104

S. Hrg. 104–37

OVERSIGHT OF THE FDIC AND THE RTC'S USE OF D'OENCH DUHME

Y 4. G 74/9: S. HRG. 104-37

Oversight of the FDIC and the RTC's...

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF GOVERNMENT MANAGEMENT AND THE DISTRICT OF COLUMBIA

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

JANUARY 31, 1995

Printed for the use of the Committee on Governmental Affairs

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OVERSIGHT OF THE FDIC AND THE RTC'S USE OF D'OENCH DUHME

TUESDAY, JANUARY 31, 1995

U.S. SENATE,
SUBCOMMITTEE ON OVERSIGHT OF GOVERNMENT
MANAGEMENT, AND THE DISTRICT OF COLUMBIA,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:07 p.m., in room SD–342, Dirksen Senate Office Building, Hon. William S. Cohen, Chairman of the Subcommittee, presiding.

Present: Senators Cohen and Levin.

Staff Present: Kim Corthell, Staff Director; Paul Brubaker, Deputy Staff Director; David Schanzer, Chief Counsel; Linda J. Gustitus, Minority Staff Director; Frankie deVergie, Chief Clerk; and Robert Shields, GAO Detailee to the Majority Staff.

OPENING STATEMENT OF SENATOR COHEN

Senator COHEN. The Committee will come to order.

The 1994 elections made it very clear that there is a deep-seated dissatisfaction with government among the citizenry. Part of this dissatisfaction is caused by the government intruding too far into the lives of individuals. Some of it is caused by government's failure to make progress on longstanding social problems despite massive investment of taxpayer funds. Some of it is caused by the inefficiencies and waste in bloated government operations.

The problem we are addressing here today concerns an even more corrosive aspect of government failure that further fuels public dissatisfaction, and that is the tendency of the government to disregard the impact of its actions on individual citizens and ignore fundamental principles of fairness. When this occurs, individuals lose faith in government. They become both disenchanted and cynical. Correcting instances of government indifference, no matter how small, should be an important concern to this Congress.

The purpose of today's hearing is twofold. The first is to examine how an arcane provision of banking law has been used by Federal agencies to prevent citizens from seeking redress for legitimate claims against failed banks. The second is to explore how we can best put right what has gone wrong with the application of this law.

The banking law in question is the D'Oench Duhme doctrine. Not surprisingly, most Americans have never heard of the doctrine. Regrettably, however, too many Americans have come to expect, or at least not be surprised by, the kind of government indifference and

contempt for fundamental principles of fairness that has been exhibited by the Resolution Trust Corporation, the RTC, and the Federal Deposit Insurance Corporation, the FDIC, in their application of the D'Oench doctrine.

Some of the innocent victims of the Federal banking agencies' indifference are small-time vendors. Others have been defrauded by bank officials into making bad loans and real estate deals. All these individual investors in small businesses have done nothing wrong but have had the misfortune of choosing to do business with banks that eventually went broke. All they ask for is the opportunity to have their day in court to show that they are entitled to relief. But the D'Oench Duhme slams that door shut.

Application of the D'Oench Duhme doctrine prevents individuals and businesses with potentially valid legal claims against banks from pursuing those claims when the banks fail and are taken over by the FDIC or RTC. These claims against failed banks run the gamut from fraud and misrepresentation, to breach of fiduciary duty and negligence, to the failure to pay for goods and services provided. The status of these claims at the time the bank fails also varies. What is common to all of them, however, is that once the FDIC or RTC steps into the shoes of that failed bank, the courthouse door is closed, and claimants are denied the right to prove their claims in a court of law.

One must return to the original 1942 U.S. Supreme Court case to understand how far the FDIC and the RTC have strayed from the original intent of the D'Oench doctrine and to appreciate the injustice of the current situation. In that original case, a brokerage firm called D'Oench Duhme & Company issued notes to assist a bank to conceal losses resulting from defaulted bonds. The bank orally agreed, however, that it would not seek payment on these notes. When the FDIC acquired the notes and sued D'Oench for payment, the company defended itself on the grounds of the oral agreement with the bank that it would not have to pay.

In *D'Oench*, the Supreme Court determined that "secret side agreements" of this sort should be unenforceable because they undermine the ability of the bank regulators to accurately assess the financial condition of the insured banks. The Court crafted a rule of Federal common law that when the FDIC acquired an asset during a bank takeover, it was immune from any obligations incurred by the failed bank that were not recorded in the bank records. This was the beginning and the birth of the D'Oench Duhme doctrine.

Congress attempted to codify this principle in 1950 by requiring that agreements which diminished the FDIC's interest in an asset acquired through a bank takeover were voided unless the agreement was in writing, was recorded in official bank records, and was approved by the bank's board of directors. Then Congress extended this protection to the RTC in 1989 through the FIRREA Act.

In 1950, when the original statute was being debated, one member stated, "It was never the intention of Congress to give the [FDIC] a stronger position than that of the bank" and that "it was the intent of Congress that any agreement in the absence of fraud is binding on the Corporation."

In its original incarnation, D'Oench Duhme served a useful purpose. Individuals who lent themselves to a scheme to deceive bank

regulators by misrepresenting the financial condition of the bank were not permitted to rely upon secret agreements when the bank failed and the FDIC attempted to collect the bank's assets.

But the doctrine has been stretched well beyond its original purpose by both the courts and the banking agencies. The doctrine now bars claims by innocent parties who, unlike the D'Oench brokerage firm, had absolutely no intention to deceive the bank examiners by misrepresenting the value of assets through secret side agreements.

One example of how D'Oench victimizes innocent people is a California case where an elderly couple entered into a real estate transaction with an S&L based on an unwritten agreement that the thrift would develop the land adjacent to the plot that was being purchased by the couple. Unbeknownst to the couple, the savings and loan had no intention of developing the land, but, in fact, they sold the property in a paper transaction that was designed to improve the bank's net worth. The couple brought suit against the bank alleging breach of contract. The bank failed and was taken over by FSLIC, the predecessor to the RTC.

FSLIC asserted that the D'Oench doctrine barred the couple's claim because it was based on an unwritten agreement with the failed bank. The court agreed and the case was dismissed. Not only did the couple fail to receive compensation for their injuries, but the agency eventually foreclosed on the couple's property. Even though the owners of that bank were convicted of over 30 criminal bank fraud violations, the elderly couple never received a hearing on the merits of the claim for breach of contract.

D'Oench is also no longer limited to disputes over "assets" acquired by the banking agencies during a takeover. Originally, this was a very important limitation because the whole purpose of D'Oench was to enable the FDIC to make a quick, accurate evaluation of a bank's assets without having to worry about secret side deals. Under current law, however, D'Oench has been applied to bar claims relating to a wide variety of bank activities such as escrow account agreements, letters of credit, and trusts that have nothing to do with bank assets.

In a Texas case, a court held that D'Oench barred a claim that a bank had breached an oral agreement to extend a line of credit to an oil and gas company. This oral agreement did not affect the value of any assets held by the bank. Nonetheless, once the bank failed and was taken over by the FDIC, the company was never permitted its day in court to argue its claim because D'Oench was asserted and the case was dismissed.

Not only have the courts erred by expanding D'Oench well beyond the intentions of the high Court and the Congress, but the banking agencies themselves have been aggressively asserting that D'Oench applies in circumstances that even the overly permissive courts will not allow. I will give but a few examples to illustrate where the banking agencies are inappropriately applying D'Oench, which one commentator referred to as bank agency "superpowers."

In a Pennsylvania case, a general contractor made improvements on a property based on an oral agreement with a bank. After approximately $12,000 of work was completed, the bank failed to pay. When the bank became insolvent and was assumed by the RTC,

the agency refused to honor the oral agreement reached between the bank and the contractor. The contractor was forced to pursue the case in Federal court where the RTC, predictably, tried to assert D'Oench to defeat the claim.

The district judge in this case would not agree to the RTC's over-extension of D'Oench. The judge wrote that "the doctrine is not a sword to be used to extinguish ordinary commercial obligations of a failed bank because they happen not to be accompanied by a formal agreement. The bank's gardener, window washer and garbage collector have a claim for services rendered whether or not they have written contracts."

A similar case arose in my own home State of Maine. A general contractor there that had provided labor and materials for a bank's construction project found itself stymied by the FDIC's misapplication of the D'Oench doctrine. The contractor had to fight his way up to the U.S. Court of Appeals before gaining relief, having spent many thousands of dollars in order to do that.

The FDIC and the RTC's misapplication of D'Oench has compelled innocent parties to spend thousands of dollars in litigation costs in order simply to get a hearing on the merits of their claims. It has also undoubtedly had a chilling effect on others with legitimate claims because few small investors or businesses have the wherewithal and the resources to fight the FDIC and the RTC through protracted litigation.

In a recent Florida case, which we will hear more about from one of our witnesses, the plaintiffs had to spend $250,000 in legal fees just to defeat the FDIC's inappropriate application of the D'Oench doctrine and to get a hearing on the merits.

As part of my earlier efforts to examine the actions of banking agencies, I was informed of an extraordinary case from Massachusetts involving Rhetta and John Sweeney, who are here with us today to testify. The Sweeneys took out a $1.6 million loan from ComFed Bank to finance an extensive real estate project. When the loan went into default, after the bank reneged on a promise to continue funding the project, and the bank attempted to foreclose on their family's ancestral property, the Sweeneys brought suit in State court, alleging that ComFed had engaged in unfair and deceptive practices against them, in violation of Massachusetts State law, by engaging in a course of conduct intentionally designed to push them into default.

But then D'Oench Duhme was rearing its ugly head. Months after the State court trial had concluded, but just weeks before a decision was issued, ComFed failed, and the RTC became conservator for the bank. The lawyers that represented ComFed in the State court litigation against the Sweeneys were hired by the RTC to pursue continued litigation against the Sweeneys. These lawyers removed the case to the Federal court, and they argued it should be dismissed under D'Oench. We will hear more about this later. It is my understanding that the attorneys improperly removed the papers from the physical custody of the State court and held them in their law offices for some 25 days. That is a highly unusual practice and one in which even the court which I spoke to yesterday could not fathom.

