149, 155-56 (1990) (explaining why banks prefer more risky investments over less risky investments).

The application of limited liability “create[s] incentives for excessive risk-taking by permitting corporations to avoid the full cost of their activities.” Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1879 (1991); see also FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 49-50 (1991) (“Because limited liability increases the probability that there will be insufficient assets to pay creditors’ claims, shareholders of a firm reap all of the benefits of risky activities but do not bear all of the costs.”); Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 143 (1980) (noting concerns that “limited liability could result in an incentive to firms to undertake excessively risky investment activities”); Mark J. Roe, *Corporate Strategic Reaction to Mass Tort*, 72 VA. L. REV. 1, 40-41 (1986) (explaining that limited liability externalizes risks without justification).

In response to concerns about potential abuses of limited liability, the law developed several exceptions to the application of limited liability, including piercing the corporate veil, equitable subordination, and fraudulent conveyances. See DOUGLAS G. BAIRD, *THE ELEMENTS OF BANKRUPTCY* 133 (1992) (fraudulent conveyances); ROBERT C. CLARK, *CORPORATE LAW* § 2.4, at 73 (1986) (veil piercing); Robert C. Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 505 (1977) (fraudulent conveyances); Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589, 597-606 (1975) (equitable subordination); *id.* at 606-25 (veil piercing).

The traditional corporate law exceptions to the application of limited liability are not well suited to the bank holding company context, however. MACEY & MILLER, *supra* note 35, at 655; see also Peter P. Swire, *Bank Insolvency Law Now That It Matters Again*, 42 DUKE L.J. 469, 475 (1992) (“Relying on fraudulent conveyance law would have enormous transaction costs and likely fail to capture most of the fraud.”).

⁵⁵ BENSTON ET AL., *supra* note 44, at 176 (explaining that opportunity for large rewards, combined with reduction of possible losses, may lead stockholders to prefer more risky firms); William R. Keeton, *Bank Holding Companies, Cross-Bank Guarantees, and Source of Strength*, FED. RESERVE BANK OF KANSAS CITY ECON. REV., May/June 1990, at 54, 57 (“[Bank holding company] owing significantly more than the value of its nonbank assets will be tempted to have its banks take big risks in order to pay off its debt.”); Macey & Miller, *supra* note 48, at 1162 (noting that loss not absorbed by bank shareholders is borne by third parties—healthy institutions who pay premiums to deposit insurance funds and federal taxpayers whose funds replenish federal insurance funds when they are depleted).

Since banks have relatively low capital as compared to other businesses, the incentive to take risks is magnified because shareholders have less capital at stake. See MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at 12-13 (noting that banks are among most highly leveraged non-government

ited liability progressively increases as the bank's net worth decreases.⁵⁶ If a bank's net worth is zero or negative and it has not yet been closed by its regulator, the "shareholders have nothing to lose from rolling the dice one more time."⁵⁷ In essence, the bank's shareholders and managers may gamble with the funds of the FDIC. "Heads, the bank wins, tails, the FDIC loses."⁵⁸

A moral hazard problem also arises from deposit insurance.⁵⁹ Deposit insurance permits a bank to continue to attract depositors by offering a risk-free rate of return even though the bank may be near insolvency because there is no risk to insured deposi-

companies in country); MACEY & MILLER, *supra* note 35, at 268 (explaining that banks are relatively highly leveraged and this increases shareholder pressure to engage in risky activities). "[B]ank risk has many elements," including interest rate risk, credit risk, fraud risk, operating risk, and diversification risk. *Id.* at 276; *see also* Richard E. Randall, *The Need to Protect Depositors of Large Banks, and the Implications for Bank Powers and Ownership*, NEW ENGLAND ECON. REV., Sept./Oct. 1990, at 63, 64 ("[T]he overwhelming majority of commercial bank failures can be attributed to credit risks in the loan portfolio."). *See generally* RISK AND CAPITAL ADEQUACY IN COMMERCIAL BANKS (Sherman J. Maisel ed., 1981) (discussing risks of commercial bank failures).

⁵⁶ The closer the bank is to zero net worth, the stronger is the incentive of the bank's shareholders "to increase [the bank's] risk exposure in the hopes of winning big and staying alive." BENSTON ET AL., *supra* note 44, at 40; *see also* REFORMING FEDERAL DEPOSIT INSURANCE, *supra* note 31, at 7 (noting that owners with little or no capital at risk are free to "gamble for resurrection").

⁵⁷ Macey, *supra* note 9, at 1294; *see also* H.R. REP. NO. 324, *supra* note 53, at 40. Shareholders keep gains if successful but FDIC bears costs if not successful, and therefore, many investments with negative expected payoffs will be made by managers whose judgments did not need to consider most of the downside risks. *Id.* Thus, the FDIC will more than likely bear substantial losses. *Id.*

⁵⁸ MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at I-13; *see also* BENSTON ET AL., *supra* note 44, at 104 ("Once insolvent, an institution has every incentive to take great risks in the hopes of getting into the black again. At that point, after all, if risk policies turn out successfully, the bank benefits. If the risks turns out badly, the losses are borne entirely by the FDIC."); REFORMING FEDERAL DEPOSIT INSURANCE, *supra* note 31, at 7 (explaining why owners and directors of failing institutions may make risky investments with deposit funds).

⁵⁹ Macey & Miller, *supra* note 26, at 33 ("[Deposit insurance] instill[s] public confidence in the banking system, [but] it does so at the cost of providing incentives for excessive risk taking by banks, which, in turn, leads to a greater risk of bank failures generally."); Woodward, *supra* note 28, at 693 ("Deposit insurance is . . . subject to moral hazard. The greater the coverage . . . the greater the potential moral hazard costs.").

tors even in the event of the bank's failure.⁶⁰ Depositors' claims will either be honored by the bank prior to its insolvency or by the FDIC after insolvency. Absent such insurance, however, a business enterprise approaching insolvency would either not be able to obtain credit or would have to pay high interest rates to compensate the creditor for the increased risk of insolvency and resulting nonpayment or partial payment of the creditor's claim.⁶¹ "Without deposit insurance, the cost of attracting [credit] is a restraint on risk-taking. . . . [T]he only way a bank can take advantage of this deposit insurance subsidy is by adopting a riskier-than-normal stance."⁶² Moreover, flat-rate premiums mean that deposit insurance is underpriced for institutions that engage in risky activities, creating what has been termed a "deposit insurance subsidy."⁶³ To take advantage of this subsidy, a bank must

⁶⁰ See Michael C. Keeley, *Deposit Insurance, Risk, and Market Power in Banking*, 80 AM. ECON. REV. 1183, 1183 (1990) (explaining that reason for excessive risk-taking is that banks "can borrow at or below the risk-free rate by issuing insured deposits and then investing the proceeds in risky assets with higher expected yields"); see also MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at I-12 (stating that creditors want highest return and do not have to consider risk-return trade-off).

⁶¹ The risk premium that may be demanded by creditors for risk being undertaken by businesses without the benefit of creditor insurance is a form of creditor discipline that also results in shareholder discipline as the return to shareholders is reduced because of high credit costs.

⁶² BENSTON ET AL., *supra* note 44, at 86; see also MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at I-12 (explaining that since no market penalty is exacted for risk, bank management has incentive to assume more risk than is consistent with safe and sound operations); Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 314 (1987) (stating that deposit insurance gives bank incentives to make risky loans that it would not make but for deposit insurance); George G. Kaufman, *Bank Runs: Causes, Benefits, and Costs*, 7 CATO J. 559, 573 (1988) ("[T]he present structure of federal deposit insurance changes the incentive structure of insured depositors in ways that will tend to increase the risk exposure of individual depository institutions.").

⁶³ BENSTON ET AL., *supra* note 44, at 177; see also Richard S. Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 ANN. REV. BANKING L. 317, 359 (1993) (flat-rate deposit insurance premiums "subsidize[] risk-taking by overcharging safe institutions and undercharging risky institutions"); Krishna G. Mantripragada, *Depositors as a Source of Market Discipline*, 9 YALE J. ON REG. 543, 548 (1992) ("Moral hazard refers to the propensity of the insured institutions to disregard the risk consequences of their actions, if the costs of such actions are shifted to the insurer. This problem arises when actions of the insured that increase either the

engage in riskier than normal activities.⁶⁴ Thus, deposit insurance joins limited liability in providing incentives to a bank's shareholders to urge management to undertake additional risk.⁶⁵

2. Limited Market Discipline

Very little market discipline is imposed on bank managers undertaking risk as the result of the moral hazards described above. Because shareholders stand to lose their investment if a bank fails, they provide some market discipline, although they exert that discipline only so long as the bank has a positive net worth.⁶⁶ Limited discipline may also be imposed by creditors not

probability or the size of the losses to the insurer have no bearing on the premiums the insured pays.”).

Although moral hazard is present whenever insurance is present, regular insurance uses deductibles, co-insurance, and risk-related premiums to control risk. The FDIC is “less successful than other types of insurers in causing their insureds to internalize the costs of risky activities.” Fischel et al., *supra* note 62, at 314; *see also* REFORMING FEDERAL DEPOSIT INSURANCE, *supra* note 31, at 6 (explaining moral hazard problem).

⁶⁴ BENSTON ET AL., *supra* note 44, at 86; *see also* George J. Benston, *Does Bank Regulation Produce Stability? Lessons from the United States*, in UNREGULATED BANKING: CHAOS OR ORDER? 207, 221-22 (Forrest Capie & Geoffrey E. Wood eds., 1991) (“[D]eposit insurance that is not priced according to risk introduces a very serious problem of moral hazard, which gives banks with insured deposits incentives towards excessive risk-taking. Moral hazard results from depositors having little reason to be concerned with how an insured institution operates (as long as the deposit insurance fund is considered to be adequate.)”); Kaufman, *supra* note 62, at 574 (stating that flat-rate premiums provide “strong incentive for insured banks to increase their risk exposures”).

The new risk-based insurance assessments will help alleviate the moral hazard, but to the extent that deposit insurance assessments vary only within a narrow range, the reduction of moral hazard will be lessened. *See supra* note 34 (describing new risk-based insurance assessments).

⁶⁵ The combination of deposit insurance and limited liability has been described as creating a “put option” for the shareholders of an insolvent bank. Carnell, *supra* note 63, at 339. “If the institution recovered, the owners alone would receive the gains. However, if it continued to deteriorate, the insurance fund would bear the increased risk of loss.” *Id.* (footnote omitted).

⁶⁶ BENSTON ET AL., *supra* note 44, at 175. Banks generally operate at much lower capital levels than other businesses, so bank shareholders have less capital at risk and exert less discipline than shareholders of other enterprises. Harris Weinstein, *Moral Hazard Deposit Insurance and Banking Regulation*, 77 CORNELL L. REV. 1099, 1101 (1992) (stating that in 1986, the average ratio of capital to assets for nonfinancial firms was 36%, while the

protected by deposit insurance,⁶⁷ but only to the extent that they expect the FDIC to select liquidation rather than a purchase and assumption transaction as the resolution method if the bank fails.⁶⁸

In nonbanking corporations, creditor discipline is an effective check on management's risk-taking strategies.⁶⁹ Because of deposit insurance, however, insured depositors—the largest single category of bank creditors⁷⁰—have no incentive to impose dis-

capital ratio for banks was only 6%); see MACEY & MILLER, *supra* note 35, at 268 (finding that bank shareholders are not particularly reliable monitors of management risk-taking).

⁶⁷ See REFORMING FEDERAL DEPOSIT INSURANCE, *supra* note 31, at 44 (explaining that uninsured depositors or uninsured creditors may exert creditor discipline by threatening to withdraw funding or charging higher interest and that if they recognize risk when loan is made, they may ask for collateral so that loan is secured); Asli Demirgüç-Kunt, *Deposit-Institution Failures: A Review of Empirical Literature*, ECON. REV., FED. RESERVE BANK OF CLEVELAND, Fourth Quarter 1989, at 2, 4 (stating that because subordinated debt holders may not withdraw their funds on demand, they do not share in increased profits that may result from increased risk-taking, and thus are a source of market discipline); Mantripragada, *supra* note 63, at 556-57 (reviewing previous studies that have found weak or non-existent market discipline exerted by uninsured depositors). *But see* Randall, *supra* note 55, at 73 (concluding that creditor discipline “cannot be effective in deterring excessive credit risks in banks . . . because the market cannot recognize and properly evaluate such risks on a timely basis, and belated market reaction is counter-productive”).

⁶⁸ MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at 8 (finding that purchase and assumption transactions further reduce market discipline and increase taxpayer exposure); Carnell, *supra* note 63, at 320 (stating that de facto protection by resolution methods means that creditors do not discipline risk-taking by bank managers); Jonathan R. Macey & Elizabeth H. Garrett, *Market Discipline by Depositors: A Summary of the Theoretical and Empirical Arguments*, 5 YALE J. ON REG. 215, 223 (1988) (explaining that market is not good tool for controlling risk unless regulators eliminate use of bank settlement techniques that insulate depositors from loss); Macey & Miller, *supra* note 48, at 1184 (“The FDIC[’s] preference for [purchase and assumption] transactions removes most of the incentive that large depositors have to provide market discipline for the risks assumed by a bank whose failure is expected to be handled by a P & A [purchase and assumption].”); Mantripragada, *supra* note 63, at 551 (“[F]ailure resolution methods also contributed to the erosion of market discipline.”) (footnote omitted).

⁶⁹ MACEY & MILLER, *supra* note 35, at 266.

⁷⁰ See MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, Table 2, after 70 (since 1983, over 75% of deposits have been insured).

cipline on the risk-taking of bank managers.⁷¹ Nor does the FDIC provide any “insurer discipline” in the form of risk-based premiums that are used in most other insurance contracts to account for the risk undertaken by the insured.⁷²

3. Little Incentive to Seek Prompt Closure of an Insolvent Bank

FDIC losses from bank failures could be virtually eliminated if a bank was closed at the moment that the market value of its assets equalled the market value of its liabilities.⁷³ A purchaser of the

⁷¹ See Benston, *supra* note 64, at 222 (“Deposit insurance . . . remove[s] the incentive for depositors to monitor risk-taking by banks”); Carnell, *supra* note 63, at 319 (“Deposit insurance impairs the discipline depositors would otherwise exert over depository institutions’ risk-taking”); Fischel et al., *supra* note 62, at 315 (“If all creditor claims are insured, creditors will invest where they are promised the highest return regardless of risk.”); Edward J. Kane, *Corporate Capital and Government Guarantees*, 5 J. OF FIN. SERVICES RES. 357, 360 (1992) (“Guarantees [such as deposit insurance] weaken creditor discipline, thereby creating incentives for the issuers of guaranteed debt to embrace additional risks of loss.”); Macey & Garrett, *supra* note 68, at 223 (“[O]ur complaint with the current regulatory scheme is that it deprives depositors of any incentive to impose market discipline on the excessive risk-taking proclivities of the nation’s banks.”); Macey & Miller, *supra* note 48, at 1165 (stating that lack of significant discipline from creditors is what makes banks fundamentally different from other types of firms).

Insured depositors may have the least ability to control an institution because of high information costs and because creditor control is difficult to exercise by a large number of depositors. As deposit insurer, the FDIC “represents insured depositors in order to exercise better creditor discipline than could the insured depositors themselves.” REFORMING FEDERAL DEPOSIT INSURANCE, *supra* note 31, at 43.

⁷² See Carnell, *supra* note 63, at 321 (“Risky and safe institutions paid the same deposit insurance premiums, which meant that safe institutions subsidized risky institutions.”) (footnote omitted). For an explanation of the implementation of a system of risk-based deposit insurance premiums see *supra* note 34.

⁷³ See BENSTON ET AL., *supra* note 44, at 40 (explaining that if bank not closed at insolvency, uninsured creditors, insurance agency, and shareholders suffer direct losses); *id.* at 103-04 (noting that some observers have argued that appropriate monitoring of bank net worth is more important to FDIC loss minimization than constraining bank risk-taking); William S. Haraf, *Toward a Sound Financial System*, 7 CATO J. 677, 679-80 (1988) (“Experience over the past decade . . . clearly shows that the extent of deposit insurance losses upon failure depends chiefly on how quickly insolvent firms are closed.”); Kaufman, *supra* note 62, at 574-75 (stating that recent study found that most important determinant of FSLIC cost for failed

assets would then be willing to assume the accompanying liabilities without any payment from the FDIC since theoretically the assets could be liquidated to yield just the amount needed to satisfy the claims of all creditors. Alternatively, if the insolvent bank was liquidated, the proceeds from the sale of its assets would be just enough to satisfy the claims of all depositors and other creditors. If Bank A in the example above was resolved by the FDIC at the moment its net worth was zero but before it became negative, only its holding company would lose any money as a result of the insolvency, and the holding company's loss would be limited to the \$100,000 in capital that it had contributed to Bank A.

As a result of the bank insolvency risk distribution scheme set forth above, however, neither a bank's shareholders nor its creditors (including depositors) have any incentive to ensure that a bank is closed at the time its capital has been exhausted and its assets equal its liabilities. When a bank's net worth reaches zero, its shareholders have already lost all they will lose under a limited liability regime, and their incentive is to delay closure hoping that the bank will miraculously earn enough to rebuild its capital position and return some value to their bank shares.⁷⁴ The bulk of a bank's creditors, who are likely to be fully protected by the FDIC upon the bank's insolvency, also have no incentive to seek prompt closure of the bank or to limit the amount of the bank's negative net worth.⁷⁵ Their preference is for the bank to continue operating and generating the returns that first attracted their funds to the bank. Nor do bank managers have an incentive to seek

thrifts during 1982-85 period was delay, averaging five months at a cost of about \$300,000 per institution, between date of insolvency under general accounting standards and date institution was declared insolvent and closed by FSLIC).