Just 19 days after the RTC removed the case to the Federal court, the State court judge entered a lengthy opinion finding that ComFed had defrauded the Sweeneys by inducing them to default on their loan. The judge explicitly found that ComFed had breached its promise to extent additional loan financing to the Sweeneys and that the bank had improperly squelched the Sweeneys' efforts to save the development project. The judge determined that the Sweeneys were entitled to approximately $3 million in damages, which, once the loan was repaid, as a jury required them to repay the original loan and interest that was accrued on it, it would have resulted in a judgment in excess of $1 million in favor of the Sweeneys.

In Federal court, however, the judge ignored the State court's findings of consumer fraud and dismissed the case based on the D'Oench doctrine. The court stated that the Sweeneys' claims could not go forward against RTC because they were based on oral representations that were not contained in the bank's record, and the First Circuit affirmed that decision and the Supreme Court refused to hear the case. So now, despite the fact that the State court judge who heard the evidence in the case rendered a multimillion-dollar verdict in favor of the Sweeneys, the Sweeneys will not be able to have their case heard in Federal court, and they are due to be evicted from their home in a matter of days. For the Sweeneys, D'Oench Duhme has meant just that—doom.

The current State of law is unprincipled. The banking agencies have been given extraordinary powers by the courts to thwart the normal operation of law, but the policy justifications for terminating claimants' legal rights, I think, are very weak. Furthermore, it appears that the banking agencies have been attempting to continue to expand the doctrine by applying it to more and more novel cases.

In a recent D.C. Circuit case, for example, the FDIC urged the court to interpret D'Oench so as to provide it "with near-absolute immunity." The court thoughtfully declined, stating that "D'Oench is not a limitless, per se guarantee of victory by Federal banking agencies."

Nonetheless, the Subcommittee has been informed of instances where the agencies continue to push the envelope by asserting that D'Oench applies in cases where it clearly should not apply. In some cases, the claimants have brought their cases to court and they have won, and there must be many other cases about which we are unaware where the claimants have simply given up in the face of the bank agencies' "superpowers." The unjustified expansion of D'Oench by the courts and the overaggressive application of D'Oench by the agencies has not only caused genuine hardship on individuals, but it has generated hostility toward the government for its excessive and arrogant assertion of power.

I think it is time that justice be done, and when the application of the law leads to gross unfairness and inequitable results, the public loses confidence in the government, and all of our legal institutions are degraded. Before more damage is done, I think we have to do much more to reform the D'Oench Duhme doctrine and restore it to its original, narrow scope.

Last year I introduced legislation designed to cure the deficiencies in the current law, and I intend to do precisely the same thing again, and very soon. The goal is going to be to allow individuals to have their legitimate claims of bank misconduct heard on the merits while still protecting the FDIC and the RTC from secret side agreements intentionally designed to misrepresent bank assets.

I am aware that the FDIC has issued new guidelines governing when D'Oench may be asserted and, in some instances, requiring approval of the general counsel's office before D'Oench can be used by attorneys in the field. This is a step in the right direction, and I am heartened that the FDIC has responded to concerns raised by myself and a number of other Senators this past year. These guidelines, however, do not obviate the need for legislation to restore the D'Oench Duhme doctrine to its original narrow scope.

Before introducing our first panel of witnesses, there is one final matter which I feel compelled to raise. Over the past 3 years, this Subcommittee has investigated and held hearings to examine abuses by FDIC and its agents. During this time, I have seen hundreds of cases where the FDIC and the RTC have resorted to overzealous pursuit of individuals and businesses whose only sin was that they did business with a bank that failed. In fact, these agencies have acted what I call something akin to being Robocops in dealing with citizens who have acted in good faith.

During my experience with the FDIC and RTC, I have grown increasingly frustrated by the culture of arrogance that exists at these agencies. Adding to this culture is Congress' reluctance to closely examine how bank agencies handle specific cases, especially in light of the Keating case. This chilling effect has stood in the way of meaningful oversight of the RTC and the FDIC by casting suspicion over Members of Congress and their staff who question the agencies' handling of specific cases. Since Keating, the banking agencies have known that the quickest way to end a congressional inquiry is to hint that a specific case may involve impropriety on the part of the subjects.

The arrogance demonstrated by the actions of the RTC and the FDIC in the name of protecting the taxpayer is a very convenient way and excuse for bullying, badgering, and intimidating many who cross their path. Clearly, the current environment stands in the way of effective oversight and is indicative of the very attitude that has resulted in the RTC and the FDIC punishing the innocent with the same fervor that should only be reserved for the guilty.

So as we continue to work on crafting legislation to reform D'Oench, we are certainly going to keep in mind the legitimate interests of the banking agencies. It is my hope that they will fully cooperate in this endeavor.

Now I am going to call upon our first panel. We will have three individuals who have had personal experience with the D'Oench Duhme doctrine: Dr. David Hess, president of Citizens and Business for D'Oench Duhme Reform, and Mrs. Rhetta Sweeney, who are among the victims of the law. The third panelist is Michael McLaughlin, an attorney with Lane & Altman in Boston. Mr. McLaughlin has represented individuals and businesses who have

had disputes with Federal banking agencies involving the D'Oench doctrine.

I would ask that Dr. Hess come forward, followed by Mrs. Sweeney, and then Mr. McLaughlin. Then we can proceed with your testimony, Dr. Hess, first.

TESTIMONY OF DAVID S. HESS,[1] PRESIDENT, CITIZENS AND BUSINESS FOR D'OENCH DUHME REFORM

Dr. HESS. Thank you, Mr. Chairman. I am here today in two roles: one as a victim of D'Oench Duhme doctrine and the other as a president of an organization that seeks to reform this doctrine.

In my own particular case, I became involved in an investment in 1987 in Jacksonville, Florida, where I invested in an automobile dealership. The floor plan financing and construction loans were provided by Southeast Bank of North America. During the course of the business of this dealership, Southeast Bank provided audit functions of the automobiles on a monthly basis. They were to ensure that when an automobile was sold that the bank received its collateral payment for that vehicle. Unbeknownst to me, the bank conducted these audits and found that automobiles were being sold but were not being paid off. The bank did not inform me of this occurrence, and as a result, the business failed.

Within 90 days of closing the dealership, I repaid approximately $2.5 to $3 million in loans to Southeast Bank without any loss to the bank. I subsequently found out about the negligent audits by Southeast Bank and brought a suit against Southeast Bank approximately 1 year prior to their becoming insolvent.

During the course of this time, I had information and evidence from bank officers that these audits were conducted in a negligent fashion and that the bank was guilty of these acts.

In September of 1991, the FDIC became the receiver of Southeast Bank once it became insolvent, and my case was removed to Federal District Court. From 1991 until 1994, I spent 3-and-a-half years and $250,000 fighting the misapplication of the D'Oench Duhme doctrine to the facts of my case.

On December 5th of 1994, the 11th Circuit ruled unanimously that the D'Oench Duhme doctrine did not apply to my case and that I did have a right to go to court and have a jury decide my case on its merits. That is how I became involved in the D'Oench Duhme doctrine.

Since then, I have founded an organization called Citizens and Business for D'Oench Duhme Reform, which has as its mission to educate Members of Congress on the D'Oench Duhme doctrine and to ask for clarification legislation on the doctrine.

My testimony today has three points: The first is that the D'Oench Duhme doctrine in its present application is unfair and causes real harm to borrowers, guarantors, vendors, and small businessmen; secondly, that the current application of the D'Oench Duhme doctrine is inconsistent with its origins in the Supreme Court and Congress; and, thirdly, that the solution to the misapplication of the D'Oench Duhme doctrine is to adopt clarification legislation which will return the doctrine to its original intent.

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[1] The prepared statement of Mr. Hess appears on page 49.

In essence, when one talks about the D'Oench Duhme doctrine, they are talking about two separate but unequal sets of law that apply to banks in their dealings with borrowers, guarantors, and vendors. One is everyday common law that applies to solvent banks and allows for standard defenses against collections and valid assertions of claims, the merits of which are then judged by a jury in a court of law. The other is the D'Oench Duhme doctrine; it is unbeknownst to most banks' borrowers, guarantors, and vendors. This ominous-sounding doctrine applies when a bank becomes insolvent and disallows otherwise valid defenses against collections or assertion of claims. In short, the doctrine slams the courthouse doors on the fingers of the innocent claimants seeking to open it against the FDIC and the RTC.

So unjust and unfair is the doctrine's application in the courts that many judges have become apologetic when handing down their decisions. For instance, in *Webb* v. *Superior Court,* in 1990, the court held: "We sympathize with Webb. The D'Oench Duhme doctrine is quite harsh and in this case, where he as the borrower" has shown that he is not at fault, "the severity of the rule is heightened. Nevertheless, we have no choice but to apply it."

Judges fully recognize that the D'Oench Duhme doctrine is unfair and inequitable.

After careful review, there appears to be one solution to the current problem of the D'Oench Duhme doctrine's widespread misapplication by the FDIC and the RTC. This solution is to recognize the original intent of the doctrine as set forth by the Supreme Court in 1942 and as was debated by both Houses of Congress in 1950. The Supreme Court held that a party who lends itself to a scheme likely to mislead the FDIC by means of a secret agreement not shown on the records of the bank is forbidden to raise that secret agreement as a defense against the FDIC once the bank has been taken over.

In addition, when these very same issues were debated in Congress, it is clear from the remarks of Representative Francis Walter that the codification by Congress in 1950 was meant to uphold this interpretation. Specifically, Representative Walter stated, "It was never the intent of Congress to give the [FDIC] a stronger position than that of the bank, and the adoption of the amendment, my amendment, is offered to prove heretofore it was the intent of Congress that any agreement in the absence of fraud is binding on the corporation."

The historical roots of the D'Oench Duhme doctrine are founded in common sense, fairness, and equitable justice. The doctrine was designed to protect the FDIC from fraud by the borrower, not to protect the FDIC from valid claims brought by the victims of negligent and fraudulent banking practices.

Citizens and Business for D'Oench Duhme Reform urges Congress to carefully re-examine the D'Oench Duhme doctrine with its ramifications and to return it to its original intent by legislative clarification. Specifically, Congress should ensure that claims that would otherwise be valid against a solvent financial institution are not barred or dismissed just because a thrift or bank has become insolvent.

Thank you.

Senator COHEN. Thank you, Dr. Hess, very much.
Mrs. Sweeney?

TESTIMONY OF RHETTA B. SWEENEY,[1] HAMILTON, MA

Ms. SWEENEY. Mr. Chairman, may I take this opportunity to thank you for allowing me to testify from my personal knowledge and experience about abuse by the Resolution Trust Corporation and the misapplication of the doctrine of D'Oench Duhme against me and my family as borrowers of a failed S&L, ComFed Savings Bank. I will inform you of the harm I have suffered as a result of the RTC's abuse of the D'Oench Duhme doctrine: first, to throw out a State court judgment entered in my favor, and now they are using D'Oench to throw me out of my home as of tonight at midnight.

Although the focus of these hearings is D'Oench, I am providing you additionally with a list of factual information which details an extensive and an apparent pattern of abuse by the RTC against me. When CNN World Headline News covered our story of the abuse we were suffering at the hand of the RTC, the RTC's response was: "We are only doing what Congress told us to do."

I want to impress upon you that I have been a victim twice, first by the bank and then by the RTC.

The background of my story begins in 1987 when I entered into a commercial loan agreement with ComFed Savings Bank to develop a real estate project in Hamilton, Massachusetts, seeking to subdivide a 14-acre piece of property, including our home, which has been in the family for five generations.

In July of 1987, ComFed was introduced to me as a potential lender. Four loan commitments were issued during July and August of 1987, and I ultimately agreed to borrow $1.6 million rather than the initial loan amount of $600,000 as a means of guaranteeing the future financial support for the entire project. I did not know that our loan officer was operating on a commission basis. The bigger the loan, the bigger his commission. Because ComFed Savings was a federally regulated, State-chartered, FSLIC S&L, I believed I was dealing with a trustworthy lender, not a back-street loan shark.

After the closing of the August 27 loan, I invested money, hiring a team of professionals, and the development work to get subdivision approval from the Hamilton Planning Board began.

Preliminary approvals for the subdivision project were in place by January, and the subdivision plan was signed in February of 1988. On the 23rd of May, construction and sales were ready to start. Suddenly, on the 24th of May, the bank officer wrote a letter to me stating the S&L was "suspending lending."

After a series of unfair and deceptive trade practices by the bank, I filed a complaint against the bank for reasons of their bad-faith dealing. The bank lost. The court agreed. The bank had committed unfair and deceptive trade practices. I was awarded a judgment in excess of $4 million, including all of the interest and costs, for the bank's unfair and deceptive trade practices.

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[1] The prepared statement of Ms. Sweeney appears on page 59.

You will find the words of the State court judge's opinion in my more detailed written statement already in your hands.

Motivated by greed, the loan officer admitted that he was being paid commissions on the loans he closed in violation of 18 U.S.C. 215.

Motivated by greed, the bank and its loan officers made intentionally false statements in an effort to close the loan of $1.6 million in violation of 18 U.S.C. 1001.

Motivated by greed, the bank and their lawyers intentionally omitted the partial agreement clause which detailed the business agreement for the payback of the loan, a violation of 18 U.S.C. 1005.

Motivated by greed, the bank and their lawyers willfully and intentionally violated the Massachusetts unfair and deceptive trade practice statute by obstructing the payback of the loan for reasons of self-dealing.

Motivated by greed, the bank intentionally and willfully over-valued our property in violation of Title 12 and 18 U.S.C. 1014.

This vicious and mean-spirited course of dealing has driven me into bankruptcy. ComFed Savings Bank was taken over by the Federal Government on December 13, 1990, for reasons of unsafe and unsound lending practices.

Now comes the RTC, kicking, clawing, elbowing their way to their weapon called D'Oench in an attempt to wipe out our State court judgment.

January 1991 began a 4-year ordeal and a period of coverup, including fraud, obstruction of justice, conflict of interest by the Federal regulator RTC against me and my family, which has been worse than what we experienced at the hands of the failed bank, ComFed, and continues to this day.

Since January of 1991, the RTC has disregarded its own rules, violated Massachusetts Rules of Civil Procedure, the Federal Rules of Civil Procedure, the Code of Federal Regulations, violated State law, violated Federal statutory law, Federal criminal statutory law, and ignored every rule of common decency, fairness, and justice, all under the guise of a court-created Federal common law doctrine known as D'Oench Duhme.

The RTC, in violation of their own conflict of interest rules, hired the same law firm, Hanify and King, which had been counsel to ComFed and its subsidiaries, to represent the RTC as an independent legal contractor. Bear in mind, this is the same law firm that was counsel for years to the bank prior to the failure of the S&L ComFed and whose representation included acting as defense lawyer for the defendants in our case. The law firm of Hanify and King defended the officers and directors whose business practices had contributed substantially to the failure of ComFed.

The RTC, in their rush to get out of State court and avoid our judgments, violated the Federal removal statute and failed to remove the case to the proper court of jurisdiction, the U.S. District Court for the District of Columbia. Instead, they went "forum shopping" to the U.S. District Court for the District of Massachusetts.

The RTC's counsel, Hanify and King, when learning of the State court judgment, removed my entire original file from State court, kept it hidden in their offices for 25 days, and never informed our

counsel either of the existence of the judgment or of the whereabouts of the case file. This was admitted in the form of an affidavit filed by Hanify and King in the district court.

Furthermore, the RTC never received the necessary writ from the Federal court allowing the removal of the files.

Incredible as it might sound to your ears, in January 1992 the Resolution Trust Corporation moved for summary judgment in Federal court on grounds of D'Oench. The Federal court allowed all of the above and implicitly countenanced such conduct and in the process completely rendered moot the findings and rulings of a State court judge—all on grounds of D'Oench.

In raising the Federal question of D'Oench, the RTC has not only misapplied a doctrine, it blatantly abused the doctrine to bludgeon the opponent for the following reasons:

The key element of D'Oench is, did the borrower have a secret side agreement with the bank that the loan would not be called for repayment which would hurt the taxpayer when the bank fails?

The record is clear that I have never asked that the note borrowed from ComFed be forgiven. In fact, the record is clear that I have tried to pay back the loan as many as four different times, only to be obstructed by the bank and subsequently, when trying to settle with the RTC, I was unable to resolve the settlement efforts.

I have been unable to this day to gain release from the bank or the RTC of my property in any fashion.

In June of 1988, a purchase and sales agreement was offered to the bank in the amount of $1.1 million for the Meyer Lane house and three acres. In January of 1989, another P&S was offered for $775,000. This also was rejected by the bank.

In January of 1991, the final judgment issued in the State court incorporated a payback of the note within my damages. The amount of $2,069,000 paid back the loan in dispute plus interest, legal fees, and costs.

In November of 1994, we attempted to make a settlement offer to the RTC seeking at least to just save our home, offering them a bigger settlement offer on the note. This offer was rejected.

At all times, the payback of the note was obstructed by the S&L and subsequently by the RTC's unwillingness to reach any kind of a reasonable settlement with us.

In raising the Federal question of 12 U.S.C. 1823(e), the RTC again has blatantly abused the Federal statute. The dispute between the parties in this case was never about a secret side agreement but, rather, written agreements which were intended to defraud and did defraud me. The agreements have at all times met the four predicates of 1823(e). The RTC has known the agreements were in writing, they were signed by both parties, they were recorded in the loan committee report, and they have been continuously recorded in the Essex County Registry of Deeds since the closing of the loan.

The RTC, using D'Oench, has spent millions of dollars in legal fees. From 1991 through June of 1994, the RTC has paid a total of $1,062,000 in legal fees to the three Boston law firms involved with my case, after the State court judgment was entered.

On October 1 of 1990, after an internal bank investigation, lengthy investigations by a grand jury, the FBI, an audit by Peat Marwick, the bank filed its own RICO lawsuit against 35 past employees of ComFed. Also cited in the complaint was appraiser Peter Reilly, who had performed the illegal appraisal for the underwriting of our loan. A similar pattern of willfully overvaluing real estate in violation of law has been reportedly admitted by individuals in the course of the Whitewater investigations who are responsible for the Madison S&L failure.

On August 9, 1991, the racketeering case was mysteriously dismissed when the RTC filed a stipulation of dismissal for the entire case. By dismissing the claims against the 35 defendants of the failed bank, the RTC has implicitly given those individuals immunity and career protection within the financial industry to the officers, directors, lawyers, accountants, and appraisers, when the S&L had admitted in their verified court filing that these individuals used ComFed as their own personal piggybank.

Further, the RTC sold part of the assets of the subsidiary, ComFed Mortgage Company, in the amount of $1,238,105,000 to Goldman Sachs, New York for $182,000,000. This would be the equivalent of 15 cents on the dollar.

The RTC sold the balance of the assets of the subsidiary, ComFed Mortgage Company, in the amount of $2,420,457,000 as a portfolio to Lomas Mortgage USA in Dallas, Texas, for a mere $218,500,000—the equivalent of 9 cents on the dollar.

On the 14th of April of 1992, the district court did enter summary judgment on the grounds of D'Oench in favor of the RTC.

On January 31 of 1994, the U.S. Court of Appeals affirmed the U.S. district court summary judgment in favor of the RTC.

On October 3 of 1994, the Supreme Court denied our writ. On January 9 of 1995, the Court also denied my petition to rehear.

On November 29, 1994, despite all of what you have heard today, the RTC held an illegal auction on our property while court matters were still pending in this case and while we were away from our property with our family for Thanksgiving.

On January 31, 1995, as I speak before you, the RTC has notified us if we are not out of our home by midnight tonight, physical eviction with begin forthwith.

In closing, the purpose of these hearings is to focus on the broad-based abuse of the misapplication of the D'Oench Duhme doctrine to borrowers of failed banks and S&L's.

The most terrible period of abuse suffered by me and my family has occurred at the hand of the RTC over the past 4 years. The RTC knew at all times of the terrible abuse we suffered at the hands of ComFed and their loan officers. Having borrowers pay for the misdeeds and the mistakes in judgment made by the S&L's directors and officers should not be condoned and allowed to happen to us, or to anyone else in the future. An unrestrained exercise of Government power cannot be the intent of Congress, not now, not ever, and only you, the lawmaker, can now correct this abuse.

The U.S. Congress and especially your Subcommittee are respectfully urged to use this occasion to dispel this confusion about D'Oench Duhme by issuing retroactive legislation.

Thank you.

Senator COHEN. Thank you, Ms. Sweeney. We will come back to you for questions.

Mr. McLaughlin?

TESTIMONY OF MICHAEL C. McLAUGHLIN, ESQ.,[1] LANE & ALTMAN, BOSTON, MA

Mr. McLAUGHLIN. Thank you, Mr. Chairman. I also appreciate the opportunity of being here. I am a banking attorney from Boston, and I have been asked to recount several examples of how D'Oench Duhme has been applied unfairly. I think that you have already given a number of excellent examples.