⁷⁴ See Bovenzi & Muldoon, *supra* note 37, at 4 n.11 (stating that when bank is at or near insolvency, risks are largely passed on to deposit insurer, while rewards accrue entirely to the bank and its shareholders if gamble is successful); Macey, *supra* note 9, at 1294; Macey & Miller, *supra* note 48, at 1199.

⁷⁵ Bank depositors are not concerned about the amount of a bank's negative net worth because of insurance. "[D]eposit insurance permits banks that are economically insolvent but have not yet been declared legally insolvent and closed to attract funds not only to meet deposit losses but also to make additional loans and investments and to expand in size." Kaufman, *supra* note 62, at 574. Therefore, those in control of these institutions are able to continue in operation for an indefinite time and are likely to further magnify losses. *Id.*

prompt closure of an insolvent bank, because once a bank is closed, its management is normally removed.⁷⁶

Only the FDIC and bank creditors who do not believe they will be fully protected by the FDIC's resolution of the insolvent institution have any incentive to close the institution upon insolvency in order to minimize the losses they will incur. The FDIC's economic incentive for prompt closure upon a bank's insolvency, however, may clash with its political incentives to "keep insolvent banks afloat" because of the "enormous political benefits to be derived" from delaying closure of an insolvent bank.⁷⁷ Even assuming an FDIC commitment to prompt closure, FDIC efforts may not be effective when arrayed against the adverse incentives of the players described above who are more closely aligned with and in control of the troubled bank.⁷⁸

C. Redistributing Bank Insolvency Risks

In significant banking laws passed in 1989 and 1991, referred

⁷⁶ The threat of job loss and damage to professional reputation, however, does give bank managers an incentive to avoid bank insolvency. MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at I-42; *see also* BENSTON ET AL., *supra* note 44, at 178 (arguing that managers fearing loss of their jobs should be source of restraint against risk-taking); Catherine England, *Agency Costs and Unregulated Banks: Could Depositors Protect Themselves?*, 7 CATO J. 770, 775 (1988) ("Because the long-term income and prestige of a bank's managers are more closely tied to the success or failure of a particular institution than is the financial security of the average stockholder, bank managers are likely to be more risk averse than the corporate owners."); Helen A. Garten, *Subtle Hazards, Financial Risks, and Diversified Banks: An Essay on the Perils of Regulatory Reform*, 49 MD. L. REV. 314, 359 (1990) (explaining that managers have incentive to prevent failure to protect their reputations); Macey & Miller, *supra* note 48, at 1164-65 (noting that bank managers, since their jobs are at stake, are more risk-averse than bank shareholders).

⁷⁷ *See* Jonathan R. Macey, *Needless Nationalization at the FDIC*, WALL ST. J., Feb. 14, 1992, at A10 ("[P]olitical benefits to be derived from keeping insolvent banks afloat . . . [are especially great] in an election year."); *see also* STAFF OF SUBCOMM. ON FIN. INSTS. SUPERVISION, REGULATION AND INS. OF HOUSE COMM. ON BANKING, FIN. AND URBAN AFFAIRS, 102D CONG., 2D SESS., MFCORP: A REGULATORY CASE STUDY 24-25 (Comm. Print 10) (faulting regulators for taking too long to act when an institution is troubled); Carnell, *supra* note 63, at 322 (stating that regulators have incentive to fail to take timely and appropriate action to reduce risk); Azar, *supra* note 54, at 157 (describing pressure on regulators not to close insolvent institutions).

⁷⁸ Azar, *supra* note 54, at 157 ("[R]apid closure requires accurate and timely measurements of capital, both of which have remained elusive for regulators.").

to in the banking vernacular as FIRREA and FDICIA,⁷⁹ Congress addressed the deposit insurance crisis brought about by the dramatic increase in depository institution failures during the 1980s.⁸⁰ Recognizing that no single solution to the problem of bank failures and the resulting drain on the federal deposit insurance system was likely to be sufficient,⁸¹ Congress attacked the problem through a combination of increased market discipline and additional regulatory discipline.⁸²

Regulatory discipline depends upon regulatory supervision, examination, and enforcement.⁸³ Regulators must identify problems, force correction of those problems, and resist the pressure to forbear from correcting such problems.⁸⁴ Moreover, the social costs of regulation are high as regulation invites avoidance,

⁷⁹ Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (codified in scattered sections of 12, 26 U.S.C.) [hereafter FIRREA]; The Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (codified in scattered sections of 12 U.S.C.) [hereafter FDICIA].

⁸⁰ Between 1943 and 1981, bank failures in any one year did not exceed 17. MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at I-25. Since then, however, bank failures have steadily increased. *Id.* In 1988, for instance, 221 banks failed. *Id.* at I-24.

⁸¹ BENSTON ET AL., *supra* note 44, at xvi.

⁸² *Cf.* MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at VII-3 (arguing that regulatory discipline is less effective in balancing risk with depositor protection than is market discipline).

⁸³ Some commentators, however, have expressed concerns about increasing market discipline rather than increasing regulatory supervision. See Katerina Simons & Stephen Cross, *Do Capital Markets Predict Problems in Large Commercial Banks?*, NEW ENGLAND ECON. REV., May/June 1991, at 51, 51 (studying effectiveness of market discipline). The concern is that outsiders (such as uninsured depositors) will not be able to assess bank risk as well as bank examiners since outsiders do not have access to the detailed financial information available to bank examiners. *Id.* This argument does not apply to market discipline exerted by a bank holding company as the shareholder of a bank, however, since it has access to the same information available to regulators and perhaps has access to additional information about the likelihood of loan repayment and market values of assets that may be more beneficial than the information reported to bank examiners.

⁸⁴ MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at X-2; see also Carnell, *supra* note 63, at 370 (arguing that regulatory efforts may not be sufficiently sophisticated or powerful to control behavior of complex institutions such as banks); Haraf, *supra* note 73, at 677 (“[I]n today’s aggressive, trading-oriented banking environment, it seems unlikely that regulation can substitute for market discipline in controlling risk taking by banking firms.”); Macey, *supra* note 9, at 1298 (concluding that regulators

evasion, delay, and results in accompanying legal costs.⁸⁵ This Article, therefore, focuses on statutory efforts to increase market discipline by readjustment of the incentives of private parties since such efforts promise to be more effective in reducing bank insolvency risk than additional regulation attempting to achieve these same goals.⁸⁶

cannot be expected to have same incentives to monitor and control risk as private sector).

⁸⁵ Fischer Black et al., *An Approach to the Regulation of Bank Holding Companies*, 51 J. OF BUS. 379, 382 (1978) (arguing that legal and other service costs are incurred in efforts to avoid regulatory constraints).

⁸⁶ Three other statutory changes that address the deposit insurance crisis are of note. These three changes are discussed in detail in a forthcoming article by Richard Carnell, Senior Counsel to the Senate Banking Committee, who notes that these other changes rely "heavily on regulators and regulation." Carnell, *supra* note 63, at 370.

First, to reduce FDIC liability for bank insolvency losses, Congress enacted capital-based prompt corrective action measures to limit insolvency losses by ensuring prompt closure of an insolvent institution before significant negative net worth accumulated. 12 U.S.C. § 1831o (Supp. III 1991). A problem with a system of early regulatory intervention, however, is that "accurately determining the current market value of a bank's assets is a daunting and possibly impossible task." MACEY & MILLER, *supra* note 35, at 279. Moreover, the heavy reliance on regulators and regulatory discretion "leaves considerable room for regulators to undercut the statute, whether by forbearance or by adopting constructions calculated to discredit unwanted provisions." Carnell, *supra* note 63, at 350. This change may also provide increased shareholder discipline since early regulatory intervention imposes a greater risk on bank shareholders. MACEY & MILLER, *supra* note 35, at 278.

A second statutory change attempts to reduce the moral hazard of deposit insurance by mandating the implementation of a risk-based assessment of deposit insurance premiums. 12 U.S.C. § 1817(b)(1) (Supp. III 1991); *see also* Carnell, *supra* note 63, at 359 ("Insofar as the system proportions premiums to risk, it will align the incentives of depository institutions' owners and managers with the interests of the insurance fund."). This second statutory change must be in effect by January 1, 1994. FDICIA, *supra* note 79, § 302(g), 105 Stat. at 2349. The FDIC has adopted regulations for an interim system of risk-based assessments effective January 1, 1993. 57 Fed. Reg. 45,263 (1992) (to be codified at 12 C.F.R. pt. 327 (1992)). A problem with risk-based deposit insurance premiums, however, is that the FDIC, as the monopoly provider of deposit insurance, will be subject to political pressure to treat all institutions similarly, rather than charging a wide range of prices to institutions with different risks. Carnell, *supra* note 63, at 360.

The third statutory change increases creditor discipline by mandating that the FDIC choose the least-cost method of resolving an insolvent institution. 12 U.S.C. § 1823(c)(4) (Supp. III 1991). FDICIA also provided that the

Statutory changes that may result in additional market discipline will help to change the incentives of bank shareholders, creditors, and managers.⁸⁷ These players, as previously discussed, have powerful incentives to increase the risk of a bank's activities to exploit the moral hazards created by limited liability and deposit insurance. The "most efficient and effective way to correct undesirable behavior is by mitigating the incentives giving rise to that behavior."⁸⁸ "[P]rovid[ing] private parties with incentives to monitor bank management and control excessive risk taking by banks"⁸⁹ should reduce the need for regulation, as market forces may be relied upon "to reestablish the trade-off between risk and return."⁹⁰

only exception to the least-cost resolution requirement is the rare instance when failure of the institution "would have serious adverse effects on economic conditions or financial stability." *Id.* § 1823(c)(4)(G)(i)(I). Some observers have questioned whether the FDIC has in good faith applied the least-cost method. *See* Macey, *supra* note 77, at A10 (criticizing the FDIC's resolution of CrossLand Savings Bank).

In addition, in FIRREA Congress codified a policy permitting the FDIC to make distributions to creditors of unequal percentages of their claims (so-called nonratable distributions), so long as all creditors receive at least the liquidation value of their claims. 12 U.S.C. § 1821(i)(2), (3) (Supp. II 1990). *See generally* Note, *Unsecured Creditors of Failed Banks: It's Not a Wonderful Life*, 104 HARV. L. REV. 1052 (1991) (focusing on FDIC's discretion to balance institutional goals with equitable treatment of creditors before and after passage of FIRREA). This FDIC practice had been rejected by several courts prior to its codification in 1989. *See, e.g.,* Texas American Bancshares v. Clarke, 740 F. Supp. 1243 (N.D. Tex. 1990); MBank New Braunfels, N.A. v. FDIC, 721 F. Supp. 120 (N.D. Tex. 1989).

⁸⁷ *See* REFORMING FEDERAL DEPOSIT INSURANCE, *supra* note 31, at xxi ("[E]nhancing the current regulatory system through a greater reliance on the marketplace could change the burden of risk and the incentives for depository institutions.").

⁸⁸ Carnell, *supra* note 63, at 324; *see also id.* at 371 ("[I]ncentives lie at the heart of a regulatory system's success or failure.").

⁸⁹ Macey & Miller, *supra* note 48, at 1225; *see also* BENSTON ET AL., *supra* note 44, at xvi (arguing that incentives for risk-monitoring and control by creditors and equity investors must be increased).

⁹⁰ *See* James B. Thomson, *Using Market Incentives to Reform Bank Regulation and Federal Deposit Insurance*, ECON. REV., FED. RESERVE BANK OF CLEVELAND, First Quarter 1990, at 28, 33 (stating that trade-off could be reestablished if those who gained from risk also bore risk when risk-seeking strategy did not pay off). Harris Weinstein, former general counsel to the Office of Thrift Supervision, characterizes the desired risk-reducing system as one of "regulation within the market." Weinstein, *supra* note 66, at 1104. Thus, regulation would "include rules that maintain the connections between the

Market discipline of an institution's activities is normally provided by its shareholders and creditors. The combination of deposit insurance and FDIC resolution methods, however, results in little meaningful creditor discipline of a bank's risk-taking activities. The Treasury Department proposed that Congress increase creditor discipline of banks by reducing deposit insurance coverage so that more depositors would be uninsured, and absent insurance, would discipline bank managers by seeking higher returns if necessary to compensate for a bank's insolvency risk.⁹¹ These changes to deposit insurance coverage were not adopted by Congress, however.⁹²

Absent significant changes in deposit insurance, increasing shareholder discipline is the only other way to inject more market discipline over the activities of bank managers. This Article examines the statutory changes designed to increase shareholder discipline of banks and to reduce FDIC insolvency losses. Congress enacted two separate statutes (which are described *infra*) that change traditional notions of limited liability and corporate separateness for banks owned by bank holding companies.⁹³ Professor Howell Jackson has also singled out these statutory provi-

private opportunity of gain and private risk of loss that deposit insurance . . . otherwise eliminate[s]." *Id.*

⁹¹ MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at 16-25. The Treasury's proposals to reduce deposit insurance coverage were modest: limitation of individual depositor coverage to \$100,000 per institution (rather than \$100,000 per account), with an eventual goal of a limit of coverage of \$100,000 per individual depositor. *Id.* at 20-21.

⁹² Although reduced insurance coverage would likely still protect banks from depositor runs and would certainly provide protection for the nest eggs of the average depositor, reduction in insurance coverage proved to be politically impossible. See MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at 20-21 (noting that less than 6% of all households have more than \$100,000 in total deposits in insured institutions). Creditor discipline was increased somewhat, however, by statutory changes in FDIC resolution procedures that make it less likely that the claims of uninsured depositors and nondeposit creditors will be protected in full upon a bank's failure. For a discussion of these statutory changes, see *supra* note 86.

⁹³ Bank holding companies control 92.7% of all bank assets. Federal Reserve Board (Banking Structure and Assets as of December 31, 1991).

A bank holding company is a regular corporation incorporated pursuant to state laws. 12 U.S.C. § 1841(a) (1988). It is regulated by the Federal Reserve Board pursuant to the Bank Holding Company Act. *Id.* §§ 1841-1846 (1988, Supp. II 1990, & Supp. III 1991). A bank holding company may own only banks operating in states permitting interstate banking, *id.* § 1842(d) (1988), and nonbanking subsidiaries engaging in activities so

sions for discussion in a forthcoming article.⁹⁴ He suggests that increasing holding company responsibility may be a more successful method of reducing bank risk than other efforts at regulatory reform, in part because increasing holding company liability relies on market forces rather than on government risk assessment and regulatory supervision and enforcement.⁹⁵

1. 1989 FIRREA Cross-Guarantee Provision

In 1989, as part of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), Congress added to the Federal Deposit Insurance Act a "cross-guarantee" provision, which provides that commonly controlled depository institutions must pay to the FDIC the amount of loss that the FDIC suffers or expects to suffer as the result of the insolvency of a depository institution.⁹⁶ Depository institutions are commonly controlled if they are con-

closely related to banking as to be considered a proper incident to banking, *id.* § 1843(c)(8).

In addition to the statutory changes that are the subject of this Article, FDICIA also provides that no capital distribution or management fees may be paid by a bank if after such distribution the bank would be undercapitalized. This provision denies bank shareholders an unwarranted priority over the FDIC when a bank is in financial difficulty. Carnell, *supra* note 63, at 335-36.

⁹⁴ Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. (forthcoming 1993) (manuscript on file with author).

⁹⁵ *Id.* (manuscript at III-1 to III-2).

⁹⁶ 12 U.S.C. § 1815(e) (Supp. III 1991). The loss is that which the FDIC reasonably anticipates incurring in connection with the default of an institution. *Id.* § 1815(e)(1)(A). The cross-guarantee provision also extends to FDIC losses in connection with FDIC assistance provided to an institution in danger of default. *Id.* § 1815(e)(1)(A)(ii).

The FDIC may make a good faith estimate of the amount of the loss that it will incur from an institution's insolvency. *Id.* § 1815(e)(2)(A). If the FDIC's estimate is too low, it may assess additional amounts; if it is too high, then it must reimburse each commonly controlled institution for its pro rata share of any overpayment. *Id.* § 1815(e)(2)(D).

If more than one commonly controlled depository institution is to be assessed, each will be jointly and severally liable for the losses suffered by the FDIC. Policy Statement, 55 Fed. Reg. 21,934, at 21,935 (1990). The FDIC, however, shall estimate the liability of each individual institution by first assessing an amount on a pro rata capital basis that results in parity in the capital ratios of the responsible institutions and will divide any additional assessment on a pro rata basis utilizing the most recent Report of Condition. *Id.*

trolled by the same holding company, and are treated for this purpose as if they were branches of a single bank.⁹⁷ The purpose of the cross-guarantee provision is “to ensure that the assets of healthy depository institution subsidiaries within the same holding company structure . . . will be available to the FDIC to help offset the cost of resolving the failed subsidiary.”⁹⁸

A bank’s cross-guarantee liability for the FDIC costs of resolving an insolvent sister bank is subordinate to all other liabilities of the bank except for liabilities owed to affiliated institutions.⁹⁹

⁹⁷ 12 U.S.C. § 1815(e)(9) (Supp. III 1991) (defining commonly controlled institutions). The definition of “control” used in the Bank Holding Company Act, *id.* § 1841(a)(2) (1988), is also applicable in the cross-guarantee context. *Id.* § 1813(w)(5) (Supp. III 1991).

⁹⁸ Policy Statement, 55 Fed. Reg. 21,934, at 21,935 (1990); *see also* H.R. CONF. REP. NO. 222, 101st Cong., 1st Sess. 393, 395 (1989), *reprinted in* 1989 U.S.C.C.A.N. 432, 434 (establishing liability to FDIC under cross-guarantee provision for losses arising from default of commonly controlled institutions); H.R. REP. NO. 54, 101st Cong., 1st Sess., pt. 1, at 1, 325, *reprinted in* 1989 U.S.C.C.A.N. 86, 121 (requiring commonly controlled institution to reimburse FDIC for resolving insolvency after default of insured institution); THRIFT MERGERS AND ACQUISITIONS AFTER FIRREA INCLUDING BANK HOLDING COMPANY ACQUISITIONS OF THRIFTS 837 (Practising Law Inst., 1990) [hereafter THRIFT MERGERS AND ACQUISITIONS] (reprinting testimony of L. William Seidman, Chairman FDIC) (“[The cross-guarantee] provision was designed to keep multi-institution holding companies from abandoning failing insured affiliates. *Insured* affiliates were made guarantors because they are the direct beneficiaries of deposit insurance.”) (emphasis in original); Keeton, *supra* note 55, at 54 (suggesting that Congress was responding to bank holding company practices evidenced by holding companies located in Texas that reduced safety and soundness).

⁹⁹ 12 U.S.C. § 1815(e)(2)(C)(ii) (Supp. III 1991). The cross-guarantee liability has priority over any obligation to shareholders and any obligation owed to any affiliate of the bank (other than an obligation that was secured as of May 1, 1989). *Id.* § 1815(e)(2)(C)(i).

The House Report explained that if FDIC claims were entitled to equal payment preference with a bank’s creditors, the claims of these creditors would be diluted. H.R. REP. NO. 54, *supra* note 98, at 412, *reprinted in* 1989 U.S.C.C.A.N. at 208.

The cross-guarantee provision is not applicable for the five-year period following the enactment of FIRREA for any FDIC loss suffered as a result of a failed institution which was acquired prior to the enactment of FIRREA. 12 U.S.C. § 1815(e)(6) (Supp. III 1991).

“Intensive lobbying by bank holding companies, including behind-the-scenes negotiations with regulators, ultimately led to a considerable softening of the original cross-guarantee design.” David L. Glass, Comment, *Cross-Guarantee Is Seen as Risk to Holding Companies*, AM. BANKER, July 19, 1990, at 19. The original version of this provision proposed that

Thus, in the event the guarantor bank is also insolvent, the FDIC's claim against the insolvent guarantor bank will not be satisfied until after satisfaction of the claims of all other non-affiliated creditors, including subordinated debtholders. Moreover, a waiver procedure permits the FDIC to waive the cross-guarantee liability if it determines that a liability exemption is in the best interests of the deposit insurance fund.¹⁰⁰

The impact of this risk-shifting provision may be best illustrated by returning to the example described earlier of the bank holding company operating under a system of limited liability and owning insolvent Bank A and solvent Bank B.¹⁰¹ Upon Bank A's insolvency, the FDIC suffers a \$150,000 loss from a purchase and assumption transaction, and the bank holding company loses its \$100,000 of Bank A capital.¹⁰² Bank B continues to operate with its \$100,000 of capital intact, unaffected by the failure of Bank A. If the FDIC elects to assert its cross-guarantee authority, however, it reduces its loss from \$150,000 to \$50,000 by using the capital of Bank B (\$100,000) to satisfy Bank B's guaranty to the FDIC for the FDIC's costs in resolving Bank A. The bank holding company loses not only its \$100,000 investment in Bank A, but

the cross-guarantee liability have priority over most other categories of claims against the bank, except deposits. *Id.* at 24.

¹⁰⁰ 12 U.S.C. § 1815(e) (Supp. III 1991); *see also* 135 CONG. REC. H5301 (daily ed. Aug. 4, 1989) (statement of Cong. Gonzalez) (“[O]ne of the purposes of the waiver authority . . . is to give the FDIC sufficient flexibility to facilitate the acquisition of a financially distressed bank by a bank holding company.”).

During the period of any exemption from cross-guarantee liability, however, the exempted depository institution and its affiliates will not be entitled to the benefits of the sister-bank exemption to the affiliate transaction rules. 12 U.S.C. § 1815(e)(5)(B) (Supp. III 1991).

The FDIC's policy statement on cross-guarantees indicates that in addition to a waiver of the cross-guarantee provision, it will also consider a request to reduce the amount of the cross-guarantee liability. Policy Statement, 55 Fed. Reg. 21,934, at 21,935 (1990). The FDIC's announced policy is to assess the cross-guarantee liability in all instances except: “(i) Where an unaffiliated party acquires control of a distressed institution and held no financial interest, directly or indirectly, prior to acquisition; or (ii) where the cumulative projected losses to the FDIC is greater than the cost of not assessing the liability.” *Id.*

¹⁰¹ *See supra* notes 44-45 and accompanying text (posing example to illustrate distribution of risk in bank insolvency).

¹⁰² The loss in value of the bank holding company is borne by the holding company's shareholders who each lose \$20,000 of the value of their original \$100,000 investment in the holding company.

also its \$100,000 investment in Bank B.¹⁰³ Bank B is now also insolvent as a result of the exercise of the cross-guarantee provision.¹⁰⁴

2. 1991 FDICIA Controlling Company Guarantee Provision

The Federal Deposit Insurance Corporation Improvement Act (FDICIA) was enacted late in 1991.¹⁰⁵ That Act was the modest result of what began as an effort to obtain very sweeping reforms of bank regulation.¹⁰⁶ One proposal set forth was the extension of the cross-guarantee provision to bank holding companies.¹⁰⁷ Many viewed this proposal as a statutory codification of a regulation promulgated by the Federal Reserve Board and termed the "source of strength" regulation which provides that a "bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks."¹⁰⁸ An administrative enforce-

¹⁰³ Thus, each shareholder in the bank holding company experiences a decline in the value of the shareholder's investment by \$40,000.

¹⁰⁴ The FDIC should experience no further costs as a result of the insolvency of Bank B since Bank B's guarantee liability is limited to the amount of its capital, and upon insolvency, its assets could be liquidated to satisfy the claims of its depositors and other creditors.

This scenario mirrors the FDIC's experience with the Bank of New England Corporation. One bank in the three-bank holding company was declared insolvent because it was unable to meet the cross-guarantee liability for losses estimated in connection with the other two insolvent bank subsidiaries. *Congressional Committees Are Investigating Bank of New England Failure*, 10 Banking Expansion Rep. 2 (1991); see also Jennifer B. Arlin, Note, *Of Property Rights and the Fifth Amendment: FIRREA's Cross-Guarantee Reexamined*, 33 WM. & MARY L. REV. 293, 308-09 (1991) (discussing FDIC's exercise of cross-guarantee power in failure of Bank of New England Corporation's subsidiary).

¹⁰⁵ FDICIA, *supra* note 79 (enacted December 19, 1991).

¹⁰⁶ Lise M. Simmons et al., *Climate for Reform Legislation is Poor in 1992; Implementation of 1991 Bill Will Preoccupy Regulators*, 58 Banking Rep. (BNA) 95, 97 (Jan. 20, 1992); see also Cantwell F. Muckenfuss, III et al., *The Federal Deposit Insurance Corporation Improvement Act of 1991*, BANK MGMT., Jan. 1992, at 37, 37. The original bills proposed in the House and Senate contained significant breakdowns of bank ownership restrictions, activity restrictions, and interstate banking restrictions. *Id.*

¹⁰⁷ H.R. 6, 102d Cong., 1st Sess. § 602 (1991).

¹⁰⁸ 12 C.F.R. § 225.4(a)(1) (1992). A holding company's "failure to assist a troubled or failing subsidiary bank . . . would generally be viewed as an unsafe and unsound banking practice." Policy Statement, 52 Fed. Reg. 15,707, at 15,707 (1987). Upon a finding of an "unsafe or unsound practice," the federal banking agency that is the primary regulator of the insolvent bank may institute an enforcement proceeding against the bank

ment proceeding brought to enforce the regulation, however, was enjoined by the United States Court of Appeals for the Fifth Circuit, which held that the source of strength regulation exceeded the Federal Reserve Board's statutory authority.¹⁰⁹ Although the Supreme Court reviewed this case, it did not reach the question of whether the source of strength regulation was within the statutory authority of the Federal Reserve Board, and the validity of this regulation remains unresolved.¹¹⁰

Congress did not extend the cross-guarantee provision to include bank holding companies along with commonly controlled depository institutions, but it did provide in certain instances for a limited guarantee by the bank holding company parent.¹¹¹ This

holding company and may in certain cases seek a cease and desist order or money damages as a result of the unsafe or unsound practice. *Id.* at 15,708.

In response to the FRB's difficulties in enforcing the source of strength policy, the House Government Operations Committee proposed in 1987 that the subsidiary bank be permitted to fail and that the bank holding company be required to reimburse the FDIC for the costs of resolving the failed institution. Keeton, *supra* note 55, at 61.

¹⁰⁹ MCorp Fin. v. Board of Governors, 900 F.2d 852 (5th Cir. 1990), *aff'd in part, rev'd in part*, 112 S. Ct. 459 (1991). MCorp, a bank holding company, owned 25 banks located in Texas. Twenty of the subsidiary banks were subsequently declared insolvent, and MCorp entered into a bankruptcy proceeding. MCorp then sought a declaration that the Federal Reserve Board's administrative enforcement proceeding had been automatically stayed by the MCorp bankruptcy filing pursuant to the Bankruptcy Code. In December 1991, the United States Supreme Court reversed the Fifth Circuit, holding that the Board's administrative enforcement proceeding fell within an exception to the automatic stay provision of the Bankruptcy Code for proceedings to enforce a "governmental unit's police or regulatory power." Board of Governors v. MCorp Fin., 112 S. Ct. 459, 464 (1991) (citing 11 U.S.C. § 362(b)(4) which sets forth exceptions to the automatic stay). The Court rejected the argument that a bankruptcy court in recognizing this exception to the automatic stay "must first determine whether the proposed exercise of police or regulatory power is legitimate." Board of Governors, 112 S. Ct. at 464 (requiring an inquiry into the legitimacy of the governmental action would be "problematic"). Therefore, it was improper for the Fifth Circuit to declare the regulatory action unlawful as beyond the agency's statutory authority. *Id.* The Court stated that the proper time for determination of the validity of the enforcement authority was when and if judicial proceedings were commenced to enforce a final administrative order. *Id.*

¹¹⁰ See Board of Governors, 112 S. Ct. at 461 ("[B]ecause we conclude that the District Court lacked jurisdiction to enjoin either regulatory proceeding, we do not reach the merits of MCorp's challenge to the regulation.").

¹¹¹ See 12 U.S.C. § 1831o(e)(2)(C) (Supp. III 1991) (requiring controlling

provision of the Act became effective in December 1992.¹¹² If a bank is found to be undercapitalized (i.e., unable to meet applicable minimum capital requirements), it must submit a capital restoration plan to its federal regulator.¹¹³ A condition to the FDIC's approval of an institution's capital restoration plan is that its controlling company (if any) guarantee that the institution will comply with the capital restoration plan until the institution has been adequately capitalized during each of four consecutive calendar quarters and provide "appropriate assurances of performance."¹¹⁴ The controlling company's guarantee liability is statutorily limited, however, to the lesser of the amount needed to bring the depository institution into compliance with all capital standards as of the time it fails to comply with its capital restoration plan, or five percent of the institution's assets at the time it became undercapitalized.¹¹⁵ The purpose of the guarantee has been described as "seek[ing] to induce a parent company to decide promptly whether to recapitalize the institution, sell it, or stand behind it until it recovers."¹¹⁶ If the bank holding company enters a bankruptcy proceeding, the FDIC's claim on the guarantee will be granted a priority position with respect to other

company to guarantee that failed institution will comply with capital restoration plan).

¹¹² FDICIA, *supra* note 79, § 131(f), 105 Stat. at 2267.

¹¹³ 12 U.S.C. § 1831o(e)(2)(A) (Supp. III 1991).

¹¹⁴ *Id.* § 1831o(e)(2)(C)(ii); see Richard S. Carnell, *Prompt Corrective Action Under the FDIC Improvement Act of 1991* (1992), reprinted in *LITIGATING FOR AND AGAINST THE FDIC AND THE RTC 1992*, at 27, 48 (Practising Law Inst., 1992) (appropriate assurances of performance might include security interests or a performance bond).

¹¹⁵ 12 U.S.C. § 1831o(e)(2)(E) (Supp. III 1991); see also *FED Rejects Banc One's Request to Waive Source of Strength Rule*, 58 Banking Rep. (BNA) 7 (Jan. 6, 1992) (suggesting that Congress did not recognize an unlimited source of strength in adopting the controlling company guarantee).

An early House version limited the bank holding company's liability only to the amount necessary to bring the bank into compliance with its capital restoration plan. H.R. REP. NO. 330, 102d Cong., 2d Sess. 20 (1991). By October 1, 1991, however, the five percent limit had appeared in the proposed legislation. The Senate Report suggests that a limit on bank holding company liability was inserted to ensure adequate investment in the banking industry. S. REP. NO. 543, 102d Cong., 2d Sess. 227 (1991). Five percent of a bank's assets approximates its capital, making the controlling company guarantee very similar to the double liability provision in effect prior to 1933. See *supra* notes 26-30 and accompanying text (discussing double liability system).

¹¹⁶ Carnell, *supra* note 63, at 339.

unsecured creditors of the bank holding company pursuant to recent amendments to the Bankruptcy Code.¹¹⁷

There is no requirement that the controlling company submit a guarantee of the undercapitalized institution's capital restoration plan. If the guarantee is not executed, however, the FDIC will not approve the plan.¹¹⁸ An institution that fails to submit an acceptable capital restoration plan is subject to numerous restrictions on its activities, including restrictions on asset growth, acquisitions, additional branches, and new lines of business.¹¹⁹

If the FDIC elects to utilize the new controlling company guarantee along with its cross-guarantee authority, the FDIC loss upon a bank's insolvency may be further minimized. Assume that Bank A had previously adopted a capital restoration plan upon being found undercapitalized, and that the bank holding company's guarantee of Bank A's capital restoration plan was limited to 5% of Bank A's assets at the time it became undercapitalized. Five percent of Bank A's assets (about \$2,000,000 at the time it became undercapitalized) might approximate \$100,000. Thus, the FDIC could look to the bank holding company as a potential source of \$100,000 pursuant to the controlling company guaran-

¹¹⁷ Crime Control Act of 1990, Pub. L. No. 101-647, § 2522(d), 104 Stat. 4789, 4867 (codified at 11 U.S.C. § 507(a)(8) (Supp. II 1990)) (affording priority to "capital maintenance agreement"); *see also* 11 U.S.C. § 365(o) (Supp. III 1991) (requiring bankruptcy trustee to assume capital maintenance commitments made to regulatory agencies); *Resolution Trust Corp. v. Firstcorp Inc. (In re Firstcorp Inc.)*, 973 F.2d 243 (4th Cir. 1992) (holding that § 365(o) requires savings and loan holding company to assume any deficit in capital maintenance agreement before filing for reorganization under Chapter 11 of Bankruptcy Code).

Capital maintenance agreements have been required by thrift regulators of thrift holding companies as a way of ensuring capital adequacy. Jackson, *supra* note 94 (manuscript at I-28 to I-37). A controlling company guarantee will apparently be considered the equivalent of a capital maintenance agreement. *See* 57 Fed. Reg. 44,866, at 44,880 (1992) (to be codified at 12 C.F.R. pts. 308, 325 (1992)) (imposing liability on guarantor up to amount necessary to resolve adequate capital standards). *But see* S. REP. NO. 167, 102d Cong., 1st Sess. 227 (1991) (additional comments by Sens. Dodd, Sanford, Shelby, Garn, D'Amato, and Chafee) (expressing fear that capital restoration and cross-guarantee provisions would unduly hamper investment in holding companies and should not be construed as capital maintenance provisions under Bankruptcy Code).

¹¹⁸ 12 U.S.C. § 1831o(e)(2)(C) (Supp. III 1991).

¹¹⁹ *Id.* § 1831o(f)(2), (4). The FDIC may also require recapitalization or divestiture, and prohibit deposits from correspondent banks. More severe restrictions may be imposed if the institution is critically undercapitalized.

tee and to Bank B as a potential source of \$100,000 pursuant to the cross-guarantee to satisfy its \$150,000 loss. The FDIC would be able to reduce its expected loss as a result of Bank A's insolvency from \$150,000 to zero.¹²⁰ Depending on how the FDIC chose to make itself whole for its losses, Bank B might continue to exist with some portion of its former capital remaining, or it too might have to be closed upon reaching zero net worth if the FDIC elected to exercise its cross-guarantee authority to the fullest extent possible against Bank B.¹²¹

II. BANK HOLDING COMPANY RESPONSIBILITY FOR BANK INSOLVENCY RISKS

This Part evaluates the statutory redistribution of bank insolvency risks, imposing more of the risk on the bank holding com-

¹²⁰ The shareholders of the bank holding company would lose their \$100,000 investment in Bank A and would lose an additional \$150,000 representing some combination of their investment in Bank B and remaining capital of the bank holding company. The \$250,000 loss in investment would result in a decrease of \$50,000 in the likely value of each shareholder's stock in the bank holding company.