Before I do get to my examples, I want to make some general statements which I think will lend some perspective to my testimony. I am not a victim, but I represent banks, I represent bank officers and directors, I represent borrowers and guarantors, and the spouses of borrowers and guarantors. I think I, more than most, as a banking attorney, understand and appreciate the need for the D'Oench theory, as it was originally decided by the court.

We have to, obviously, have integrity in the system and accountability, and I am not here to dispute the original D'Oench theory. However, Mr. Chairman, you must realize and the Committee must eventually realize that superpowers is something that is far beyond what the court in D'Oench ever envisioned or the Congress in 1823(e) when it was drafted could have ever imagined.

To the best of my knowledge, FDIC, RTC, NCUAB, which is the National Credit Union Administration Board, and the general regulatory authorities have greater powers under the superpowers than any agency that I am aware of, even the IRS.

Right now, under D'Oench and under FIRREA, which is generally considered part of D'Oench, the right for injunctive relief from any court in this land is denied if the FDIC is operating as a liquidator or a conservator of a failed bank. That is an amazing power. You cannot go to any court and seek injunctive relief no matter what they are doing if it is within their role as a liquidator. You cannot seek any declaratory relief from any court in the land. That is another amazing power.

Essentially, your right for judicial review has been essentially stripped, so that the borrower or the bank—there are many banks that I represent that are also hit by D'Oench, solvent banks who have done things the way they are supposed to that have been hit by D'Oench as well.

Some modicum of relief for borrower citizens who have been abused by this process has to be in order at this point.

Now, as I said, you have already given some good examples. My examples are largely examples that I have dealt with on my own. I have done dozens and dozens, if not hundreds and hundreds of cases dealing with the Federal authorities and abuses under D'Oench.

My first example is a case that I handled, and I think it illustrates how the D'Oench theory thwarts even the interests and the intents of Congress on other laws; specifically, the law is the Equal Credit Opportunity Act, which was passed by Congress decades ago

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[1] The prepared statement of Mr. McLaughlin appears on page 85.

to protect primarily women—it is a sex-based discrimination statute, civil rights statute—intended to protect women from banking violations, in particular to protect women from being required to sign loan documents on behalf of their husbands' loans, their husbands' business loans, where typically the woman may be a housewife with no connection with the loan whatsoever.

That was made illegal under the Equal Credit Opportunity Act. That act is regularly being violated today by banks across the country. But when a bank violates a woman's rights by requiring her to sign those documents, Congress has said that woman has remedies that are available and defenses that are available right in the statute.

If that bank is taken over by the FDIC, their position is she has no rights. This is the banking authority saying that the protections under a banking statute, ECOA, are not available to the women who have been violated by requiring of their signatures. I have literally done dozens of cases involving ECOA. The FDIC, the RTC, the NCUAB will commence foreclosure on these women's homes if their husbands have gone into default. And there is no remedy. You cannot stop them. You cannot seek any redress at all.

That is an extraordinary situation, one that I do not believe Congress ever considered as being even a remote possibility.

My second example is another example of violation against protection afforded by ECOA, and it involves two women that were required to sign documents on behalf of their husbands' business. And, in addition, they were required to sign a mortgage on their home. The bank officer in question promised these women that the mortgage on their home would be for 6 months, and, in fact, he issued a commitment letter to the two husbands, indicating that the mortgage would be for 6 months.

Subsequent to making that loan—oh, by the way, the note and the mortgage never had any language in it whatsoever concerning this obligation for the bank to discharge in 6 months, only the commitment letter. Subsequent to making the loan, the bank officer was indicted in Federal court tried and convicted of bank fraud for matters similar to the activity that took place in this case. Subsequent to that conviction, the bank was taken over. Subsequent to that, the banking authority—in this case, the NCUAB—proceeded against the women and started foreclosing on their homes.

The women said, wait a minute, there is a mortgage that was supposed to be discharged 18 months ago; surely that has happened. The answer was: No, it was not. The bank authority was absolutely aware of the indictment, the trial and conviction, and the serving of time in a Federal penitentiary for that bank officer. The foreclosures proceeded. They had no redress to anyone.

Extraordinary that the FDIC and RTC and NCUAB—this is just one case of many—are in the position of enforcing fraudulent documents which they acknowledge were derived from fraud, but these women were "D'Oenched." It is an extraordinary position for them to be in, one that certainly hits the credibility of the banking authorities within the general public.

The third example is another example of fraud. This was not a case that I handled personally, but was one that is typical and did receive some notoriety, and this is a case of a farmer who essen-

tially is looking for a loan to buy a tractor, literally. We are talking about the heartland issues here. This is a farmer trying to buy a tractor. He goes to a bank, attempts to borrow the money. The bank officer says, here, fill out these documents. He fills out the applications, including a blank note which he was told to fill out by the bank officer. He did. Several days later he was rejected on that application. He was told he was not going to qualify. He was told to seek financing elsewhere. He did.

He went to another bank. He borrowed the money to buy his tractor. In the meantime, the bank officer completed the note which had been signed by the farmer and absconded with $62,000. Then the bank went under. FDIC came in, saw the note signed by the farmer, the farmer having no idea that the money had ever been lent, sued the farmer. The farmer said, I did not receive any money, I do not know what you are talking about. He was viewed as having lent his name to a scheme, and he was found to be liable under that note, the FDIC knowing the circumstances that arose under the issuance of that note.

Another extraordinary situation which strains credibility, as far as I am concerned, as to the FDIC taking those types of positions.

The fourth example is a case that I did handle. It is even harder to understand. We have an unsophisticated borrower who goes to what I will call a private lender, and I am using that term very loosely. This private lender lends several hundred thousand dollars at usurious rates that violate State law. For all intents and purposes, this was a loan shark note.

The private lender then assigns that note to an FDIC member institution to secure a loan that the private lender was taking. The bank goes under. The loan shark note is now an asset of the FDIC. They proceed to enforce it against the unsophisticated borrower, who never knew that it was a usurious note because the interest rates were buried in penalties, late fees, et cetera. So while it was a very high interest rate, once someone figured out what the real interest rate was, it exceeded 30 percent.

Now the FDIC is in this position of enforcing a loan shark note, what I call a loan shark note, against this borrower who would have had defenses under State law which could—not necessarily always, but could void the loan shark note. He was "D'Oenched" and they foreclosed on him.

Now, again, is this the image that we want of the FDIC enforcing these types of loans?

There are literally thousands of similar cases, and in my limited time, I am going to limit myself to the ones that I have just discussed. Essentially, however, D'Oench and the superpowers, as I said, exceeds what any agency has, including the IRS. At least with the IRS, which is generally viewed as one of the most powerful agencies as far as the general public is concerned, there is the Taxpayers Bill of Rights. If you are being abused by the IRS, you can do something about it. You can go to a court. You cannot do that with the FDIC, and I do not believe Congress really intended to have it that way.

I think we have to be careful in bringing up these issues and then expecting—or I would say I expect that the FDIC's position

is we cannot go back, if we allow any retrenching at all we are going to be in trouble, we will lose control.

I do not believe for a second that the changes that were proposed last year by you will have any impact on the accountability or the integrity of the banking system, but it will restore at least a modicum of protection for these borrowers, which right now, FDIC has to be brought in line with some reasonable standard of fairness and equity.

I appreciate your time. Thank you.

Senator COHEN. Thank you, Mr. McLaughlin. My only regret is that there are not more members here today. There are several committee hearings going on and several conferences being held.

I have been in touch with the Chairman of the Banking Committee, Senator D'Amato. He is now fully apprised of what has been going on, and I believe he is going to lend his support to changes that have been long overdue.

My second regret is that it is necessary to have to have a public hearing. But I will say for the benefit of those who are here from the RTC and the FDIC, on each and every occasion in the future I am going to hold a public hearing. I am not ever going to be put in the position of having to negotiate with RTC lawyers about what I can ask and what I cannot ask and what information I can have and under what circumstances the Director is going to meet with me in my office. That will never happen again. And so on each and every occasion we are going to have oversight hearings. It is going to be right here in a public hearing, and hopefully there will be more coverage than currently is here, because this is an issue which needs to be explained to the American people.

I left a Republican Conference at 2 o'clock to come over here. There must have been 25 reporters waiting outside. I said, "Please, I am running late for a hearing on D'Oench Duhme." It immediately provoked laughter because not one of them could even pronounce D'Oench Duhme, let alone explain what it meant.

I would venture to say not more than five people, at the outside, in the Senate know anything about D'Oench Duhme or how it has been applied. So this is an issue that needs much greater exposure, and once the facts are exposed, then I think we are going to see corrective action so we do not see the kind of inequities, serious inequities, that have been inflicted by the application and, I believe, misapplication of this doctrine.

I have a few questions, Dr. Hess. Tell me more about your organization. I do not know how many members you have, how many cases have been brought to your attention. Why don't you tell me a little bit about the number of complaints and the nature of the complaints, and whether or not people have been discouraged from even challenging RTC and FDIC.

Dr. HESS. Well, we do have a small organization that I founded in 1993, because I felt that this activity by the FDIC was occurring without the consent of Congress that regulates those types of things. So the main purpose of the organization was to come to Washington on a regular basis—we have since relocated to this area—to educate members and their staffs about D'Oench Duhme and what has been going on.

As an aside to that, we have been contacted by many plaintiffs' attorneys and many victims of D'Oench Duhme across the United States. We provide for them information on what our organization is doing. We provide to them the Members of Congress they should be writing, and give mostly support. We do not judge who is right and who is wrong.

The basis of our organization is that we just all would like a day in court and let a jury decide the merits of a case, whether it be the Sweeneys' case or my case or those of other victims. So that is the main purpose of the organization.

We have heard horror stories, as we have heard today, of what has been going on that most of us would say this does not seem just or fair. And there seems to be an absence of fairness and of what we call justice when you hear some of these cases. We encourage these people to contact their Members of Congress, and many have.

We have also found many victims have become very callous about it. They have lost their homes. They have lost their loans. They have had no recourse, and they have become cynical. And they have given up. We hope that whatever legislation occurs will be retroactive so that they may have some justice given to them, because they have become discouraged.

And I can understand that. I was very fortunate to have the resources and the resolve to fight my case, and I was very fortunate that the Circuit Court of Appeals said I was right. But that only made me more angry that I had to spend that kind of money to get something I should have had before, which is a day in court.