The numbers in the example may be changed to reduce the capital contribution of each shareholder in the bank holding company to \$40,000, for \$200,000 of total capital, in order to demonstrate that limited liability remains intact for individual shareholders of the bank holding company. Leaving all other assumptions the same, the FDIC's \$150,000 loss could potentially be recovered from a combination of the exercise of the cross-guarantee power (\$100,000 in capital in Bank B available) and the bank holding company guarantee of Bank A's capital restoration plan of \$100,000. The bank holding company's guarantee would not be effective, however, because in this scenario the bank holding company's \$200,000 of capital is invested entirely in Bank A and Bank B. Thus, the FDIC's costs from Bank A's insolvency will not be reduced below \$50,000. The shareholders of the bank holding company will lose their entire \$200,000 investment, but no more. The FDIC loses \$50,000 and limited liability protects the individual shareholders of the bank holding company from being assessed any amount beyond their original investment. Bank B will become insolvent as the cross-guarantee is exercised to its fullest extent against Bank B.

¹²¹ In this example, both the controlling company guarantee and the cross-guarantee authority must be used to make the FDIC whole. If past practice is any guide, the FDIC may prefer to exercise the cross-guarantee fully against Bank B so that both holding company banks may be closed at the same time and resolved together. A potential purchaser may want to preserve the franchise value of the holding company by purchasing the assets of both banks.

pany and commonly controlled depository institutions, and correspondingly less risk on the FDIC. The redistribution of risks should lead to a reduction of risks because the redistribution reduces the moral hazard of limited liability, increases the market discipline that will be imposed on bank managers, and provides a bank holding company with a strong incentive to seek closure of an insolvent bank subsidiary before significant negative net worth accrues.¹²² In addition, the redistribution is compatible with equitable notions of loss distribution by placing more of the risk of insolvency on the entity which stands to benefit from any gains that might be realized from that risk.¹²³

A. Redistribution of Bank Insolvency Risks to Bank Holding Companies and Reduction of Risk

1. Reduction of Moral Hazard

In a limited liability system, as a bank's capital declines, its shareholders have little left to lose from the bank's insolvency. Consequently, they may encourage bank managers to engage in increasingly risky activities which, if successful, will return value to their shares, and, if unsuccessful, will result in little or no further loss to them.¹²⁴ Deposit insurance permits banks to attract funds at a risk-free rate of return and provides shareholders with an incentive to encourage the bank to use the funds in risky activities likely to generate a high return that will redound to the benefit of bank shareholders.¹²⁵

The risk redistribution statutes, however, have attacked part of this two-pronged moral hazard by modifying traditional conceptions of limited liability. Under these statutes, shareholders of a bank holding company stand to lose more than their capital

¹²² See Jackson, *supra* note 94 (manuscript at II-2) (noting that one reason additional liability was imposed on holding companies "was to replenish dwindling reserves in public insurance funds").

¹²³ See *infra* notes 167-86 and accompanying text (discussing distributional equity).

¹²⁴ See MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at 12 (finding that banks are less likely to take risks when substantial amounts of their own money are at risk); Jackson, *supra* note 94 (manuscript at II-19) (increasing holding company obligations deal directly with moral hazard).

¹²⁵ See *supra* notes 54-65 and accompanying text (discussing moral hazard of shareholder incentive to encourage risky investments because deposit insurance minimizes risk).

investment upon a subsidiary bank's insolvency.¹²⁶ For a multibank holding company, the cross-guarantee provision may be applied to recover FDIC losses from the remaining solvent banks owned by the bank holding company.¹²⁷ The cross-guarantee assessment might render solvent banks insolvent and result in the loss of bank holding company capital in other bank subsidiaries.¹²⁸ If a bank holding company elects to guarantee the capital restoration plan of an undercapitalized bank subsidiary it may lose its capital investment in that subsidiary upon its insolvency plus an approximately equivalent amount representing five percent of the bank's assets at the time the bank became undercapitalized.¹²⁹

With greater responsibility for the losses created by bank risk, the bank holding company shareholder now has an incentive to reduce the likelihood of loss and the amount of loss. Thus, the statutes help to "transform[] shareholders from investors seeking to advantage themselves at the expense of other investors by *increasing* the riskiness of the banks in which they have invested into investors who benefit themselves by *decreasing* the riskiness of these firms."¹³⁰

2. Increase of Market Discipline

Pursuant to the risk distribution scheme described in Part I, bank shareholders provided some discipline on the activities undertaken by bank managers because shareholder capital would be lost if a bank became insolvent.¹³¹ The fervency of this disci-

¹²⁶ See Jackson, *supra* note 94 (manuscript at II-10) ("[M]oral hazard problems common to all financial institutions are exacerbated when the entire equity interest of [a] financial institution is controlled by a single corporate shareholder well-situated to exploit the moral hazard.") (footnote omitted).

¹²⁷ See *supra* notes 96-98 and accompanying text (explaining effect of cross-guarantee provision). The cross-guarantee provision will reduce the risk of bank failures of a geographically diverse multibank holding company. Keeton, *supra* note 55, at 58-59. The holding company will only let a troubled bank fail if it has little chance of returning to profitability. *Id.* at 59. Further, the cross-guarantee eliminates any incentive to transfer resources from the holding company's troubled banks to its healthier banks. *Id.*

¹²⁸ See *supra* notes 101-04 and accompanying text (posing example where solvent bank becomes insolvent because of cross-guarantee provision).

¹²⁹ 12 U.S.C. § 1831o(e)(2)(E) (Supp. III 1991).

¹³⁰ Macey & Miller, *supra* note 26, at 33 (emphasis in original).

¹³¹ BENSTON ET AL., *supra* note 44, at 175; see also *supra* note 66 and

pline was no doubt affected by the fact that shareholder liability upon a bank's insolvency was limited to bank capital, and further weakened as the bank's capital approached zero and moral hazard increased.¹³²

The statutory modifications of limited liability increase the discipline imposed by a bank holding company as bank shareholder, because the bank holding company now has more to lose if its bank subsidiary becomes insolvent.¹³³ Imposed discipline by a bank holding company shareholder should also increase because the redistribution statutes may reduce the bank holding company's assets upon a subsidiary bank's insolvency. The redistribution statutes should also increase creditor discipline. Although the claims of nondeposit creditors against the insolvent bank will be treated no differently as a result of the cross-guarantee than they were under the prior risk distribution scheme,¹³⁴ application of the cross-guarantee may force a sister bank into insolvency and deprive its creditors of continued interest on their credit extension. Thus, the discipline exerted by nondeposit creditors of a bank in a multibank holding company system should increase.¹³⁵

accompanying text (explaining role of shareholder in asserting market discipline).

¹³² See *supra* notes 54-58 and accompanying text (discussing moral hazard of shareholders encouraging bank managers to undertake excessive risks).

¹³³ See H.R. REP. NO. 324, *supra* note 53, at 48 (explaining that additional liability rule "would provide an enhanced incentive for the holding company to closely supervise the affairs of any subsidiary bank or thrift that is in severely weakened financial condition"); England, *supra* note 76, at 782 (arguing that imposition of additional liability on shareholders should increase their incentives to encourage bank managers to avoid failure).

A study that monitored the stock market returns of publicly traded bank holding companies cast doubt, however, on the "supposed advantages investors . . . would have over bank regulators in restraining risk-taking by banks and in monitoring their management." Simons & Cross, *supra* note 83, at 55.

¹³⁴ The cross-guarantee liability is subordinate to claims made against an insolvent bank by other creditors except affiliated creditors and shareholders. See Glass, *supra* note 99, at 24 (arguing that if not subordinated, cross-guarantee provision would have "major chilling effect" on ability of healthy sister banks and thrifts to maintain and build funding).

¹³⁵ But see JAMES L. PIERCE, *THE FUTURE OF BANKING* 121 (1991) (stating that cross-guarantee provision will "confound market discipline" for banks in multibank holding company because large depositors and other creditors bear risk of all depository institutions but can only exercise discipline over activities of bank to which they provided funds).

The controlling company guarantee provision affects bank creditors only

The effect of the new statutory provisions on bank holding company creditors is more profound.¹³⁶ Since the bank holding company stands to lose more under the new risk distribution than the former scheme, bank holding company creditors must also consider the increased possibility of the bank holding company's insolvency as the result of these losses.¹³⁷ Moreover, the controlling company guarantee is likely to be treated as a priority claim upon the bank holding company's bankruptcy, coming ahead of most other unsecured creditors of the holding company.¹³⁸ If the FDIC obtains assurances of payment of the controlling company guarantee from the bank holding company so that it is a secured claimant of the insolvent bank holding company, then the claim will be paid before any unsecured claims.¹³⁹ Thus, market discipline exerted by unsecured creditors of the bank holding company should increase as the result of the statutory risk redistribution.

Finally, the new redistribution statutes may result in a reshaping of credit funding for a bank holding company enterprise. It is now "preferable to make a subordinated capital loan to the insured bank than to its parent. In effect, . . . the parent bank holding company [is] the weakest link in the chain of entities constituting a bank holding company system."¹⁴⁰ Thus, some of

slightly by possibly reducing the amount of bank holding company capital that is available to be contributed to bank subsidiaries.

¹³⁶ See William Gifford, *Bailout Law Gives FDIC Power: NBW's Rescue May Be Charged to Sister Banks*, LEGAL TIMES, Sept. 24, 1990, at 10, 11 (stating that if cross-guarantee provision is used to cause sister banks to fail, bank holding company's creditors will not have many assets at their disposal); Steve Klinkerman, *Provision Dims Appeal of S&Ls for Bank Firms*, AM. BANKER, Aug. 11, 1989, at 1 (noting that some complain that cross-guarantee provision means that holding company creditors cannot look to bank assets for settlement of their claims).

¹³⁷ See Klinkerman, *supra* note 136, at 12 (quoting a Standard & Poor's officer who stated that the cross-guarantee provision will "jolt investors into monitoring multibank companies more closely").

¹³⁸ See *supra* note 117 and accompanying text (explaining priority claim of guarantee).

¹³⁹ 11 U.S.C. § 507(a)(8) (Supp. II 1990); see also Carnell, *supra* note 114, at 48 (appropriate assurances of performance might include security interests or a performance bond).

¹⁴⁰ Glass, *supra* note 99, at 24; see also Keeton, *supra* note 55, at 59 (explaining that cross-guarantee provision may slow growth of holding companies because FDIC will bear less of loss and holding companies "will

the creditors previously dealing with bank holding companies may prefer to lend directly to the bank instead.

Some observers have characterized shareholder and creditor discipline as a disadvantage of the new statutes because of the possible adverse effect on the capital and credit markets for banks and bank holding companies.¹⁴¹ Increased market discipline may well preclude some banks and bank holding companies from obtaining capital and credit on acceptable terms.¹⁴² The market is simply telling these institutions that their risk profile does not make a capital investment or credit extension prudent. The result of this market discipline should be to force bank managers to reduce bank risk to levels that will attract capital investment and credit.¹⁴³ There is no reason that a bank or bank holding com-

not be able to promise as high a return to shareholders, making it harder for them to attract the new capital they need to grow”).

¹⁴¹ See, e.g., PIERCE, *supra* note 135, at 121 (criticizing proposals to impose additional liability on bank holding companies because bank holding companies would then find it difficult, if not impossible, to raise funds because of the risk to their creditors); see also Paul L. Lee, *Liability of Bank Holding Companies, Savings and Loan Holding Companies and their Affiliates for Failed Bank and Thrift Subsidiaries* (1990), reprinted in COUNSELLING CREDITORS OF BANKS AND THRIFTS: DEALING WITH THE FDIC AND RTC 363, 370 (Practising Law Inst., 1991) (noting that provisions increasing holding company responsibility for bank insolvency loss may “weaken the depository sector if potential providers of capital or debt financing to holding companies and depository subsidiaries are dissuaded from investing or providing funding because of the uncertainty created by these measures”); Kieran J. Fallon, Note, *Source of Strength or Source of Weakness?: A Critique of the “Source-of-Strength” Doctrine in Banking Reform*, 66 N.Y.U. L. REV. 1344, 1350, 1384-90 (1991) (arguing that there are already sufficient market incentives for a bank holding company to support its subsidiary and that additional holding company liability will prevent banking industry from raising needed capital).

¹⁴² To the extent that there is creditor discipline, the cost of excessive risk-taking is passed on to the bank’s shareholders in the form of higher interest payments and increased capital costs. Macey & Garrett, *supra* note 68, at 232.

¹⁴³ See Douglas, *supra* note 39, at 26 (“The banking industry likely will go through some fairly difficult times as the market weeds out the marginal institutions. In the long run, however, the result should be a much safer and stronger banking industry.”).

The controlling company guarantee will “force holding companies to face at an early stage the difficult question of whether holding company assets should be preserved for holding company stakeholders, or used to recapitalize troubled depository subsidiaries.” Craig M. Wasserman & John C. Coates, IV, *Consensus Needed on Early Resolution’s Legal Issues*, AM. BANKER,

pany taking inordinate risk should have the same access to capital and credit as an institution taking less risk.

It is also possible that the bank holding company discipline that will be exerted because of the potential application of the cross-guarantee provision may act as a disincentive to a bank holding company that might otherwise consider the purchase of a troubled or failing depository institution.¹⁴⁴ The cross-guarantee provision is imposed against depository institutions that are commonly controlled at the time of the insolvency.¹⁴⁵ Thus, other depository subsidiaries of the purchaser of a troubled bank or thrift are at risk even though the troubled institution's insolvency may be traced to causes occurring prior to the purchase. In a previous article, I discussed the statutory authority provided in 1989 to permit bank holding company acquisitions of solvent savings associations.¹⁴⁶ I applauded the new authority as permitting a private market solution to the savings and loan crisis by providing a mechanism for bank holding companies to inject capital into savings associations in an effort to keep them from insolvency and government takeover.¹⁴⁷ I cautioned, however, that unless the cross-guarantee provision was waived as a condition to the purchase, many bank holding companies might find it more beneficial to permit a targeted depository institution to fail and then to enter into a purchase and assumption transaction for the institution, rather than to purchase it prior to government takeover and

Mar. 25, 1992, at 4. The "holding company may wish to explore an early-resolution transaction as an alternative to, or component of, the guarantee of a capital-restoration plan." *Id.* at 6.

¹⁴⁴ See Jackson, *supra* note 94 (manuscript at III-45) ("[A] common objection to enhanced obligations is that they discourage corporations from acquiring control of financial intermediaries."); Keeton, *supra* note 55, at 60 (noting that cross-guarantees discourage holding companies from acquiring failing banks); Klinkerman, *supra* note 136, at 1 ("[T]he most damaging aspect of the cross-guarantee provision is the chilling effect it will have on interstate acquisitions.").

¹⁴⁵ 12 U.S.C. § 1815(e) (Supp. III 1991); see also *supra* note 97 and accompanying text (defining "commonly controlled").

¹⁴⁶ Prior to the 1989 statute, bank holding companies were authorized to purchase only failed thrifts. Lissa L. Broome, *Private Market Solutions to the Savings and Loan Crisis: Bank Holding Company Acquisitions of Savings Associations*, 59 *FORDHAM L. REV.* S111 (1991) (discussing 12 U.S.C. § 1843(i) (Supp. II 1990)).

¹⁴⁷ Broome, *supra* note 146, at S146-47.

bear the risks associated with potential application of the cross-guarantee provision.¹⁴⁸

The FDIC's agreement to waive the cross-guarantee liability removes this disincentive to a bank holding company's proposed purchase of a troubled depository institution, but it also reduces the efficiency of the redistribution statutes by retaining the prior insolvency risk distribution scheme.¹⁴⁹

3. Bank Holding Company Incentive to Seek Prompt Closure of an Insolvent Bank Subsidiary

Under the previous insolvency risk distribution scheme, bank shareholders had an incentive to keep an insolvent bank open and gamble with FDIC funds in the hope that the gamble would be successful and return some value to their bank shares.¹⁵⁰ If the gamble was not successful, limited liability protected the shareholders from any additional loss.

The statutory modifications to limited liability give the bank holding company a strong incentive to seek closure of or voluntarily liquidate a bank subsidiary promptly upon its insolvency.¹⁵¹ As the bank's shareholder, the bank holding company now stands to bear part of the insolvency loss when the bank is closed with a negative net worth, and thus has an incentive to limit its losses by urging bank regulators to close a bank at zero net worth before additional losses mount.

4. A Bank Holding Company is a Better Risk Bearer than the FDIC

The statutory shift in liability promises gains in efficiency

¹⁴⁸ *Id.* at S150-51; *see also* Klinkerman, *supra* note 136, at 1 (fearing that bank holding companies will acquire weak institutions only after they fail).

¹⁴⁹ *See* Keeton, *supra* note 55, at 60 (explaining that cross-guarantee waiver may also require increased regulatory scrutiny of institution to which it applies to be sure that its bank holding company does not transfer resources from acquired institution to its other banks).

¹⁵⁰ *See supra* notes 73-78 and accompanying text (discussing shareholder's lack of incentive to seek prompt closure of insolvent bank).

¹⁵¹ *See* Kaufman, *supra* note 62, at 582 ("[M]ore timely bank failure resolution . . . [is] a politically acceptable, an economically efficient, and an equitable solution for offsetting the undesirable incentive effects of deposit insurance"); *see also* Macey & Miller, *supra* note 26, at 53 ("[W]hen a bank's shareholders face the specter of double liability, these shareholders have a strong incentive to move for early closure or merger in order to avoid such additional liability.").

because a bank holding company is better situated to monitor and reduce a subsidiary bank's risk than the FDIC. Redistributing more of a bank's insolvency risk to a bank holding company should, therefore, result in a greater reduction of insolvency risk and loss. A bank holding company is a better monitor of insolvency risk than the FDIC because it has continuous access to its subsidiary bank's financial information,¹⁵² as opposed to the FDIC's periodically acquired information through on-site bank examinations and quarterly review of financial data.¹⁵³ The bank holding company may also have access to information about the fair market value of a bank's assets and off-balance sheet liabilities that the FDIC might be unable to obtain upon a routine bank examination.¹⁵⁴ Moreover, the costs of obtaining information about the financial condition of a bank may well be less for its bank holding company parent than for the FDIC which is responsible for overseeing the safety and soundness of all FDIC-insured institutions.¹⁵⁵

¹⁵² See Macey, *supra* note 9, at 1288 (noting that problems of monitoring and coordination are eliminated if holding companies own banks); see also Note, *Liability of Parent Corporations for Hazardous Waste Cleanup and Damages*, 99 HARV. L. REV. 986, 993 (1986) (finding that because of hierarchical structure and information flows within corporate structure, parent company may easily and inexpensively monitor activities throughout entire organization).

¹⁵³ A problem for the FDIC in supervising banks is obtaining accurate and timely data because it is "generally not feasible to have a regulatory examination force evaluating the loan assets of impaired institutions on a weekly or even a monthly basis." H.R. REP. NO. 324, *supra* note 53, at 34; see also Macey & Miller, *supra* note 26, at 53 ("There simply are too many insured banks with too many loans for bank regulators to be able to monitor and evaluate their solvency effectively.").

¹⁵⁴ See Demirgüç-Kunt, *supra* note 67, at 9 ("Since troubled institutions often try to hide their problems from the public and the regulators, it is difficult for examiners to detect problems by looking at the institution's accounts and financial statements."); Kaufman, *supra* note 62, at 576 n.28 ("It may reasonably be assumed that shareholders would have better information about the 'true' market value of their institutions than do the regulators . . ."); see also MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at VIII-4 (stating that banks possess more information about their risk type than FDIC does because risk assessment is special skill of banks and ex ante information gap between insurer and insured may be larger than in most insurance settings).

¹⁵⁵ Jackson, *supra* note 94 (manuscript at III-7). The FDIC must regulate risk-taking on an industry-wide basis, but holding companies need be concerned only with individual subsidiaries. The resulting monitoring and

Perhaps more importantly, the bank holding company parent is better situated to eliminate or reduce a bank's risky business practices that might lead to its insolvency.¹⁵⁶ A bank holding company is defined by statute as a company which has "control" over a bank.¹⁵⁷ "Control" is found where the bank holding company owns a substantial block of voting stock of the bank (twenty-five percent or more), controls the election of a majority of the bank's board of directors, or exercises a controlling influence over the management policies of the bank.¹⁵⁸ A bank holding company may exercise this control to reduce the risk of the bank's insolvency.

The FDIC and other banking regulators regulate the lending activities of banks "to ensure that a depository institution does not make its lending decision in an unsafe or unsound fashion."¹⁵⁹ These regulations impose lending limits on the amount of loans to any one borrower and restrict the loans that may be made to bank insiders.¹⁶⁰ They are "designed to prevent banks from investing their assets in *excessively* risky or inappropriate ways."¹⁶¹ The regulators, moreover, "cannot be expected to

risk-reduction by bank holding companies is thus likely to be more tailored and less disruptive than governmental intervention. *Id.*

¹⁵⁶ Jackson, *supra* note 94 (manuscript at II-2) (noting that increased holding company responsibility "has also been understood as having the regulatory function in reducing the risks associated with financial subsidiaries operating within holding company organizations").

¹⁵⁷ 12 U.S.C. § 1841(a)(1) (1988) (emphasis added). A savings and loan holding company is defined as a "company that directly or indirectly controls a savings association." *Id.* § 1467a(a)(1)(D) (Supp. III 1991).

¹⁵⁸ *Id.* § 1841(a)(2) (1988) (stock ownership test is met by ownership of 25% or more of *any class* of voting securities of bank). Federal Reserve Board regulations implementing the Bank Holding Company Act set forth several rebuttable presumptions of a controlling influence. *See, e.g.*, 12 C.F.R. § 225.31(d)(2)(iii) (1992) (one or more common managers accompanied by 5% ownership constitutes a rebuttable presumption of control so long as no other person has at least 5% ownership); *see generally* PAULINE B. HELLER, FEDERAL BANK HOLDING COMPANY LAW § 1.03[3] (1992) (discussing exercise of controlling influence).

¹⁵⁹ MACEY & MILLER, *supra* note 35, at 179.

¹⁶⁰ Macey & Garrett, *supra* note 68, at 215.

¹⁶¹ MACEY & MILLER, *supra* note 35, at 179 (emphasis added). Although lending limits and insider lending restrictions prohibit "excessive" risk, federal regulators leave decisions about the specific level of risk to bank managers. Risk can be undertaken in so many different ways that "it is difficult to see how the deposit insurer can prohibit all activities that a risk-seeking banker could employ." BENSTON ET AL., *supra* note 44, at 21; *see also*

have the same incentives to monitor and control risk-taking as private sector actors, whose own money is at stake."¹⁶²

Moreover, a recent empirical study by Professor Howell Jackson demonstrated that thrifts supported by holding company commitments to maintain the capital of the thrift subsidiary performed better than other thrifts in the sample.¹⁶³ The thrifts with holding company capital commitments failed less often and cost the government less money than other thrifts when they did fail.¹⁶⁴ This superior performance was the result of more consistent and profitable operations, rather than capital contributions from the holding company.¹⁶⁵ From this empirical evidence, Professor Jackson concludes that increasing holding company responsibility for depository subsidiary insolvency losses can be effective in controlling the behavior of such subsidiaries.¹⁶⁶ This evidence suggests that the cross-guarantee and controlling company guarantee will be successful in reducing the risk of bank insolvency and the amount of any insolvency loss.

B. Distributional Equity

The previous section attempted to demonstrate that the redistribution statutes are economically efficient because they are likely to result in a reduction of bank risk. Judging the statutes efficient is not the end of an evaluative discussion, however, for "efficiency notions ignore important equitable considera-

Carnell, *supra* note 63, at 325 ("Opportunities for risk-taking [by depository institutions] are so diverse that no regulator or legislature can realistically prohibit them all . . .").

¹⁶² Macey, *supra* note 9, at 1298; *see also* Macey & Garrett, *supra* note 68, at 220, 222 ("[R]egulators have a lower incentive to impose effective restrictions on risk-taking," and regulatory restrictions "impose fewer constraints on excessive risk-taking than would be optimal from a societal perspective.").

¹⁶³ Howell E. Jackson, *Capital Maintenance Obligations and Their Effect on Savings and Loan Associations with Substantial Holding Companies*, 22 J. OF LEGAL STUD. (forthcoming June 1993) (manuscript at 67, on file with author); *see also* 55 Fed. Reg. 7475 (1990) (codified at 12 C.F.R. § 567.13) (requiring those with capital maintenance obligations to give notice to Office of Thrift Supervision prior to divesting control of savings association); Policy Statement, 53 Fed. Reg. 31,761 (1988) (stating policy regarding capital maintenance obligations of acquirors of insured institutions).

¹⁶⁴ Jackson, *supra* note 163 (manuscript at 10).

¹⁶⁵ *Id.*

¹⁶⁶ *Id.*

tions.”¹⁶⁷ The redistribution of a portion of the risk of a bank’s insolvency from the FDIC to its parent holding company results in a more equitable risk distribution scheme¹⁶⁸ by “reestablish[ing] the trade-off between risk and return . . . so that those who benefit from the gains of risky strategies . . . also bear the losses when these strategies [do] not pan out.”¹⁶⁹ The primary beneficiaries of successful risky activities undertaken by bank managers are the bank’s shareholders who reap the higher returns associated with high risk activities through a combination of increased dividends and higher share values.¹⁷⁰ Thus, in allocating losses associated with a bank insolvency, it seems fair that those who are likely to benefit from increased bank risk should also shoulder the burden of bank risk, without limitation of that burden to the amount of the bank’s capital.

It may also be argued that if a bank holding company operates in an integrated fashion and benefits from integrated operations, it is appropriate to look to the bank holding company enterprise to bear the losses of resolving an insolvent bank that is part of that common enterprise.¹⁷¹ Many bank holding companies operate as a single enterprise, with entities within the bank holding company sharing common names and common management.¹⁷²

¹⁶⁷ Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 IND. L.J. 951, 1002 (1992); see also JOHN RAWLS, *A THEORY OF JUSTICE* 71 (1971) (“[T]he principle of efficiency cannot serve alone as a conception of justice.”) (footnote omitted).

¹⁶⁸ Block, *supra* note 167, at 1037 (concluding that distributive justice considers to whom benefits are flowing and from whom costs will be extracted).

¹⁶⁹ Thomson, *supra* note 90, at 33; cf. Ronald G. Aronovsky & Lynn D. Fuller, *Liability of Parent Corporations for Hazardous Substance Releases Under CERCLA*, 24 U.S.F. L. REV. 421, 437 (1990) (arguing that persons who share in profits, control activities, and possess capacity to prevent or mitigate harmful effects of hazardous waste practices should bear risk and assume cost of clean-up).

¹⁷⁰ Other beneficiaries of successful risky activities include a bank’s management which will retain its employment, and bank creditors who may have bargained for a higher return because of a bank’s greater risk. Once creditors have agreed to a specific return, they are limited to that amount and do not profit further from a bank’s success.

¹⁷¹ *Oversight Hearings on the Condition of the Banking System Before the Senate Comm. on Banking, Housing, and Urban Aff.*, 101st Cong., 1st Sess. 508 (1989) (statement of Kenneth W. Littlefield, Texas Banking Commission) (“The whole is the sum of the parts, so why shouldn’t the whole have to pay for the cost of failure of a part?”).

¹⁷² See Anthony Cornyn et al., *An Analysis of the Concept of Corporate*

Entities within the holding company often cross-market various products and services, and take advantage of operational efficiencies associated with integrated operations.¹⁷³ These bank holding companies seemingly have little basis for asserting that it is unfair to impose more of the costs associated with an affiliated bank's insolvency upon them. The FDIC, which previously bore the bulk of bank insolvency losses, did not directly benefit from synergies

Separateness in BHC Regulation from an Economic Perspective, in PROCEEDINGS: A CONFERENCE ON BANK STRUCTURE AND COMPETITION, FED. RESERVE BANK CHICAGO 174, 183 (May 14-16, 1986) (“[M]arket participants . . . tend to view bank holding companies as single entities.”); John T. Rose, *Bank Holding Companies as Operational Single Entities*, in THE BANK HOLDING COMPANY MOVEMENT TO 1978: A COMPENDIUM 69, 76 (1978) (“[T]he amount of formal control exercised by BHCs [bank holding companies] over their bank subsidiaries varies sharply among different companies, from very little control in some cases to extremely tight control, approximating that of a branching system, in others.”).

¹⁷³ H.R. REP. NO. 324, *supra* note 53, at 42; *see also* James Burke, *Bank Holding Company Affiliation and Cost Efficiency*, in THE BANK HOLDING COMPANY MOVEMENT TO 1978: A COMPENDIUM 121, 128 (1978) (reviewing studies indicating that for larger banks, affiliation with bank holding company results in certain economies that enable them to achieve lower average costs than independent banks of similar size); Robert C. Clark, *The Regulation of Financial Holding Companies*, 92 HARV. L. REV. 787, 819-22 (1979) (explaining positive benefit of increased efficiencies from holding company formation); Robert A. Eisenbeis, *How Should Bank Holding Companies Be Regulated?*, ECON. REV., FED. RESERVE BANK OF ATLANTA, Jan. 1983, at 42, 43 (noting that bank holding companies are operated as “integrated firms” because they dictate key aspects of their subsidiaries’ operations, including funds management, assets and liability management, capitalization and budgets); Rose, *supra* note 172, at 89 (“While the evidence is limited, it nevertheless suggests that most BHCs [bank holding companies] are trying to manage their organizations as integrated entities, at least to some degree.”); *FDIC Issues First Cross-Guarantees Bill*, *General Counsel Douglas Says*, 53 Banking Rep. (BNA) 375, 375 (Sept. 18, 1989) (“Banks in a multi-bank holding company structure typically engage in cross-marketing and cross-advertising activities, as well as share data processing services.”). *But see* STAFF OF HOUSE COMM. ON BANKING, FIN. AND URBAN AFFAIRS, 102D CONG., 2D SESS., ANALYSIS OF BANKING INDUSTRY CONSOLIDATION ISSUES 18 (Comm. Print 1992) (explaining that although industry consolidation from 1985-1991 was substantial, shifting control of \$350 billion from smaller financial institutions to larger organizations, there were “few visible effects from this consolidation” and “no increase in industry profitability”); *see also* Randall J. Pozdena, *Banks Affiliated with Bank Holding Companies: A New Look at their Performance*, ECON. REV., FED. RESERVE BANK OF SAN FRANCISCO, Fall 1988, at 29, 38 (concluding that banks cannot be corporately separated from activities of sister or parent organizations).

brought about by integrated bank holding company operations. Redistributing insolvency losses from the FDIC to the bank holding company enterprise seems appropriate.

Bank subsidiaries of a bank holding company are exempted from rules that otherwise restrict transactions between affiliates within a bank holding company.¹⁷⁴ The so-called "sister bank" exemption treats commonly controlled banks as if they were branches of the same bank.¹⁷⁵ The cross-guarantee provision, which makes commonly controlled banks liable for the FDIC's losses incurred in connection with an insolvent bank, merely mirrors this preexisting treatment of a bank holding company's bank subsidiaries. This similarity in treatment of the cross-guarantee liability and the sister bank exemption is continued if the FDIC elects to waive application of the cross-guarantee provision. In such a case, the sister-bank exemption to the affiliate transaction rules is also lost with respect to the institution for which the cross-guarantee waiver was obtained.¹⁷⁶

Bank holding companies (including those that do not operate their subsidiaries in an integrated fashion) may be entitled to file a consolidated tax return for the entire enterprise and achieve the tax benefit of offsetting income earned by some subsidiaries with losses suffered by other subsidiaries.¹⁷⁷ The holding company structure also permits favorable tax treatment for debt incurred by the holding company to acquire subsidiaries over the treatment available for debt incurrence by a noncorporate shareholder.¹⁷⁸ These tax advantages of the holding company form of

¹⁷⁴ 12 U.S.C. § 371c(d)(1) exempts commonly controlled banks from certain prohibited transactions between a bank and its affiliate. *Id.* § 371c(b)(7). The affiliate transaction rules permit banks to make loans to their holding company affiliates only if fully secured and permit banks to transfer assets to their affiliates only at a fair market price. *Id.*

¹⁷⁵ See MACEY & MILLER, *supra* note 35, at 379 (noting that bank may engage in transactions with subsidiaries of same holding company).

¹⁷⁶ 12 U.S.C. § 1815(e)(5) (Supp. III 1991).

¹⁷⁷ I.R.C. § 1504(a) (1988) (defining affiliated group for determining eligibility for filing consolidated returns as bank holding company controlling at least 80% of subsidiaries' voting stock); see also Clark, *supra* note 173, at 818-19 (discussing tax considerations as positive reason for holding company formation).

¹⁷⁸ If individual shareholders hold debt incurred to acquire the shares of an existing bank, they may need to receive dividends from the bank in order to pay back the acquisition debt. The Internal Revenue Service treats dividends as taxable income to the individual shareholders. I.R.C. § 61(a)(7) (1988). A bank holding company receiving dividends from a

operation also provide little basis for objection that imposing insolvency losses of a bank subsidiary on the holding company is somehow inequitable.

Some observers have argued that redistributing additional bank insolvency risk to a bank holding company is inequitable if the holding company is not operating its subsidiaries as a single enterprise or is not filing a consolidated tax return.¹⁷⁹ Bank holding company status, however, is triggered by a finding that the company "controls" a subsidiary bank.¹⁸⁰ If the bank holding company has control over a bank subsidiary, then it may exercise that control to reduce the insolvency risk of the bank.¹⁸¹ If the bank holding company has been found to be exercising control because of a bright-line rule presuming control,¹⁸² but is not in fact exercising control or interested in doing so in the future,

subsidiary is, however, entitled under certain circumstances to deduct the amount of the dividends from its own taxable income. I.R.C. § 243 (1988). A bank holding company, therefore, needs less in dividends to repay acquisition debt than would individual shareholders, permitting the bank subsidiary to reduce dividend payments and retain more earnings than a similarly situated bank owned by individual shareholders. See Clark, *supra* note 173, at 818-19 (explaining that creation of parent holding company allows management to "declare the intermediary's earnings as a nontaxable intercorporate dividend"); Eisenbeis, *supra* note 173, at 43 (noting that there are "powerful tax incentives for expansion-minded firms to form BHCs [bank holding companies]"); Pozdena, *supra* note 173, at 31 (discussing tax-related incentives of bank holding company form of organization).

¹⁷⁹ See, e.g., PIERCE, *supra* note 135, at 120 (criticizing cross-guarantee provision as permitting "FDIC to shift its losses to banks and thrifts that themselves have done nothing wrong but happen to be affiliated with an institution that fails"); Barbara A. Rehm, *FDIC is Testing Authority to Seize Assets of Failed Bank's Affiliate*, AM. BANKER, Sept. 13, 1989, at 3 (noting that bank holding companies argue that cross-guarantee provision should not apply unless there is evidence that affiliated banks are operated together). But see Eisenbeis, *supra* note 173, at 43 ("Even a casual inspection of how bank holding companies typically operate . . . suggests that virtually none operates as a passive investor.").

¹⁸⁰ 12 U.S.C. § 1841(a)(1); see also *supra* notes 157-58 and accompanying text (explaining definition of bank holding company).