That is what our organization seeks for the people who contact us.

Senator COHEN. Have any of the other people that are in this small burgeoning organization had to spend some $250,000, as you did, in their cases? Did they have the resources to do that, or have they just given up?

Dr. HESS. Many give up. We did a survey of approximately 100 attorneys in the New England area, and we asked the question: For every client that you represent against the FDIC in a D'Oench Duhme case, how many do you turn away because you know the futility and expenses cannot be afforded by the client? And the estimate is they probably turn away five people for every one case they take on. And that is probably because these people do not have the resources to fight 3 or 4 years in court just to find out, Can I get to jury trial? And we estimate there may be 100,000 people who have been denied justice across the United States based on our surveys.

Senator COHEN. Was there any point in time when you sought to settle with RTC or FDIC?

Dr. HESS. I have sought all along to settle with the RTC and the FDIC. When Southeast Bank of North America became insolvent, there is something in the law about adjudicating the claim through an administrative court, which I thought, gosh, this is good. We will write down the facts, and they will study the facts, and if I have a good claim, we will get a settlement and be done with this.

We did that. We waited the 6 months to hear, and then they said, well, since your case is pending in court, we cannot make a

ruling on it, so you have to go back to court. So that became an exercise in futility, trying to adjudicate the claim.

Throughout our dealings with the FDIC and RTC, we have said we should talk, we really feel we have a claim, but the power of the D'Oench Duhme, they never thought they would lose. They said that even on the day that the appeal was argued.

After the appeal has come through and I have won a day in court, they have contacted me about talking about a settlement. But it has been a very long, hard battle, and I am not certain that they want to settle even still, because they have now asked for a retry of the appeal.

Senator COHEN. Do you have a list of cases of similar dealings that people have had with the RTC?

Dr. HESS. We have some cases from the victims who have contacted us and also from our own research of the literature, many of which I have given to members of your staff.

Senator COHEN. We already have those?

Dr. HESS. Yes, sir.

Senator COHEN. Mr. McLaughlin, have you done similar lists?

Mr. MCLAUGHLIN. No, I have not, ad there are some significant reasons for victims of D'Oench to not want to go on with the fight. A majority of my clients—because before I came, I actually attempted to talk to some of my clients and see if their examples could be used, and their view was that, one, it was an extraordinarily expensive and humiliating process that they went through, and they want to get it behind them. So it is difficult at this point for many of my clients to make their cases known, and I literally have had dozens and dozens of cases.

Senator COHEN. Would it be possible for you to summarize those cases without disclosing the names of the individuals so that we could have it for our record?

Mr. MCLAUGHLIN. Yes. With clients' permission, because some of them are easily detectable by the Federal agency. They can look at a specific—some of them are not settled, some of them are in litigation.

Senator COHEN. Basically they are embarrassed, number one, that they were taken advantage of or defrauded by the bank; then, number two, the way in which they have been treated by Federal agencies?

Mr. MCLAUGHLIN. That is correct.

Senator COHEN. In losing their homes and other assets?

Mr. MCLAUGHLIN. That is correct. And the Federal agencies are extraordinary opponents in that they have unlimited resources. I have one case right now—and I do have authority to speak about it—where the individual is being pursued for the third time by the RTC, and approximately 20 days ago, 3 or 4 days prior to us having to answer a complaint by the RTC, he had a massive heart attack and was at Massachusetts General Hospital for 14 days. And the RTC attorneys believed it was a fake heart attack and would not consent to an extension of time to answer until a Federal judge told them that they had to.

There is no limit to the way the RTC or the FDIC can handle a case if they want to, so that a lot of these individuals, you have

to say to them as their attorneys, I would like to talk about this, but I do not want to because this is what could happen.

There has always been within the RTC and the FDIC a process that if any borrower goes to any congressional delegation to complain about the process and that is duly noted—and I can say without reservation that in the cases where my clients have, it has come up in the meetings, and they have said you are going to pay.

So there is a huge reluctance to do that.

Senator COHEN. Mr. McLaughlin, you do not have to tell me this. I saw it firsthand a couple of years ago when Senator Kerry of Massachusetts and I held hearings first in Maine and then in Boston. I had firsthand experience where those who were involved with Recoll—you are probably familiar with Recoll.

Mr. MCLAUGHLIN. Very.

Senator COHEN. It is a collection agency, a brass-knuckle collection agency for FDIC. What they did to innocent citizens was unforgivable. This involved people who had been paying their loans. They have what are called performing, non-performing loans, where they are paying every month on their mortgage, but the auditors came in and said, there has been a re-evaluation of the assets so now we want it all, and Recoll threw people out into the street. And when anyone complained to me or to any other congressional office, they did exactly what you are saying. They threatened them that things would go much rougher if they ever voiced a complaint.

Now, that is the attitude of a Gestapo, as far as I am concerned. Fortunately, we put a stop to it, at least for the time being in Maine. I think the FDIC was sufficiently embarrassed about what was being exposed. But I must say that, from what I am hearing today, there is a lot further that we have to go in order to cure the kind of excess that tends to gather around "superpowers" or unlimited powers.

I would like to turn to you, Mrs. Sweeney. I should make it very clear for the record—and I have never tried to mislead anyone about this—that I knew the Sweeneys 30 years ago. I have not seen them in 30 years. But at the hearing in Boston, they brought their complaint to me when I was there with Senator Kerry. And as I looked over the case, frankly, I was astonished at the factual situation that had unfolded at that point.

Here we have a bank that made a loan of $1.6 million. As I understand it, it did not even conduct an appraisal at that time, which was required by law. Then after having made a commitment for further financing, the bank then advised the Sweeneys that it was not going to make good on that commitment. The loan went into default. At one point in an effort to save the project, Mrs. Sweeney used her family jewels, antiques, and heirlooms as collateral in order to go to a builder to borrow $65,000. That money was paid to the bank because the loan officer said, if you bring the interest payments up to date, we will go forward with the financing.

After having paid the $65,000 over to the bank, of course, the bank refused to go forward with the financing. Then the builder brought suit to collect on the collateral which she then had to surrender.

So this was a pattern, it seemed to me, of fraudulent misrepresentations by the bank. As Mrs. Sweeney pointed out this afternoon, at one point they had a purchaser for a portion of the land that was being subdivided. The purchaser offered $1.1 million for a portion of the land, went to the bank, and the bank said no. Then when it was found out that the Sweeneys were in distress, the next offer that came in was about $775,000, as I recall. They went to the bank again; the bank said no.

It became very clear that the bank was determined to foreclose on this particular property, and it turns out that a number of the bank's loan officers were, in fact, simply collecting very inflated commissions on inflated appraisals of property.

I spoke with the court yesterday. I spoke with the court in terms of how this particular case was handled. The jury decision rendered in the case of the Sweeneys was that the money was owed to the bank on the mortgage. But there were two complaints that were to be decided by the court. The court advised me that the attorney for the bank, the same attorney with the law firm that was hired by RTC to represent it, inquired on a frequent if not daily basis when that decision was going to be handed down. The judge who was writing the opinion, of course, had a number of other opinions to write and was in the process of completing it. And unbeknownst to the court, the attorney for RTC at that point physically removed the documents from the court and took possession of them for some 25 days, never having notified the court that he had possession.

So when the opinion was finally written, by that time the case had been not only physically removed from the court but removed to the Federal court. Shortly thereafter, the RTC asserted D'Oench Duhme.

That does not, to me, smack of any element of equity, and I do not care what RTC comes forward to testify to later. That seems to me to be an example of gross abuse of power; you know a decision is coming down from the State court, and the decision is going to be favorable to the plaintiffs in this case that would have, in fact, been enough to pay off the loan, plus provide the plaintiffs with some monetary compensation for the intentional affliction of emotional distress.

Originally, the jury said only $65,000. The court decided it was worth a great deal more than that in terms of what that particular bank put the Sweeneys through. And yet all of that has been wiped out by the invocation of D'Oench Duhme. I think an outrage has been perpetrated. Under the authority of D'Oench, the RTC can come in here and say that it is perfectly legal. It is. You cannot say to me it is perfectly equitable. It is not. A great inequity has been done, and when you tell me or anyone else that the Sweeneys now have to vacate their home by midnight tonight, or else they will be physically evicted, it seems to me you are going to lend a great deal of support to the movement to revise and reform the D'Oench Duhme doctrine. Hopefully we can make it retroactive, notwithstanding any complaints we might cause serious dislocations doing so.

When you have a situation in which a legitimate claim for fraud and misrepresentation is before a court of law, it seems to me those

kinds of cases at the very minimum ought to be heard and not thrown out under the invocation of this doctrine.

Mrs. Sweeney, I do not have any questions to ask you. I have lived with your case almost, but not quite, as long as you have. I have frankly tried to intervene to see if the RTC could not arrange for some kind of reasonable accommodation, if they could not find a way in which you could save your family homestead, particularly in view of the fact that a State court had rendered a verdict that you had, in fact, been defrauded and that you should be awarded some compensation, and when, in fact, right now you are facing becoming homeless. That is not fair under anyone's standard of interpretation.

I will call the next panel and proceed, but please remain in the hearing room. I may have a need to call you back because we will have testimony from other witnesses who may contest what I have said.

I want to agree with you, Dr. Hess and Mr. McLaughlin. We need to have a D'Oench Duhme doctrine, but it surely should be confined as originally conceived by the Supreme Court. It should not have been expanded in the way it has been expanded to give the RTC and the FDIC the kind of arrogant authority that they have and have exhibited in many of these cases.

We have two witnesses on our second panel, both of whom are experts in the field of banking law. Mr. Michael Malloy is a professor at Fordham Law School in New York, and Michael Echevarria—did I pronounce that correctly——

Mr. ECHEVARRIA. Yes.

Senator COHEN. Not to be confused with FIRREA. He is a professor at Southwestern University School of Law in Los Angeles.

Professor Malloy, why don't you go first, and then Mr. Echevarria—or either way, if you prefer otherwise.

Mr. ECHEVARRIA. I think I will go first.

Senator COHEN. Fine.

TESTIMONY OF J. MICHAEL ECHEVARRIA,[1] PROFESSOR OF LAW, SOUTHWESTERN UNIVERSITY SCHOOL OF LAW

Mr. ECHEVARRIA. I would like to thank the chairman for this opportunity to address the Committee, and the people in the audience.

I come to this problem two ways—one, as an academic. I recently wrote a law review article in the Catholic Law Review, chronicling the evolution of the D'Oench Duhme doctrine and critiquing what I think is its essential unfairness and inefficacy; and second, I come as a repentant sinner. That is, for a number of years I was in practice, and I represented, through a private law firm, the FDIC. D'Oench Duhme is known as a verb. We "D'Oench" people, or the FDIC "D'Oench's" them, and it leads to some harsh and inequitable results.

I think the first example highlighted by Senator Cohen was, unfortunately, a case that I worked on, a case where an elderly couple who had invested their retirement income was defrauded by a person who was later convicted of 30 counts of criminal bank fraud.

[1] The prepared statement of Mr. Echevarria appears on page 97.

I think the person was the first officer or director of a savings and loan institution in Southern California to be criminally convicted. On the first day of trial in the civil case, I raised as a banner the D'Oench Duhme doctrine, and the case was dismissed.

I wrote the article subsequently because I remember the look on their faces as I exited the courtroom. I, of course, was representing my client and doing what I perceived to be within the bounds of the law, but it does not mean that I believed it was fair.

What I would like to talk about today is really two things—first, how did we get to where we are today, and second, what is to be done?

With respect to where we got to where we are today, there has already been testimony concerning the original D'Oench case. The original D'Oench case concerns something that we call an "accommodation note." It is a note executed by a person who knows it to be untrue; that is, they sign a piece of paper saying they are going to repay a loan, knowing they are not going to repay the loan, knowing that it will inflate the assets of the institution. And the Supreme Court in 1942 rightfully provided that under those kinds of circumstances, that borrower should be estopped, that is, legally prevented, from raising as a defense any secret side agreement he had with the bank.

Later, D'Oench was codified in 12 U.S.C. 1823(e), which—and there has also been testimony to this effect—was not intended to expand the powers of the FDIC. A number of courts in the first 30 or 40 years of D'Oench's life really did not cite it for any substantive provision, and it really was not much of an issue and was not a controversial topic.

It was not until the late 1970's and early 1980's, when there were massive failures by S and Ls, that D'Oench came into vogue, and it came through a gradual evolution in case law whereby the FDIC was seen as a super "holder in due course." That is, it was given the powers of an ordinary "holder in due course" who acquires through the process of negotiation a commercial instrument. Of course, the FDIC ordinarily would not qualify, since it acquires commercial paper in bulk when it takes over as a receiver, and ordinarily the "holder in due course" doctrine does not apply to that.

The D'Oench doctrine expanded not only because of the D'Oench case itself and a looser interpretation of it, but also because of an interpretation of 1823(e). In particularly, in 1987, the Supreme Court in a case called Langley interpreted the word "agreement" in 1823(e) to encompass not what you and I would think of as an agreement, but also misrepresentation. That is, if there were a misrepresentation made by a bank officer or director to a bank borrower, that was considered to be akin to this secret side agreement which D'Oench prohibited.

In addition to D'Oench and 1823, there was a third line of cases that sprung up in the Eleventh Circuit in a case by the name of *Gunter* v. *Hutcheson,* which went beyond both of these cases. Now, as it stands, D'Oench basically precludes any defense or claim by a bank borrower based on something that is not a recorded official bank record. That is, if your claim arises out of some oral misrepresentation or claim not founded in official bank record, you really do not have much in the way of recourse.

The National Law Journal described D'Oench as follows: "D'Oench, a once little used doctrine, has been applied to nearly every major S and L failure as myriad borrowers try to get out from under their debts."

Essentially, the way D'Oench is being applied now is to make what would traditionally be the basis of a common law defense a nullity. That is, because of the expansive view of D'Oench and its statutory codification, a lot of the force of the common law has been preempted, which brings me to my second question, and that is what are we to do.

I think the bottom line question is this. If Congress were sitting today, would they pass 1823(e) again in its current form, not as contemplated by amendments. And by "current form," I mean also as interpreted by the United States Supreme Court.

If the answer to that question is no, then I think we have to change the statute. That is, we have—I think the recent elections made it clear—a mandate for change, and if we have unfair, oppressive statutes on the books, I think it is obviously within the power but also the mandate to the Congress to change these laws.

I think that the answer to would we pass 1823(e) in its original form as recently interpreted by the Supreme Court has to be no for at least two reasons. First, we often see in the literature a discussion about the "superpowers" of the FDIC, or why the FDIC or the RTC should be treated differently or accorded special protections. That only looks at one-half of the equation. That is, in each instance when D'Oench is raised, you always have a case where there is a borrower or a customer of the bank who is either asserting a defense or asserting a claim, and it is used against that person.

I do not think it is the case that we should look at D'Oench simply—should ask ourselves the question, well, what kinds of special protections should the Federal Government have. I think we should look at it this way. Should we discriminate against certain citizens, those certain citizens being those citizens who have the unfortunate experience of entering into a transaction with the bank that later was taken over by the FDIC.

Now, there probably is justification for certain types of discrimination, that is, certain rules as they pertain to financial institutions. But remember, when we are talking about D'Oench, we are talking about a rule that pertains not to financial institutions, which are all subject to common law, but to financial institutions that have been taken over by the FDIC—something that obviously a customer or a consumer dealing with the bank cannot foresee in the future. So it becomes somewhat Kafka-esque, its application, in that it only applies when you have had the misfortune of dealing with a bank that was later declared insolvent.

The second reason why I do not believe Congress would pass a similar statute as recently interpreted again has to do with the notion of what do we see the role of the Federal regulatory agency as. Here, there have been elaborate and I should say quite eloquent testimony to the effect that the FDIC and the RTC are not acting as the protectorate of the public, but rather they have sort of an institutional concern. You see this in the case law as a need to protect its insurance fund.

But I do not think that that is the mandate or the goal of the RTC—or the FDIC. As originally contemplated, they were designed to increase confidence in the banking system, to regulate over abuses of the banking system. As it stands now with D'Oench, they are used as a tool of abuse. There is a credo in the medical field that at a very minimum, the doctor should "do no harm" I think that what the FDIC is doing with its invocation of D'Oench is harm. That is, it is clearly not protecting the public, it is clearly not increasing confidence in the public, which brings me to a few final points, and that is with respect to legislative suggestions.

I think by and large a lot of the problems that arise in the D'Oench area have to do with a rather cramped interpretation of 1823 as interpreted by the Supreme Court. And I am talking about more in particular the term "agreement." "Agreement" has been stretched beyond its normal, everyday usage to include affirmative misrepresentations by banks. I do not know about other people, but it seems to me that a misrepresentation is the opposite of an agreement. An agreement is when two people agree on the same fixed object, not when someone is lying to you. So at a minimum, I think the legislation should address this interpretation of the word "agreement" to have it comport to a more common sense notion.

Second, I think, as I have seen in the proposed changes to the statute, that the FDIC should not be accorded "holder in due course" status. "Holder in due course" status really does not have application, or does not have fairness, when you are talking about an institution that has been taken over by the Federal Government. That is an institution that by definition has only one successor in interest, and that is the Federal Government. You cannot really seek recourse against the institution anymore and it is particularly unfair to eliminate that type of recourse for the individual borrower or customer.

Senator COHEN. What about extending it to private parties who then purchase from the RTC? My understanding is they have even gone so far as that those who purchase from the RTC are allowed to invoke D'Oench.

Mr. ECHEVARRIA. Yes. Private bridge banks and other purchasers from the FDIC can also invoke D'Oench. That brings me to my third point, and that is under the contemplated changes to the statute, I firmly believe that fraud, at least fraud in the nonpromissory sense, should be removed from the strictures of the statute because that is where you have the greatest unfairness.

A final point I would like to mention is the notion of surprise. I know when I exited that courtroom about 3 or 4 years ago that the Bartrams and the Tessitoris, who are mentioned in my law review article and I think mentioned in my formal statement, were very surprised that based on some esoteric Federal common law rule, they really had no recourse, and it was really undisputed that they had been defrauded. I think in large part commercial law should be designed so that people can predictably arrange their affairs so that they are not surprised by sort of egregious outcomes, and I think that that is what D'Oench does. I think the fact that we do not have C–SPAN here, or that most people in Congress do not know about it, really points up the problem with D'Oench. It

is an esoteric doctrine, but it is used in almost every S and L failure, most often to the detriment of the individual consumer.

Thank you.

Senator COHEN. Thank you very much, Professor.

Senator COHEN. Professor Malloy?

TESTIMONY OF MICHAEL P. MALLOY,[1] PROFESSOR OF LAW, FORDHAM UNIVERSITY SCHOOL OF LAW

Mr. MALLOY. Thank you, Senator. I want to thank you for this opportunity to present my views on D'Oench Duhme, the case and its statutory heir.

In my written statement, I have examined the 1942 case on its own terms and then related that to some of the statutory developments and case law developments that were referred to by Professor Echevarria.

I would like to respond directly to the issues that were posed by the Subcommittee in your letter of invitation.

First, concerning the expansion of the doctrine, under the statute and the cases. I have no doubt, and I think it is clear from what we have heard so far, that in the 5 decades since D'Oench Duhme was decided, the legal principle enunciated in the case has been expanded significantly, and indeed it may be said beyond recognition.

On the other hand, I think it is important for balance to stress the fact that this was not entirely the result of the regulators' efforts, unaided, perhaps inadvertently, by other sources.

First and foremost is the case itself. Justice Douglas' opinion, which I think is intuitively the correct result on those facts in that case, really does not give a very rigorous justification of why that should be the result. What we do know from the case is that he wanted a Federal rule that would be generally applicable because he was worried about the integrity of the regulatory process.

Justice Jackson, who is a personal hero of mine, writing in concurrence urged some further articulation of why this result was the correct one, not just intuitively, but as a technical matter.

Absent that kind of infrastructure in the majority opinion, we are left with a holding which on its own facts seems sensible, but then does not give us a great deal of indication of what direction to take it.

The provisions of the statute itself, 1823(e) also, I think, lead us in the direction of some of these results. In point of fact, the technical requirements of 1823(e), which you yourself, Senator, referred to in your opening remarks, are not by any means foreshadowed by D'Oench Duhme the case. It is certainly an admirable effort to give some further guidance that was absent from the case, and one could argue that the effect of complying with those requirements is that a third party dealing with a bank in a sense ends up with a safe harbor; they know if they do comply with these requirements, they ought to be freed up from the effects of the case itself.