¹⁸¹ Gary Whalen, *Operational Policies of Multibank Holding Companies*, ECON. REV., FED. RESERVE BANK OF CLEVELAND, Winter 1981-82, at 20, 29 ("In general, [multibank holding companies] typically exercise relatively centralized control over subsidiary bank budgets, capital management, and securities and loan portfolio management policies.").

¹⁸² For instance, ownership of 25% or more of any class of voting stock of a bank triggers a finding of control, even though the class of voting stock

then it may take the necessary steps to avoid statutory classification as a bank holding company.¹⁸³

A few commentators have also been concerned that the differing treatment of a bank holding company shareholder and other shareholders of an insolvent bank is unfair in affording the other shareholders the protection of limited liability, but subjecting the bank holding company to additional liability through the cross-guarantee and controlling company guarantee provisions.¹⁸⁴

may be relatively small compared to other voting stock issued by the bank. 12 U.S.C. § 1841(a)(2)(A).

¹⁸³ For a bank holding company that does not attempt to influence bank management, the “bank holding company” label may be avoided by sale of some bank stock, resignation of a common director, or elimination of one of the other indicia of control. *See supra* note 158 and accompanying text (listing control factors). The Bank Holding Company Act’s statutory and regulatory definition of “control” provides a bright-line rule and is preferable to the case-by-case approach used by courts applying the CERCLA environmental statute to determine if a corporate parent should be found to be an “operator” of property owned by a subsidiary and on which hazardous wastes have been disposed. *See* 42 U.S.C. § 9607(a)(2) (1988) (imposing liability on person owning facility at time of disposal). The corporate parent may try to avoid environmental cleanup liability under CERCLA by disassociating itself from control of its subsidiary. *See* James A. King, Kayser-Roth, Joslyn, *and the Problem of Parent Corporation Liability Under CERCLA*, 25 AKRON L. REV. 123, 141-42 (1991) (explaining that statute imposes liability on parent corporation for subsidiary’s dumping). In the banking arena, however, it is presumably beneficial for the holding company to have an incentive to reduce its liability for its subsidiary bank’s insolvency risks by exercising its control in a responsible manner, rather than seeking to avoid a finding of control.

¹⁸⁴ *See, e.g., Problems of the Federal Savings and Loan Insurance Corporation (FSLIC), Part III: Hearings on S. 413 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 101st Cong., 1st Sess. 331 (1989) [hereafter *Senate FIRREA Hearings: Part III*] (testimony of O. Jay Tomson, President, Independent Bankers Ass’n) (stating that since finding of “control” can be triggered by ownership of as little as 5 percent of bank’s stock, this ownership “does not provide justification to hold the other 95 percent . . . liable for the actions or losses of another institution”); V. Gerard Comizio, *Post-FIRREA “Cross-Industry” Depository Institution Transactions: Current Regulatory Issues in Industry Consolidation*, 45 CONSUMER FIN. L.Q. REP. 275, 291 (1991) (arguing that distinction between bank holding company as shareholder and individual as shareholder seems to be “inconsistent with the general goals of the [cross-guarantee] provision”); Keeton, *supra* note 55, at 62-63 (noting that corporate shareholders are arbitrarily subject to greater liability than personal shareholders).

Professor Jackson is concerned with additional holding company liability bifurcating the regulation of financial intermediaries so that financial

This concern is not justified. Other shareholders may not have the ability to directly affect the risk of the bank in which they own stock through control of the bank managers. If they cannot affect the risk undertaken by the bank, it seems unfair to impose upon them losses resulting from that risk in excess of their original capital contribution to the bank.¹⁸⁵ Moreover, in this context it may be important to continue to respect traditional notions of limited liability to encourage public investment in bank stock and to preclude possibly costly attempts to impose additional liability on a diverse and disparate group of shareholders.¹⁸⁶

C. *Objections to Redistribution of Bank Insolvency Losses*

Redistribution of bank insolvency risks obviously imposes additional costs on bank holding companies. Some commentators in the banking press have objected to the redistribution because they believe it is not in the best interests of the bank holding company.¹⁸⁷ Several objections to this risk redistribution have

institutions controlled by holding companies are subject to a more onerous regulatory regime than independent financial institutions. Jackson, *supra* note 94 (manuscript at III-48 to III-50). As possible solutions to this problem, Jackson suggests rewarding financial institutions for maintaining valuable holding company financial guarantees, or mandating that independent institutions obtain comparable support. *Id.* (manuscript at III-50 to III-54). Jackson finds neither of these solutions entirely satisfactory, however. *Id.*

¹⁸⁵ *Cf.* Jackson, *supra* note 94 (manuscript at II-10 to II-12) (explaining that moral hazard problem is accentuated when financial institution is owned by single shareholder who has incentive and ability to increase financial institution's risk and expected return). Another commentator asserts that with unlimited liability for all bank shareholders, regulators would have to screen bank stock transfers to ensure that shareholders do not escape liability by selling their shares to buyers with few personal assets to lose. Keeton, *supra* note 55, at 63. Thus, in general, a system of unlimited liability would hurt the liquidity of bank shares. *Id.* The regulatory screening process would be much less onerous for a bank holding company shareholder than for a regular shareholder. *Id.* "Thus, . . . imposing limited liability on BHCs [bank holding companies] but not on individual shareholders may be justified." *Id.*

¹⁸⁶ *See* CLARK, *supra* note 54, § 1.2.1 (explaining that limited liability eliminates huge transaction costs that would be incurred in attempting to collect from numerous corporate investors). *But see* Aronovsky & Fuller, *supra* note 169, at 437-38 (arguing that it is fairer to impose CERCLA losses for environmental cleanup on shareholders of a corporation than on involuntary creditors of the corporation such as federal taxpayers).

¹⁸⁷ *See, e.g.,* Wasserman & Coates, *supra* note 143, at 6 ("[D]uties to

already been indicated.¹⁸⁸ Other objections are briefly considered here because of the frequency with which they are mentioned and because they may be raised in litigation pending over the application of the cross-guarantee provision. This section concludes that these objections lack force and should not prevent the statutory risk redistribution from being effected.

1. Improper Modification of Limited Liability

Some critics object to the statutory modification of limited liability notions as “stretching beyond recognition—and doing violence to—the traditional corporate law concept of the separation of corporate existence.”¹⁸⁹ The corporate law conception of cor-

shareholders and creditors may limit the holding company’s ability to use nonbank assets to guarantee the subsidiary’s performance [pursuant to the cross-guarantee provision].”). It is an obvious point that a bank holding company will incur additional costs under the new statutory provisions that impose more of the risk of bank insolvency losses on it and its subsidiaries than the previous system which fully respected limited liability notions. Although in most instances, satisfying the controlling company guarantee or the cross-guarantee would not otherwise be a profit maximizing or shareholder wealth maximizing strategy, it is not an improper wasting of corporate assets. *But cf.* MCorp Fin. v. Board of Governors, 900 F.2d 852, 863 (5th Cir. 1990) (stating that source of strength regulation “would require MCorp to disregard its own corporation’s separate status . . . amount[ing] to a wasting of the holding company’s assets in violation of its duty to its shareholders”), *aff’d in part, rev’d in part*, 112 S. Ct. 459 (1991). It surely cannot be a violation of fiduciary duties for a bank holding company’s board of directors to comply with a statutory liability to the FDIC. Corporations are often required by law to undertake duties that may not be in the best interests of the corporation in terms of profit maximization or shareholder value maximization.

¹⁸⁸ See *supra* notes 141-43 and accompanying text (discussing how some observers have argued that redistribution to bank holding company and commonly controlled depository institutions will adversely affect the capital and credit markets for banks and bank holding companies); *supra* notes 184-86 and accompanying text (explaining commentators’ concerns that redistribution to bank holding companies unfairly treats bank holding companies more severely than other bank shareholders).

¹⁸⁹ V. Gerard Comizio, *FIRREA: New Provisions Affect Structuring, Powers and Activities of Savings Associations*, 44 CONSUMER FIN. L.Q. REP. 155, 166 (1990) (discussing how cross-guarantee provision essentially pierces corporate veil); see also *Senate FIRREA Hearings: Part III*, *supra* note 184, at 270 (testimony of William Haraf, Chairman, Issues Committee, Financial Services Council) (criticizing cross-guarantee provisions as too broad and against legal doctrine of limited liability); PIERCE, *supra* note 135, at 121 (arguing that cross-guarantee provision “undermines the principle of

porate separateness, however, may not deserve protection in the context of a bank holding company. In most industries failure of a holding company subsidiary "imposes no cost on the public. Only the creditors of the subsidiary are hurt by failure, and they can be trusted to protect their own interests."¹⁹⁰ A bank subsidiary's failure, however, "imposes an external cost on the public by increasing FDIC losses and depleting the insurance fund,"¹⁹¹ so government intervention into the normal limited liability scheme is justified.¹⁹² The crucial distinction, then, between bank holding companies and other holding companies is that the liabilities of the bank subsidiaries of the bank holding company are federally insured.¹⁹³ This difference justifies the distinct treatment of limited liability notions in bank holding companies.

Moreover, historically bank shareholders have been treated differently from shareholders of regular corporations. Prior to the imposition of federal deposit insurance, shareholders in national banks and in many state banks were subject to double liability in the event of a bank failure.¹⁹⁴ A recent empirical study by Professors Jonathan Macey and Geoffrey Miller demonstrates that the double liability system was a success.¹⁹⁵ Recoveries benefitted creditors of insolvent banks, and shareholders liable for additional assessments encouraged cautious bank management.¹⁹⁶ Macey and Miller conclude that the success of double liability "should be of considerable interest for the analysis of limited liability . . . and for the reform of banking regulation and the deposit insurance system."¹⁹⁷

corporate separateness, which is essential for achieving long-lasting reform").

¹⁹⁰ Keeton, *supra* note 55, at 55.

¹⁹¹ *Id.* "This external cost justifies some form of government regulation to limit practices by BHCs [bank holding companies] that increase their banks' risk of failure." *Id.* at 55-56.

¹⁹² Jackson, *supra* note 94 (manuscript at II-20) (suggesting that increasing holding company liability to help solve moral hazard problem facing bank managers is analogous to argument for removing traditional rules of limited liability when corporations engage in high-risk activities that might impose unanticipated losses on third parties).

¹⁹³ Keeton, *supra* note 55, at 55.

¹⁹⁴ See Woodward, *supra* note 28, at 689 ("Banks were among the last firms to limit liability."); see also *supra* notes 26-30 and accompanying text (discussing double liability system).

¹⁹⁵ Macey & Miller, *supra* note 26, at 61.

¹⁹⁶ *Id.* at 61-62.

¹⁹⁷ *Id.* at 61. Professors Macey and Miller recommend a second look at

When limited liability was first developed, corporations did not have the authority to own stock in other corporations.¹⁹⁸ It was not until the late nineteenth century that states began to authorize intercorporate stock ownership.¹⁹⁹ In the words of one commentator, “[l]imited liability for corporate groups, although one of the most important legal rules in modern economic society, appears to have emerged as an historical accident.”²⁰⁰ Nor are the policies justifying a limited liability system served when the shareholder is a corporation.²⁰¹ The individual shareholders of a

double liability either as a supplement to or a replacement for the current system. *Id.* It has also been argued, however, that a return to a double liability system would be unwise. Woodward, *supra* note 28, at 689. “Publicly traded shares and extended liability are not compatible, so precluding limited liability would be a serious impediment to large banks’ attempts to raise equity capital from a large number of shareholders.” *Id.*

¹⁹⁸ See BLUMBERG, *supra* note 28, at 59 (“It took more than a half century after the limited liability for corporations had been accepted before American law authorized corporations generally to acquire and own the shares of another corporation.”).

¹⁹⁹ See *id.* (By 1910, only 13 states had adopted statutes authorizing a corporation to own stock in another corporation.); see also William R. Compton, *Early History of Stock Ownership by Corporations*, 9 GEO. WASH. L. REV. 125 (1940) (discussing history of corporate stock ownership).

²⁰⁰ BLUMBERG, *supra* note 28, at 56.

²⁰¹ See King, *supra* note 183, at 128 (“[F]rom an economic perspective, limited liability has less significance when applied to corporations.”) (footnote omitted). Limited liability has several purposes. One is to encourage widespread public investment in business enterprise. See Landers, *supra* note 54, at 617-19 (positing that limited liability was necessary to stimulate capital investments). A second purpose is to enhance the transferability of stock. EASTERBROOK & FISCHER, *supra* note 54, at 42 (explaining that under a system of unlimited liability, share value would in part be a function of wealth of shareholders which would impede share acquisition, while under a system of limited liability, shares are fungible and wealth of individual shareholders is irrelevant). Professor Landers noted that:

The historical background indicates that limited liability was never intended to protect a parent corporation against liability for the debts of its subsidiary. More importantly, the policies justifying limited liability do not require a contrary result: only the entity responsible for the management of the subsidiary (the parent) will be held liable, and therefore a larger group of shareholders will not be held directly responsible for behavior over which they retain only theoretical control. Moreover, no individual stockholder is subjected to risks greater than his original investment.

Landers, *supra* note 54, at 619; see also EASTERBROOK & FISCHER, *supra* note

corporate parent are protected by limited liability, and it is not clear that the corporate parent, as the shareholder of its subsidiary, should be insulated with a second layer of limited liability.²⁰²

Supporters of the application of limited liability within a bank holding company do not want to disturb the corporate separateness of the entities within a bank holding company.²⁰³ The elaborate structure of multiple banking and nonbanking subsidiaries present in many bank holding companies, however, developed in large part for reasons other than the advantages inherent in the separate corporate form such as limited liability for shareholders. Subsidiaries of bank holding companies were formed primarily because of restrictions on the locations of banking operations within a state and across state lines and because of limitations on bank activities.²⁰⁴ It would, therefore, seem like the tail wagging the dog to argue that the corporate formalities of elaborate bank holding company structures should control the issue of liability imposition for the FDIC's losses in resolving an insolvent bank.²⁰⁵

54, at 41-44 (setting forth additional justifications for limited liability); Keeton, *supra* note 55, at 63. If unlimited bank shareholder liability was recognized and a bank was failing, then the only shareholders willing to buy bank stock would be those with little to lose. *Id.* The purpose of compensating the FDIC would be defeated. *Id.* Thus, the only way shareholder liability would be effective is if regulators carefully screened each sale of bank shares to make sure the buyer had enough resources to satisfy future FDIC claims. *Id.* This screening process would be less onerous for a bank holding company than for an individual bank shareholder. *Id.*

²⁰² Cf. Note, *supra* note 152, at 988-98 (arguing that economic considerations favor imposing full liability on parent corporations for CERCLA environmental response costs that cannot be covered by subsidiary corporations). *But see* William P. Hackney & Tracey G. Benson, *Shareholder Liability for Inadequate Capital*, 43 U. PITT. L. REV. 837, 872-73 (1982) (arguing that there is some "lack of logic" in the argument that the parent corporation's shareholders have "duplicate insulation with respect to the obligations of the subsidiary").

²⁰³ See PIERCE, *supra* note 135, at 120-21 (setting forth corporate separateness argument). *But see* Pozdena, *supra* note 173, at 38 ("[T]he behavior of a bank is not independent of the nonbank and holding company affiliations it forms . . .").

²⁰⁴ See Clark, *supra* note 173, at 816-17, 822-23 (explaining that positive reasons for holding company formation include overcoming geographical constraints on doing business and overcoming restrictions on lines of business); Pozdena, *supra* note 173, at 30 (listing as motives for bank holding company formation, among others, expansion into other activities and avoiding branching restrictions).

²⁰⁵ Moreover, it is likely that freed of these restrictions on bank locations

2. A Taking of Property by Defeating Investment-Backed Expectations

Some critics have suggested that the cross-guarantee provision could be challenged as an “unconstitutional taking of property.”²⁰⁶ While the expectations of shareholders and creditors of bank holding companies and bank subsidiaries who invested or loaned money prior to the enactment of these statutory provisions will be disappointed by their operation, payments made pursuant to these new statutes should not constitute a taking of property without just compensation in violation of the Fifth Amendment.

The government may regulate activities of private enterprises without being found to have taken personal property, so long as the regulation advances legitimate governmental interests.²⁰⁷ Without doubt, the recovery of money to replenish the FDIC fund advances a legitimate governmental interest.²⁰⁸ Moreover, because of the government’s traditional high degree of control over personal property, an owner of personal property ought to be aware that regulation might render that property worthless.²⁰⁹

and activities, bank holding companies would consolidate many of their existing subsidiaries. The chief executive officer of NationsBank has testified before congressional committees that, upon the passage of interstate banking legislation, NationsBank would collapse its multiple bank subsidiaries located in separate states, into a single bank subsidiary. *Interstate Branching Bill Questionable in 1992; Member Consensus Being Sought*, 59 *Banking Rep. (BNA)* 7, 9-10 (July 6, 1992). NationsBank estimates that it would save \$50 million per year from streamlined operations upon such a consolidation. *Id.*

²⁰⁶ Glass, *supra* note 99, at 25; see also MACEY & MILLER, *supra* note 35, at 657 (asking whether the government may “insert itself in the priority hierarchy above existing interests without the payment of just compensation”); Arlin, *supra* note 104, at 296 (“Critics of the cross-guarantee argue that its exercise constitutes an unconstitutional taking of property without due process of law.”) (footnote omitted); David A. Segal, Note, *A Note to Congress and the FDIC: After FIRREA Where’s the BIF?*, 59 *FORDHAM L. REV.* S411, S451 (1991) (noting possible constitutional challenge to cross-guarantee provision).

²⁰⁷ See *Lucas v. South Carolina Coastal Council*, 112 S. Ct. 2886, 2897 (1992) (requiring legitimate government interest to justify regulation).

²⁰⁸ See *FDIC v. Jenkins*, 888 F.2d 1537, 1541 (11th Cir. 1989) (minimizing depletion of insurance fund is express goal of FDIC’s statutory framework).

²⁰⁹ See *Lucas*, 112 S. Ct. at 2899 (“[I]n the case of personal property, by reason of the State’s traditionally high degree of control over commercial

The field of banking has always been highly regulated by federal and state governments so that investors in and creditors of banking enterprises should expect extensive governmental regulation and should expect that the type and degree of such regulation is likely to change over time.²¹⁰ Thus, payments made to the FDIC pursuant to the cross-guarantee provision do not constitute a taking.²¹¹ Furthermore, payments made pursuant to the controlling company guarantee reduce a bank holding company's liability pursuant to the guarantee and are thus made in return for just compensation.²¹²

3. Fraudulent Conveyances

It has also been suggested that “[i]f the guarantee of the subsidiary's performance renders the holding company insolvent, the guarantee may be challenged on grounds of fraudulent conveyance[s].”²¹³ A payment made by a bank holding company pursu-

dealings, [the property owner] ought to be aware of the possibility that new regulation might even render his property economically worthless”).

²¹⁰ See Christopher T. Curtis, *The Takings Clause and Regulatory Takeovers of Banks and Thrifts*, 27 HARV. J. ON LEGIS. 367, 389 (1990) (stating that cross-guarantee is not a “violation of legitimate investment-backed expectations because, . . . [investors] are aware that the overall statutory and regulatory framework is directed to protecting depositors at least cost to the insurance fund, and that this framework is subject to reasonable extension in furtherance of that purpose as circumstances require”); Glass, *supra* note 99, at 25 (noting FDIC's discretion to impose inability on bank holding companies for losses to insurance fund); *see also* Connolly v. Pension Benefit Guaranty Corp., 475 U.S. 211, 223 (1986) (“Given the propriety of the governmental power to regulate, it cannot be said that the Taking Clause is violated whenever legislation requires one person to use his or her assets for the benefit of another.”).

²¹¹ Curtis, *supra* note 210, at 389-90; Glass, *supra* note 99, at 25 (noting possibility that court would “determine that the risk of such regulatory action [as the cross-guarantee] comes with the territory”); *see also* Greenspan Responds to FDIC Proposal on BHCs and Failing Banks, 7 BANKING EXPANSION RPT. 17 (Aug. 15, 1988) (noting opposition by Federal Reserve Board to FDIC proposal containing appraisal and payment process to compensate shareholders and creditors whose interests would have been affected by the statute).

²¹² The execution of the controlling company guarantee is voluntary on the part of the bank holding company, and because the guarantee is a condition to the FDIC's approval of an undercapitalized bank subsidiary's capital restoration plan, the guarantee is given in return for the FDIC's consideration of approval of the plan.

²¹³ Wasserman & Coates, *supra* note 143, at 6; *see also* Kelley Holland,

ant to a controlling company guarantee cannot be characterized as a fraudulent conveyance, however. A fraudulent conveyance results if property is transferred for "less than a reasonably equivalent value in exchange for such transfer" and the transferor was insolvent or became insolvent as a result of the transfer.²¹⁴ Satisfaction of the controlling company guarantee liability constitutes value, and since liability is reduced dollar-for-dollar by the bank holding company's payment, the value undoubtedly would be "reasonably equivalent."²¹⁵

While payment to the FDIC in satisfaction of the controlling company guarantee does not appear to be problematical, execution of the guarantee might itself constitute a fraudulent conveyance. However, since execution of the controlling company guarantee is a condition to the FDIC's approval of a bank's capital restoration plan, the FDIC's approval of the plan would constitute value. Whether that value is "reasonably equivalent" is an issue that may be decided only on a case-by-case basis.

For similar reasons, one can hardly imagine that the FDIC, as receiver of a failed bank, would challenge the bank's payment to the FDIC to satisfy a cross-guarantee assessment as a result of a sister bank's insolvency. If the payment is made to discharge a statutorily imposed liability, and such liability is discharged or proportionately reduced by the payment, the transfer is not fraudulent because it is made for a fair consideration.²¹⁶

Capital: BNE Corp.'s Creditors May Sue Regulator, AM. BANKER, Sept. 24, 1991, at 16 (explaining case where creditors alleged that regulator used fraudulent conveyances to move assets into subsidiaries from holding company).

²¹⁴ 11 U.S.C. § 548(a)(2)(A) (1988). A fraudulent transfer also occurs if a transfer was made with "actual intent to hinder, delay, or defraud," *id.* § 548(a)(1), although this type of fraudulent transfer has not been argued in this context.

²¹⁵ The bankruptcy code defines "value" as "satisfaction . . . of a present or antecedent debt" of the transferring bank holding company. *Id.* § 548(d)(2)(A). "Debt" is defined as "liability on a claim," *id.* § 101(12) (Supp. III 1991), and "claim" is in turn defined as a "right to payment," *id.* § 101(5)(A).

²¹⁶ Payments made pursuant to the source of strength regulation have been challenged as fraudulent conveyances. Holland, *supra* note 213, at 16 (challenge in Bank of New England Corporation bankruptcy). Unless the bank subsidiary is hopelessly insolvent, however, it may be argued that such payments are in return for value since the value of the holding company's stock in the bank should increase as the result of the holding company's infusion of capital into the bank subsidiary. Whether such value is reasonably equivalent is an issue that must be determined in each case.

III. PROPOSED REFORM—HOLDING COMPANY FAMILY LIABILITY

The redistributive statutes discussed in this Article represent a substantial improvement over the prior distribution of bank insolvency risks. The statutes should result in a reduction in bank insolvency risk by reducing the moral hazard associated with limited liability in the bank holding company structure, increasing market discipline, and giving a bank holding company an incentive to seek prompt closure of an insolvent bank so as to minimize its negative net worth.

Notwithstanding these important benefits, the redistributive statutes do not maximize the utility possible from a redistribution of insolvency risk. This Part considers two significant problems with the new statutory scheme—avoidance of the statutory provisions and remaining limitations on a bank holding company's liability. This Part sets forth the outline of a proposal for holding company family liability to replace the cross-guarantee and controlling company guarantee provisions. This proposal's response to the major problems with the new redistributive statutes is discussed, and additional benefits of the proposal are explored.

A. Problems with the New Redistributive Statutes

The risk redistribution statutes are flawed in two respects. First, application of the cross-guarantee and controlling company guarantee provisions may be avoided. If these statutes are not applied, it is obvious that the problems inherent in the prior system of bank insolvency risk distribution will continue to exist. Moreover, bank holding companies may well spend time and effort trying to exploit these avoidance opportunities rather than trying to reduce bank insolvency risk. Second, the new statutes still contain limits on bank holding company liability, although the limits are larger than under the prior scheme. The closer the insolvent bank's negative net worth is to the liability limit, the more likely the bank holding company is to encourage bank managers to engage in risky activities at the FDIC's expense. The bank holding company again becomes indifferent about the amounts of bank insolvency loss in excess of its own liability.

1. Avoidance of the Statutory Provisions

The cross-guarantee liability is assessed against depository institutions affiliated with a bank at the time it becomes insol-

vent.²¹⁷ Thus, a bank holding company has an incentive to sell a problem depository institution prior to the declaration of its insolvency.²¹⁸ Another bank holding company contemplating the purchase of such a troubled bank will obviously be concerned about the potential application of the cross-guarantee provision.²¹⁹ The FDIC is permitted by statute, however, to grant a waiver of the cross-guarantee provision if it determines that such an exemption from liability is in the best interests of the deposit insurance fund.²²⁰ The FDIC has indicated in a policy statement that it will consider requests for waiver of the cross-guarantee provision “where an unaffiliated party acquires control of a distressed institution and held no financial interest . . . prior to acquisition.”²²¹ Thus, FDIC policy is to waive application of the cross-guarantee provision where a depository institution insolvency is a distinct possibility. Even if the cross-guarantee provision is applied, recovery pursuant to the provision may be

²¹⁷ See *supra* notes 96-97 and accompanying text (explaining when cross-guarantee provision applies).

²¹⁸ In 1990, William Seidman, the chairman of the FDIC, stated that the cross-guarantee “has not proven to be as effective as the agency originally had expected.” *Amendments to FIRREA, Elimination of OTS Would Be Premature, Clarke, Seidman Say*, 54 *Banking Rep. (BNA)* 490, 490-91 (Mar. 19, 1990) [hereafter *Amendments*]. Because application of the cross-guarantee is at the time of failure “it creates an incentive for holding companies to sell or otherwise separate the healthy insured institutions prior to failure.” *Id.*; see also Jackson, *supra* note 94 (manuscript at III-49) (“[H]olding companies may engage in a variety of avoidance strategies (such as divertiture [sic] of regulated subsidiaries) once it appears likely that their enhanced obligations will have to be honored.”). Cf. Hansmann & Kraakman, *supra* note 54, at 1881 (noting that some firms engaged in hazardous activities are disaggregating or downsizing to avoid tort liability).

A proposal before Congress prior to its adoption of FDICIA dealt with this problem by adding the bank holding company to the cross-guarantee provision and declaring invalid “transfers by a controlling company of assets to an affiliate that is not an insured depository institution within one year of default or assistance.” S. 543, 102d Cong., 1st Sess. § 223(a)(2) (1991).

²¹⁹ See Broome, *supra* note 146, at S150 (discussing concerns of bank holding company).

²²⁰ 12 U.S.C. § 1815(e)(5) (Supp. III 1991); see also *supra* note 100 and accompanying text (explaining waiver procedure).

²²¹ Policy Statement, 55 *Fed. Reg.* 21,934, at 21,935 (1990). Also the FDIC indicated that it will consider requests for “partial” waivers of the cross-guarantee. *Id.* However, such waiver will normally be granted only for a short fixed period not exceeding the time reasonably required for problems to be identified and resolved. *Id.* at 21,936.

unlikely because of its statutory subordination to all other non-affiliated bank debt.²²²

The cross-guarantee provision applies only to commonly controlled *depository* institutions. Consequently, even if the cross-guarantee provision is not waived, its efficacy may be substantially reduced if the bank holding company strips its bank subsidiaries of value by transferring nondeposit-taking functions (such as trust department activities, data processing, and credit card operations)²²³ out of banking subsidiaries and into nonbanking subsidiaries or the bank holding company.²²⁴ These transfers not only remove assets from potential cross-guarantee recovery, they may also weaken the profitability of the bank subsidiaries.²²⁵

The controlling company guarantee liability may be avoided even more easily. A bank holding company is only asked to execute a controlling company guarantee upon a finding that a bank subsidiary is undercapitalized.²²⁶ Thus, a bank holding company could avoid the issue of whether to execute the controlling company guarantee if it could sell the troubled depository institution before it was found to be undercapitalized. Even if a bank is

²²² See *supra* note 99 and accompanying text (explaining subordination provision). Even subordinated bank debt will be satisfied before the cross-guarantee liability. An insolvent bank's subordinated creditors are rarely paid upon its resolution, making the satisfaction of the cross-guarantee liability remote. MODERNIZING THE FINANCIAL SYSTEM, *supra* note 33, at I-42.

²²³ *Amendments, supra* note 218, at 491; see also Klinkerman, *supra* note 136, at 12 (noting that "parent-company assets such as cash, credit card units, and data processing units could not be attached by the FDIC" under the cross-guarantee).

²²⁴ Cf. Fallon, *supra* note 141, at 1383 (explaining that provision eliminates incentive to transfer resources); Klinkerman, *supra* note 136, at 1 ("[A]n industry restructuring will begin as bank holding company managers shift valuable assets to the parent company."); see also Riegle *Offers Sweeping Deposit Insurance Reform Bill to Set Stage for 1991 Action*, 55 *Banking Rep. (BNA)* 523, 525 (Oct. 1, 1990) (discussing proposal, S. 3103, to apply the cross-guarantee provision to nonbank affiliates because cross-guarantee liability can otherwise be avoided by transferring assets to non-depository affiliates).

²²⁵ Rose, *supra* note 172, at 140-41 ("[T]o the extent that the decrease in diversification of banking activities resulting from any such spin-off widens the variation in bank earnings . . . bank risk exposure should increase."); Klinkerman, *supra* note 136, at 12 (stating that transferring assets out of troubled bank subsidiaries would make them "more prone to failure").

²²⁶ See *supra* notes 113-14 and accompanying text (explaining when controlling company must execute guarantee).

found undercapitalized, its holding company may avoid liability simply by refusing to execute a controlling company guarantee.²²⁷ If the bank holding company declines to execute the guarantee, the subsidiary's capital restoration plan will not be approved and severe statutory restrictions will then be imposed upon the operation of the bank subsidiary, but no liability will be assessed against the holding company if the undercapitalized bank subsidiary subsequently fails.²²⁸ Presumably, a bank holding company will seriously consider not executing the guarantee when it believes that the bank's insolvency is inevitable, leaving much of the former risk distribution scheme in place.²²⁹

Efforts spent to avoid application of the cross-guarantee and controlling company guarantee will likely lessen bank holding company efforts to reduce the insolvency risk of their bank subsidiaries.²³⁰ If an important goal of the redistribution statutes is to reduce bank insolvency risk, a statute imposing liability without exception is best designed to achieve this objective. Removing or reducing avoidance opportunities will serve to maximize bank holding company efforts to monitor and reduce subsidiary bank insolvency risks.

2. Remaining Limitations on Bank Holding Company Liability

Although the new statutes distribute more insolvency risk to a bank holding company than did the previous distribution scheme,

²²⁷ See *supra* notes 118-19 and accompanying text (noting that holding company is not required to execute guarantee).

²²⁸ See *supra* notes 118-19 and accompanying text (discussing restrictions on subsidiary's activities if holding company fails to execute guarantee).

²²⁹ This strategy will not be sufficient to avoid application of the cross-guarantee provision if there are other banks in the holding company. Refusing to execute the guarantee may send such an adverse signal to the market that many holding companies may not consider it a practical alternative.

²³⁰ Statutes that encourage a bank holding company to circumvent banking regulations by spinning activities out of bank subsidiaries are likely to be self-defeating. Eisenbeis, *supra* note 173, at 44. These shifts in function within a bank holding company are likely to increase operational interdependencies and to make the entire holding company more integrated with respect to risk-taking. *Id.* An alternative regulatory approach would be to regulate the holding company as a single entity. *Id.*; see also Carnell, *supra* note 63, at 325 ("Owners and managers desiring to evade a regulatory constraint can often keep a step ahead of the regulators and even further ahead of any legislative response . . .").

they still provide artificial limits on a bank holding company's responsibility. Thus, the cross-guarantee provision excludes from liability assets of the bank holding company itself and of its nonbanking subsidiaries.²³¹ The liability of a bank holding company pursuant to the cross-guarantee is limited by the capital of its subsidiary banks.²³² If a controlling company guarantee is not executed, the bank holding company's risk is not changed from the prior allocation. Even when the controlling company guarantee is in place, it is by statute limited in amount to the lesser of five percent of the assets of the subsidiary bank at the time it was found to be undercapitalized or the amount needed to bring the subsidiary bank into compliance with all capital standards at the time it fails to comply with its capital restoration plan.²³³

The limits contained in these statutes on bank holding company liability mean that although the moral hazard created by limited liability is reduced by increasing the amount a bank holding company stands to lose from a bank subsidiary's insolvency, it is not eliminated. Thus, as a bank subsidiary's insolvency losses approach the bank holding company's new statutory liability limits, the moral hazard problem rears its ugly head.²³⁴ The bank holding company regains the incentive to induce bank managers to engage in activities likely to increase bank risk, hoping that the return from such activities, if successful, will reduce or eliminate bank holding company liability. At the same time, the bank holding company does not care about the amount of the loss that might be generated if the risky activities do not succeed because losses beyond the limit of the bank holding company's liability will be borne by the FDIC.²³⁵ Similarly, as the insolvency loss approaches the bank holding company's liability limit, the bank

²³¹ See *supra* note 96 and accompanying text (explaining liability of bank holding company for FDIC losses).

²³² The cross-guarantee provision is, of course, not applicable unless the bank holding company owns more than one bank.

²³³ See *supra* note 115 and accompanying text (setting forth limits of bank holding company's liability). The controlling company guarantee is also limited in duration in that the holding company guarantees that the undercapitalized bank will comply with its capital restoration plan until it has been adequately capitalized during each of four consecutive quarters. 12 U.S.C. § 1831o(e)(2)(C)(ii) (Supp. III 1991).

²³⁴ See *supra* notes 54-56 and accompanying text (discussing presence of moral hazard created by limited liability).

²³⁵ See *supra* note 49 and accompanying text (explaining that shareholder liability is limited to amount of bank capital).

holding company no longer has an incentive to seek prompt closure of the insolvent bank.²³⁶ The bank holding company will again be in a position where its interests will be maximized if the bank remains open to, in essence, gamble with FDIC money.

B. Holding Company Family Liability Proposal

The potential benefits of insolvency risk redistribution are not maximized by the new statutes. The substantial avoidance possibilities and the continued limits on bank holding company liability lessen the utility of these statutes in reducing bank insolvency risk and bank insolvency losses. This Part outlines a proposal to replace the cross-guarantee and controlling company guarantee provisions that addresses these concerns.