Unfortunately, as we have seen, both the courts subsequently interpreting the statute and the regulators aggressively using it have tended to distort what we might view as the natural development of that area of the law. But part of the problem certainly has been

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[1] The prepared statement of Mr. Malloy appears on page 116.

unstated assumptions about what we thought the results should be, not necessarily put into binding statutory language that would avoid some of these problems—not all of them. If the Supreme Court in Langley decides to interpret "agreement" to mean something other than "agreement," there is little one can do except——

Senator COHEN. Could that be reversed?

Mr. MALLOY. I think that that should be removed as the rule through amendment of the statute, and that certainly seems to be the sensible approach.

The case law clearly has vastly expanded the original intuitive result. The decisions, particularly those following the "agreement" line, I think have resulted in a number of results which are simply startling and in many cases quite unfortunate.

That leads me to the second question that you asked, which has already been addressed by my colleague here, concerning the "holder in due course" status accorded to the FDIC.

The cases that insulate the FDIC from defenses like fraud in the inducement, where a fraud was used to draw someone into a credit transaction, is an extraordinary departure from traditional common law and the Uniform Commercial Code. Even in non-bulk transfers of credit instruments where theoretically, the "holder in due course" rule would apply, generally, that rule does not apply to defenses of fraud in the inducement, fraud in luring the party into the transaction itself.

This so-called "super holder in due course" status that has been given to the FDIC in fact has the end result of placing the FDIC in a position that no other holder could possibly entertain.

The third question that you ask concerns the impact on innocent parties. We have certainly seen some examples of that, specific cases that have been referred to. I think it is clear that the impact of the doctrine, as reinterpreted and redirected by the statute and the cases interpreting it, places innocent third parties who have dealt with now insolvent institutions in an intolerably unfair position. The effect of this I think is well illustrated by the "holder in due course" concept. One reason why the commercial laws generally free a "holder in due course" from many of the defenses that would otherwise apply is the assumption that the maker of that note could always go back to the original holder who had negotiated it and bring up these defenses in that context.

So as a practical matter, any time we are talking about the operation of 1823(e), we are in a situation where, if nothing else is clear, it is clear that the maker of that note cannot go back to the original holder because that entity, that institution is gone, and for all intents and purposes, judgment-proof.

So there is a great deal of unfairness here, and it leads to results that are simply unpredictable based on normal notions of commercial practice.

Third, as to the continued application of the expanded doctrine, I would have to say that there is nevertheless some merit in continuing to apply the doctrine in some form that is more extensive than the original case. The case is very fact-specific in its context. It does not give any guidance to good-faith parties trying to deal with the bank, to know what they should do if they are properly advised to protect themselves. One benefit of a statute of this type

is that it would provide more concrete guidance to all the concerned parties.

As a result, I think that some version of the 1823(e) provision needs to remain in the statute. I think scrapping the rule has very significant problems of its own, which we have not had to deal with because historical events have overrun this.

But first, we have to keep in mind that revoking section 1823(e), simply removing that doctrine from the statutory law, would not necessarily return us to the intuitively satisfying result we got in D'Oench Duhme, for a number of reasons.

First of all, and perhaps most significantly, we have a very recent Supreme Court case, a 1994 decision in *O'Melveney & Myers* v. *FDIC,* in which there seems to be some very serious suggestion that D'Oench Duhme, which is a Federal common law decision—at least, based that way by Justice Douglas—would simply not exist today given current interpretations. In O'Melveney and Myers, the FDIC tried to argue for a specialized uniform Federal common law rule governing when we attribute knowledge to bank officers, which happened to be a key issue in that particular case.

Writing for a unanimous Court, Justice Scalia rejected the contention that there could be a Federal common law rule in existence to displace local law on these kinds of issues, and the needs of the FDIC under its comprehensive legislation was not a sufficient basis to argue the contrary in the Court's view.

The end result, then, is that if we simply attempt to address this problem by removing it from the Federal statutory law, what we are likely to end up with is not D'Oench Duhme itself, but a situation of considerable confusion. That is to say, we will be scurrying, as in fact Justice Frankfurter tried to get us to do, to 50 different bodies of State law, trying to determine what would be the appropriate rule in each case. In the short term, I think that is a very troubling situation. We have a Federal rule; there is something wrong with it; it should be fixed.

That leads me to your final question, which is what are the possibilities of reforming the doctrine. Section 1823(e) clearly should not be left alone with all of its interpretive gloss. I would recommend at a minimum the following features to be included in an amendment to the Act.

First of all, there needs to be explicit statutory expression of legislative purpose, and, I would recommend, to the effect that the claim preclusion rule that we find in 1823(e) is supposed to be applied to concealed agreements with respect to assets acquired by or assumed by the FDIC, that would tend to mislead the supervisory authorities as to the financial condition of the institution, and I would add "in a material way," so that we do not revert to some technical gloss on the statute. That should be an explicit part of it; that should guide the courts in deciding how far to go with this and in what direction.

Second, I think we do need an explicit provision stating that this preclusion rule is not to be construed as conferring "holder in due course" status on the FDIC. But I would also add that I do not think the preclusion rule with this proviso should be interpreted as affecting the FDIC's "holder in due course" status if it does have it under normally applicable principles.

What I am suggesting, then, is that the statute should be neutral on that kind of issue, but at the very least should not accord the FDIC "super holder" status.

Third, I think one needs a provision that states that a claim or a defense against the FDIC or against the institution in receivership, if that claim is based on fraud, on intentional misrepresentation, or any other similar common law causes of action by that institution—what my colleague has referred to as "nonpromissory" frauds—that those should not be required to be based upon a written agreement. That is to say, they should be allowed to proceed on their own merits, outside of the special limiting safe harbor rule.

I think these changes are necessary. We are not dealing, so far as I can tell from my review of the literature, with a few dramatic but isolated incidents. There is clearly a trend toward expansive and unusual readings of the act that needs to be addressed, and it needs to be addressed, the sooner, the better.

Once again, I thank you for this opportunity to present my views to the Subcommittee.

Senator COHEN. Thank you very much, Professor Malloy.

Professor Echevarria, do you have any disagreement with what Professor Malloy has recommended?

Mr. ECHEVARRIA. No. In fact, we talked about it at lunch. I do not think either one of us is of the view that 1823(e) should be completely repealed, and we both recognize, I think, the need for uniformity in the area of banking law. We want a consistent rule that applies throughout the various jurisdictions.

The question is is 1823 in its current formulation as interpreted by the Supreme Court that rule, and I think we are both in agreement that it is not. There are significant problems with it. I think I have more of an emphasis on the technical language of the statute agreement than possibly Professor Malloy, but I do not think we are really in any substantive disagreement at all.

Senator COHEN. What if we were to take the other course of action and simply say, from now on, a bank must post a big sign in its window: "D'Oench Duhme," beware that any business you do with us must be in writing; it must be part of the bank's records; the board of directors must include it in its weekly or biweekly meetings, and a copy of that record should be sent out to every customer in the bank. Does that sound implausible, impractical?

Mr. MALLOY. It sounds like something you could do. I am not sure, human nature being what it is, that it would make any difference to the results that we see in these cases, for two reasons.

I do not think that the ordinary retail customer of the bank is necessarily focusing on those kinds of things. We have a lot of disclaimers, a lot of informational requirements in banking law as it is, and there are at least some empirical studies suggesting that many of those kinds of disclosure-oriented approaches do not necessarily alter the behavior of people who deal with a bank.

Also, if we are talking about a problem involving egregious intentional conduct on the part of bank officers, they will target their potential victims despite this panoply of disclosures, and that worries me. If we in effect just say, "Look, once it has been disclosed to you, you are stuck with it," well, in a very technical sense that

is the case already. We assume that people know what the law is; we assume that they take their own interests into account when they deal in a significant transaction—but human nature tells us otherwise, and it seems to me that that would not be sufficient.

Senator COHEN. It was more of a rhetorical question because it is not a serious pursuit on my part. The point is that no one, or hardly anyone, prior to a bank going insolvent has every heard of the doctrine of D'Oench Duhme. Most people, at least in my State, still know the bankers on a first name basis; the banker looks at the person for his credit, his history, the basic judgment values that he would make in making a loan, and they do a lot of things orally. If we were to require every transaction of a bank to be committed to writing, a copy to be sent to the customer or consumer, it would be impossible for the bank to do business.

What is greatly ironic in this situation is FDIC comes in and says, number one, this agreement was not in writing; number two, it was not in the bank's records; number three, it was never approved by the board of directors; and so your oral agreement is null and void as far as we are concerned.

Of course, the only thing that makes it null and void is that the bank has gone insolvent. If you go into a bank that is solvent, that is how you carry on business. People still go in and make agreements to wash windows, to put furniture in, to engage in carpentry, to do remodelling, and they do it without written agreements. That is fine. Those agreements are enforceable as long as the bank is solvent. The minute it goes insolvent, the agreement is no good.

So the notion that somehow we are going to change that by saying now, "D'Oench Duhme, Beware," is not realistic.

Mr. ECHEVARRIA. I would like to make two comments with respect to that. Even if you had a rule that everything had to be in writing, and you told the consumer about that, that would not necessarily satisfy 1823(e). It still has to be an officially-recorded bank record. The consumer has very little control over that. He can sign papers, but they do not wind up as officially recorded bank records.

Senator COHEN. Let us take your case, for example, the one that you are so embarrassed about now.

Mr. ECHEVARRIA. Well, that case did involve something that was——

Senator COHEN. Wasn't there a representation that was made to an elderly couple that there was going to be a development in the adjoining lots, thereby increasing the value of their own property?

Mr. ECHEVARRIA. Yes. Two elderly couples in Orange County owned four undeveloped parcels of land, really to feather their retirement nests. They swapped them with a savings and loan institution known as Ramona Savings and Loan, based on representations by a person named John Molinaro that if they swapped two of these units for some condominiums in San Diego County, he would develop the undeveloped parcels of land, thereby increasing the remaining parcels they owned.

But that, the law is undisputable, because what happened was the day after he entered into those transactions, he entered into a paper transaction designed to inflate the assets, whereby he sold it to another person; they had no intention whatsoever of develop-

ing the parcels. It was also the case that the FDIC got full recourse. They took back the collateral for the property, which was the condominium units, and they were paid up. The only party that really had no recourse was the couple that had been defrauded.