The proposed statutory scheme may be called the "holding company family liability provision" or "family liability," for short.²³⁷ Family liability imposes liability on the holding company and its subsidiaries for FDIC losses incurred in resolving an insolvent depository institution that is owned by a holding company.²³⁸ The FDIC may exercise its discretion in determining from which of the responsible entities to seek collection. Moreover, the liability is imposed not only on the holding company family owning the depository institution at the time of insolvency, but also on any holding company family owning the depository

²³⁶ See *supra* notes 73-78 and accompanying text (noting lack of shareholder and creditor incentive to seek prompt closure of insolvent bank under limited liability system). If the FDIC is successful in implementing the prompt closure practices set forth in FDICIA, see *supra* note 86 (discussing statutory changes), then it is possible that the problems alluded to above will not be realized if insolvent banks are closed well before the bank holding company's new liability limits are approached. The possibility of regulatory failure, inability to foresee bank losses, or a catastrophic event that results in sudden losses could, however, result in bank insolvency prior to implementation of early closure policies. See Kaufman, *supra* note 62, at 576 n.28 (describing the "possibility of abrupt declines in the market value of an institution's net worth").

²³⁷ Jackson, *supra* note 94 (manuscript at IV-1) (proposing an alternative "regime of expanded holding company obligations").

²³⁸ Professor Jackson would impose liability only on "qualified holding companies," which he defines as holding companies where the market value of junior liabilities minus the total investment in regulated subsidiaries is two to three times the holding company's maximum liability under the enhanced obligation. *Id.* (manuscript at IV-6). If this ratio is not met, then the holding company would have to find alternative support for its regulated subsidiaries. *Id.* (manuscript at IV-6 to IV-7).

institution during the one-year period preceding the institution's insolvency.²³⁹ If more than one bank holding company may be assessed for the FDIC's insolvency losses, because more than one holding company owns a bank subsidiary or because of consecutive ownership during the one-year period preceding the bank subsidiary's insolvency, the liability of the bank holding companies is joint and several. No waiver of the bank holding company liability provision is available.²⁴⁰ When the liability provision is asserted against an insolvent institution, it shall be considered the equivalent of an unsecured claim against the institution, so that the FDIC will recover on a pro rata basis with other unsecured creditors of the insolvent institution.²⁴¹

1. Reduction of Opportunities for Avoidance

The holding company family liability proposal imposes liability by statute so, unlike the controlling company guarantee, it cannot be avoided by a bank holding company's refusal to incur additional responsibility.²⁴² Moreover, the family liability proposal is mandatory; unlike the cross-guarantee provision, its application may not be waived. Further, the proposal eliminates artificial shifting of assets within the holding company. Holding compa-

²³⁹ Professor Jackson's proposal would continue holding company liability until either honored by the holding company or replaced with a satisfactory alternative guarantee. Jackson, *supra* note 94 (manuscript at IV-3 to IV-4).

²⁴⁰ Professor Jackson also proposes mandatory liability. *Id.* (manuscript at IV-2).

²⁴¹ Professor Jackson's proposal grants priority treatment of the enhanced obligations upon the bankruptcy of the bank holding company. *Id.* (manuscript at IV-10).

²⁴² The family liability proposal could be avoided if the bank holding company parent were dissolved or if subsidiary banks ended their affiliation with the holding company. See PIERCE, *supra* note 135, at 121 (arguing that cross-guarantee provision will discourage operation of multibank holding companies and banks may avoid new liability by ending their affiliation with holding company).

This form of liability avoidance is not likely, however, because of the many benefits associated with the bank holding company form of operation. See *supra* notes 172-73, 177-78 and accompanying text (discussing benefits of bank holding company form of organization). If the costs of bank holding company affiliation through operation of the family liability provision outweigh the benefits of such affiliation, however, then separation of the bank subsidiary from the bank holding company should be respected, subject to the proviso that the bank holding company retains liability for one year.

nies should not be tempted to remove profitable nonbanking operations from bank subsidiaries because *all* subsidiaries, non-banking corporations as well as bank subsidiaries, may be assessed for a bank subsidiary's insolvency losses.

Nor may a bank holding company escape the family liability proposal by ridding itself of a failing bank subsidiary before it becomes undercapitalized or before it becomes insolvent (the events that trigger application of the controlling company guarantee and cross-guarantee provisions). Just as a car driver should not escape liability for an automobile accident he was involved in by selling his car, so a holding company should not be able to escape liability for its insolvent bank's losses by ridding itself of the problem institution.²⁴³ The family liability proposal significantly reduces the benefits of selling a troubled depository institution subsidiary because the selling bank holding company retains responsibility for the FDIC's insolvency losses if the institution becomes insolvent within one year of the sale.²⁴⁴ The one-year "look-back" period is analogous to bankruptcy provisions permitting an insolvent debtor's bankruptcy trustee to recover certain transfers made by the debtor during the one-year period before the debtor's bankruptcy.²⁴⁵ Joint and several liability in conjunction with the one-year look-back period, diminishes the spin-off problem.

The family liability proposal helps to reduce the current disincentive for a bank holding company to purchase a troubled institution since the seller retains statutory liability if the institution becomes insolvent within one year of purchase. It would be possible for the purchasing and selling bank holding companies to negotiate over indemnification of this statutory liability.²⁴⁶ Thus,

²⁴³ Cf. BAIRD, *supra* note 54, at 196 (analogizing car accident liability to environmental clean-up liability).

²⁴⁴ This is similar to a suggestion made by the FDIC chairman that the FDIC should be permitted "to reach assets of formerly affiliated insured institutions that are separated from common control relationship within a certain amount of time prior to the failure of an insured affiliate." THRIFT MERGERS AND ACQUISITIONS, *supra* note 98, at 837 (statement of William Seidman, FDIC Chairman).

²⁴⁵ See 11 U.S.C. § 547(b)(4)(B) (allowing avoidance of preferential transfers to an insider of the debtor); *id.* § 548 (allowing avoidance of fraudulent transfers).

²⁴⁶ Cf. Leebron, *supra* note 24, at 1625. If limited liability is modified so that a parent corporation has liability for the torts of its subsidiary and the parent elects to sell the subsidiary, liability should lie both with the parent

the proposal shifts from the FDIC to the market the judgment of what incentive is necessary to consummate a proposed purchase transaction. The proposal provides market incentives without reducing the FDIC's potential recovery and without the time and administrative costs involved in dealing with waiver applications. To facilitate a sale, a bank holding company desiring to sell a depository institution might agree that if the depository institution is declared insolvent within one year of the purchase, the seller will indemnify the purchasing bank holding company to the extent of some or all of the amount the purchaser may have to pay to the FDIC pursuant to the family liability provision. Alternatively, the buyer might agree to indemnify the seller for part or all of the amount the seller is required to pay to the FDIC as a result of the institution's insolvency within one year of purchase. The relative bargaining position of each party based on the possibility that the depository institution might become insolvent within one year would determine who would bear what portion of the FDIC's loss.²⁴⁷

Relative bargaining position would also dictate whether the indemnification agreement would be unsecured or secured by collateral, a bond, letter of credit, or some other arrangement. A holding company relying on an indemnification agreement is not absolved from liability to the FDIC since liability is joint and several. An action for contribution by the indemnitee pursuant to the indemnification agreement may not be successful if the indemnitor is insolvent. Thus, a bank holding company has an even greater incentive under the family liability proposal than the current structure to reduce the insolvency risks of its bank subsidiaries.

2. Elimination of Liability Limits

The risk redistribution statutes do not eliminate the moral hazard associated with limited shareholder liability because they still

seller and the acquiror. *Id.* The two will be free to make independent indemnity agreements. *Id.* The seller should remain liable to discourage sanitization of its subsidiaries by sale. *Id.*

²⁴⁷ If the possibility of insolvency is so high that the selling holding company wants the buyer to provide indemnification, but no buyer is willing to purchase the depository subsidiary and indemnify the seller, then the seller will be encouraged to liquidate the subsidiary prior to its insolvency or to at least ensure that it is closed promptly upon insolvency to minimize the holding company's losses.

place limits on the bank holding company's liability for its bank subsidiary's insolvency losses.²⁴⁸ The family liability proposal, however, places no artificial limits on a holding company's liability.²⁴⁹ The only moral hazard remaining as the result of limited shareholder liability under the family liability proposal is that as the bank holding company itself approaches insolvency, with little or nothing left to lose, it will be tempted to engage in risky activities with the possibility of sufficiently high returns that its shareholders will regain some value in their holding company investment.²⁵⁰ A bank holding company's creditors, however, are not subject to the moral hazard created by deposit insurance or the FDIC's insolvent bank resolution methods since they are not protected by deposit insurance.²⁵¹ Therefore, these creditors will

²⁴⁸ See *supra* notes 234-36 and accompanying text (noting that moral hazard remains potential problem).

²⁴⁹ Professor Jackson agrees that "[t]heoretically, an open-ended obligation might be justified, but for practical considerations" would limit the scope of liability to five percent of an institution's average assets. Jackson, *supra* note 94 (manuscript at IV-3).

²⁵⁰ Professor Jackson addresses this concern. "Enhanced holding company obligations are effective only to the extent that there is value at the holding company level to make good on obligations to support regulated subsidiaries." *Id.* (manuscript at III-41) (footnote omitted). Jackson believes, however, that occasional bank holding company failure does not present the same problems as a bank failure. *Id.* First, when a financial institution fails, he is concerned about the imposition of losses on public claimants such as depositors. This concern, he notes, is paternalistic. The same concern is not present, however, for creditors of a holding company. *Id.* (manuscript at III-42). Second, financial institution failure could result in runs, but again this is not a result that will follow from the failure of a holding company. *Id.* (manuscript at III-42); see also Garten, *supra* note 76, at 375 (explaining that bank holding company failure will result in the normal course following subsidiary bank's failure if failed bank is holding company's primary asset).

A possible danger where holding company failure is likely is "abusive violations of the lending and asset transfer rules even if the holding company has full liability for insurance losses." H.R. REP. NO. 324, *supra* note 53, at 49. The report proposes putting insured institutions into regulatory custody if the holding company is severely weakened and in imminent danger of abuse of insured deposits. *Id.* at 48-49.

²⁵¹ Open bank assistance such as the FDIC gave to Continental Illinois National Bank protecting the claims of the bank holding company's creditors and shareholders, is not likely under FDICIA's least-cost resolution standards. See MACEY & MILLER, *supra* note 35, at 643-44; see also *supra* note 86 (explaining proposed least-cost method of resolving insolvent institutions).

presumably force an insolvent bank holding company into an involuntary bankruptcy proceeding promptly at the bank holding company's insolvency to reduce their own loss on their credit claims against the holding company, thereby counterbalancing the bank holding company's (and its shareholders') incentive to postpone the holding company's entry into a bankruptcy proceeding.

3. Additional Benefits of Family Liability Proposal

The risk redistribution statutes distort the credit markets for bank holding companies and their subsidiaries. Because the cross-guarantee liability provision is subordinated to the claims of all non-affiliated bank creditors²⁵² and the controlling company guarantee provision has a priority position with respect to other bank holding company creditors,²⁵³ a creditor would prefer to lend to a bank subsidiary (where its claim will be satisfied before any cross-guarantee liability to the FDIC) than to a bank holding company (where its claim will be satisfied only after full satisfaction of the controlling company guarantee). Lending to a non-banking subsidiary is also preferable to lending to the bank holding company since the creditor of the nonbanking subsidiary must be paid upon the subsidiary's insolvency before any value is returned to the bank holding company shareholder for the purpose of satisfying the controlling company guarantee.

The family liability proposal eliminates this distortion and any resulting manipulation of credit within the holding company structure to take maximum advantage of the priority and subordination provisions of the current statutes. Under the proposal, each creditor of the bank holding company or any of its subsidiaries may expect the same treatment upon exercise of the family liability provision. To the extent the creditor's claim is secured and the debtor becomes insolvent, the secured creditor will be paid before the family liability provision is satisfied. To the extent the creditor's claim is unsecured, the creditor and other unsecured creditors, including the FDIC asserting its claim pursu-

²⁵² See *supra* note 99 and accompanying text (discussing subordination of cross-guarantee liability to FDIC).

²⁵³ See *supra* note 117 and accompanying text (noting that guarantee has priority claim if bank holding company files bankruptcy).

ant to the family liability provision, will be paid on a pro rata basis.²⁵⁴

Finally, the administrative implementation of the family liability proposal would surely be less costly than implementation of the present statutory scheme. The FDIC would not have to consider applications for waivers of the cross-guarantee provision, nor need it concern itself with the execution of the controlling company guarantee upon a finding that a depository institution is undercapitalized.²⁵⁵

CONCLUSION

The redistribution of bank insolvency risks from the FDIC to bank holding companies should reduce the risk of bank insolvency, and in the event a bank does become insolvent, should reduce the amount of the insolvency loss over the prior risk distribution scheme. Insolvency risk and loss should be reduced because the statutes will reduce moral hazard, increase market discipline, and provide the bank holding company with an incentive to seek prompt closure of an insolvent bank subsidiary.

²⁵⁴ The family liability proposal eliminates the priority treatment of the FDIC's claim upon the bank holding company's bankruptcy that is afforded for the controlling company guarantee pursuant to the Bankruptcy Code. *See supra* note 117 and accompanying text (explaining present priority treatment of guarantee under Bankruptcy Code). The Bankruptcy Code priority provision extends to any "commitment" to maintain capital. 11 U.S.C. § 507(a)(8) (Supp. II 1990). Thus, the holding company family liability, which is statutorily imposed rather than the result of a voluntary commitment, does not fall within this priority provision of the Bankruptcy Code. Nor is amendment of this priority rule to include the proposed family liability provision appropriate. If the family liability provision had priority over the claims of unsecured creditors of the bank holding company and its subsidiaries, concerns about the availability of credit to banks and bank holding companies would probably be justified. *See supra* notes 141-43 and accompanying text (discussing potential adverse effects on capital and credit markets resulting from shareholder and creditor discipline under new statutes). These concerns no doubt account, at least in part, for the inclusion of the provision subordinating liability imposed pursuant to the cross-guarantee provision. Subordination, however, may go too far by honoring the claims of unsecured creditors and contractually subordinated creditors prior to the FDIC's claim. Thus, the proposal seeks to find a middle ground by treating the FDIC's claim as an unsecured nonpriority claim that will be paid on a pro rata basis with the claims of other unsecured creditors.

²⁵⁵ Nor does the statutory cap on the amount that may be recovered under the controlling company guarantee provision need to be computed.

Moreover, the redistribution combines the benefits of efficiency with equity by placing the burdens of risky bank activities on the primary beneficiary of those activities.

The family liability proposal outlined in this Article sets forth an even more efficient risk distribution scheme than that provided by the new redistribution statutes. The family liability proposal significantly reduces the opportunities for a bank holding company to avoid additional liability for a subsidiary bank's insolvency losses. The elimination of avoidance opportunities should result in greater incentives for a bank holding company to eliminate or reduce a subsidiary bank's insolvency loss, and disincentives to expend time and effort seeking to devise avoidance strategies and exploit loopholes of the risk redistribution statutes. The family liability provision also removes the moral hazard occasioned by any limitation on a holding company's liability for a bank's insolvency losses. The elimination of artificial limits on a holding company's liability should increase a holding company's incentives to limit the amount of negative net worth of any insolvent bank subsidiary. Moreover, the family liability proposal furthers the equitable redistribution of bank insolvency losses. A bank holding company's benefits from bank risk are not limited by any arbitrary figure; nor should the burdens be so limited.

There may be additional benefits from increasing the incentives of a bank holding company to ensure that an insolvent bank is closed at a time when the FDIC may realize enough from the bank's assets to satisfy all deposit liabilities. To enhance the likelihood of a liquidation in which the only loss is shareholder capital, bank holding companies may urge regulators to value a bank's assets based on fair market values rather than historical costs,²⁵⁶ to look more critically at the likelihood of loan repayments,²⁵⁷ and to assess more realistically the effect of off-balance sheet liabilities on bank solvency.

The private market incentives that are partially provided by the cross-guarantee and controlling company guarantee provisions

²⁵⁶ FDICIA requires federal banking agencies to "provide supplemental disclosure of the estimated fair market value of assets and liabilities, to the extent feasible and practicable." 12 U.S.C. § 1831n(a)(3)(D) (Supp. III 1991). This information should "strengthen[] market oversight of depository institutions." Carnell, *supra* note 63, at 353.

²⁵⁷ If loan-loss reserves are inadequate, a bank may be economically insolvent. Carnell, *supra* note 63, at 354. FDICIA did not set any rules for these "fact-specific judgments . . . ill-suited for statutory control." *Id.*

provide hope for a realistic reduction of bank insolvency risk. Congress should continue to consider providing private market solutions as alternatives to regulation-based efforts to solve banking industry problems.²⁵⁸ Regulation-based solutions require regulatory supervision, examination, and enforcement that is time-consuming and costly. Moreover, regulations invite creative avoidance. Providing statutory provisions that align the interests and incentives of the regulator with the regulated so that they work together to reduce bank insolvency costs, rather than against each other, promises a long-term solution to a very serious problem.

²⁵⁸ See H.R. REP. NO. 324, *supra* note 53, at 48 (explaining 1988 proposal to make bank holding company liable for all costs borne by deposit insurance fund from failure of insured institution that "would be self-enforcing . . . and would not require operational restrictions or regulatory burdens for implementation"). It has been estimated that the regulatory burden imposed by FDICIA will add \$4 billion to the \$11 billion already spent by the banking industry on regulatory compliance. Robert M. Garsson, *For Bankers, '91 Law Was "Red Tape Act,"* AM. BANKER, Nov. 30, 1992, at 1.