They did go to trial, and they did get a judgment against John Molinaro in the amount of $600,000. Unfortunately, Mr. Molinaro was doing I think 10 to 12 years in prison, all of his assets were frozen or taken, and there was really no recourse for them. That is one of the things I think that made the case so ironic, that the person who defrauded them was indisputably a crook.

Senator COHEN. Let me give you one more example. Recently, there was a case in Illinois where a couple had purchased some property owned by an S and L, and it was undisputed that the S and L had plastered over major cracks in the wall in order to conceal the fact that the house was sinking. The couple, when they discovered that the house in fact was sinking, filed a claim against the S and L; the bank failed; the RTC took over the case and asserted D'Oench. The argument was that since the false representation was not part of the written agreement, the couple was out of luck, and that is, of course, exactly what happened. It's not similar to your case, but it's not too different in terms of the impact on the couple.

Mr. ECHEVARRIA. Yes, and it would be hard to find a situation where you would ever find that kind of representation in writing.

Senator COHEN. You heard the recitation of the Sweeney case?

Mr. ECHEVARRIA. Yes.

Senator COHEN. Had you, prior to coming here, ever been apprised of those facts?

Mr. ECHEVARRIA. No.

Senator COHEN. I would like to give you a rundown of it so you can include it in some of your future academic writings as a classic case of an inequity being inflicted.

Senator Levin?

Senator LEVIN. Thank you, Mr. Chairman. These are important hearings that you have scheduled, and I commend you on it. These are technical matters as well as emotional matters, and trying to understand the complexity takes some effort. I commend the Chairman because he does take the time to understand these issues. But I am trying to understand this issue, so I will ask questions that I hope have not been asked at least in this format.

To what extent should the FDIC or RTC, for instance, be better off than a "holder in due course"—if at all? To what extent should the FDIC or RTC not be as well off as a "holder in due course"—or not at all? To what extent, under current law, is the FDIC or RTC better or worse off than a "holder in due course"? It is really three questions, and maybe you can reverse them and put the current law first—I think it may be more logical—and then tell us how you would change it so that specifically, the FDIC or RTC would be either better off, worse off, or the same as a "holder in due course."

Mr. MALLOY. Well, the last part of that is the easy part. At least in certain circuits, certainly the 11th, where this was a major issue in the Gunter case, the FDIC holds a status as "holder in due course" that in fact is better than what any "holder in due course"

would have under generally applicable commercial law—better in two senses. First, as Professor Echevarria mentioned in his testimony, the FDIC is going to be considered a "holder in due course" even if it takes over paper in bulk, which is generally outside the "holder in due course" concept. But even assuming, as was the case in the D'Oench case itself, you had a specific transaction for this paper, because it was pledged to the FDIC for a loan, the FDIC under the Gunter interpretation is immune from a defense by the maker that would say, "I was fraudulently lured into this transaction by the original holder."

Under generally applicable commercial law, a fraud claim going to the creation of the relationship is one that can still be brought against a "holder in due course." So in those two senses, the FDIC currently will end up in a better position.

Mr. ECHEVARRIA. It should also be noted that some courts have applied this "holder in due course" concept to a non-negotiable paper. Ordinarily, the concept of "holder in due course" has no application to a non-negotiable paper.

Senator LEVIN. Now, in what case should the law be changed to make the FDIC or RTC either better off or worse off than a "holder in due course"—or should it be put in exactly the same position?

Mr. MALLOY. I think the starting position as a general rule is, as the D'Oench Duhme case itself assumed, that the FDIC essentially steps into the shoes of that institution. It has the right to collect those assets, to liquidate them, to formulate a fund. That means generally that they are going to have no better rights than they would have.

Senator LEVIN. You said the institution. I asked you better off than a "holder in due course."

Mr. MALLOY. Well, presumably, somewhere, the "holder in due course" inherits from the bank itself. What I am saying is that the basic assumption is that the FDIC and the bank are the same in terms of their interests, so that in many cases it really becomes a misnomer to talk about them being a "holder in due course."

Senator LEVIN. I am asking you, though, should the FDIC or RTC have all the rights of a "holder in due course"?

Mr. MALLOY. Only as appropriate under commercial law.

Senator LEVIN. That is what I am saying—should the FDIC or RTC have the same rights that a "holder in due course" has under commercial law—no more, no less?

Mr. ECHEVARRIA. Yes.

Mr. MALLOY. Yes, absolutely

Senator LEVIN. OK. I have tried to understand this decision in *Langley*. You both said it was wrongly decided, I believe.

Mr. MALLOY. Yes.

Mr. ECHEVARRIA. I explicitly said that in my law review article.

Senator LEVIN. OK. And what was the decision? Was it 5–4, 6–3—I did not read the decision. I read the Solicitor General's brief.

Mr. ECHEVARRIA. It was 9–0.

Senator LEVIN. OK, 9–0. I read the Solicitor General's brief in 1986, so this would be the Reagan administration's solicitor general arguing for the application of *D'Oench Duhme* to those facts. And this is what the Solicitor General said in that case, and I am wondering if you could comment on this—I mean, in his brief, not in

the case, but in his brief—that “the D’Oench doctrine applies notwithstanding an allegation of fraud by a co-participant in the scheme. The doctrine not only encourages debtors to insist that all loan terms be recorded in bank records, but reflects the equitable principle that if a loss is to be incurred as a result of a fraudulent unrecorded arrangement, the loss should fall not on the National insurance fund and hence on depositors Nationwide, but on the person who lent himself to and could have avoided the side arrangement.”

I am wondering if you would comment on just that paragraph in the Solicitor General’s brief.

Mr. ECHEVARRIA. Sure. To the extent you can identify a miscreant, a person who is culpable for any bank loss, sure, they should definitely bear the brunt of that. That is not necessarily what D’Oench or their interpretation of 1823(e) does. In the Langley case, we were talking about people who were defrauded, and there were certain nonpromissory misrepresentations made by a bank official. To say that they were somehow in a better position to guard against the hazards that befall the S and L, or that they were somehow more at fault than the general public, I think just is not consistent with the facts.

What D’Oench does is it is a risk-shifting rule. It is going to shift the burden, or at least in part the burden, of the S and L failures to individuals, which would be fine if we could target culpable individuals

Senator LEVIN. Well, here is what the Solicitor General says about the facts. This is what the petitioners allege they were told, and we have to compare this to depositors across the Nation. They signed a collateral mortgage note, personal guarantees, a collateral mortgage, which were all unconditional on their face; they signed them. Now, here is what they say that the bank officials told them: One, that they would have no personal liability on their loans and personal guarantees. They just signed a personal guarantee, but they say they were told that is not true, that what you just signed is not true, and you can forget that. They were told that no payments would be due them until the property was resold. That violates the terms of the note they signed. They were told, they say, that petitioners would be provided a purchaser for the property, that the petitioners would realize a large profit on reselling the property. These are quotes, these are the representations. And then there was a description of the dispute over the acreage and so forth and mineral rights. But it seems to me there is at least some, some obligation on the part of people who are signing notes that are unconditional, and which they know are negotiable—I think they are negotiable; these are mortgage notes—that if they are told something which is flat out inconsistent—and maybe I am wrong on the negotiability—but if they are told something which is flat out inconsistent with what they have just signed, don’t they have some responsibility?

Mr. ECHEVARRIA. Well, I do not disagree with any of that. When I discuss it in my article, I discuss it in the context of other representations, that is, representations concerning the acreages and encumbrances on the land. But to the extent you have oral agreements that contradict the written, sure, 1823 has its place. There

is also common law protection under something called the parol evidence rule, the statute of frauds, et cetera, that guards against those types of hazards.

Mr. MALLOY. May I address that, because I have worked on a few of these briefs in a former life, and I really find both of those passages, which I think are well-chosen, to be extremely facile or, quite bluntly, rather sneaky.

Senator LEVIN. Charles Fried, Solicitor General?

Mr. MALLOY. Absolutely; one of the best. Argumentatively sneaky; I use that in part as a compliment—the first passage that you read is really speaking in two voices, if you think about it. The first half of it essentially is just paraphrasing the D'Oench Duhme case.

The second part of it, where he reaches his conclusion, starts talking about "or should have been in a position to do something about it," words to that effect.

Senator LEVIN. Well, it is "the person who lent himself to and could have avoided. . . ."

Mr. MALLOY. ". . . could have avoided. . . ." OK. We are sliding down into what sounds very much like a negligence argument, that is, "You were in the best position to inquire about this," but that is not what D'Oench Duhme is about. In D'Oench Duhme—and this is repeatedly emphasized in Douglas' opinion—he is talking about a bad actor. He is talking about someone who knew what this was about, who was actively involved in helping the bank to do it—not somebody who may not have been as bright as he should have been.

So we are beginning to slide into an entirely different scenario, which of course is typically what has happened in the development of this case law.

The second passage that you read, again I think begins to mix a few things together. As to each of the sequence of misrepresentations at the beginning of that list, I would agree, if that is all we are talking about, I do not care whether you are applying D'Oench Duhme, or the statute of frauds, or the parol evidence rule or whatever, you have got a problem—you, as a maker of that note—because none of those things, under any theory you apply, would get you out from under that liability.

The problem is at the end of that sequence of misrepresentations listed in the solicitor's argument, you have ones which are in fact about fraud in the inducement, or at least arguably so. Those are not the same kind, and they raise an issue that was simply not present in the D'Oench Duhme case itself, or in the original congressional consideration of 1823(e).

Senator LEVIN. I will close with this comment. I think the reason why one through four that I read are relevant is that it may put an average person on notice that the person whom he or she is dealing with may be somewhat suspect in terms of his or her honesty.

The banker has me sign those notes—now, I have legal training, so maybe I am not the average person, obviously—but I would think that the average person who signs a note saying I am personally liable when these payments are due is told, "You can ignore that, and you can ignore this, and we are going to get a purchaser

for you, and you are going to realize a large profit"—I would begin to be a little suspicious, I think—now, maybe not; maybe I am being too strict—of who that is that is giving me that line of malarkey. So I think they are there for that purpose, not just——

Mr. MALLOY. Senator, I agree with you. I think it is very relevant to that. But you see, we are already talking about the merits of the claim that the signer of that note is going to make, and D'Oench Duhme is not going to let us do that.

I agree with you, that first series of misrepresentations at the very least go to the question of whether, when the signer of that note brings his claim for fraud in the inducement—since one of the traditional elements of fraud is reasonable reliance—certainly it is available as a defense to say, "Wait a minute—how could you be reasonably relying on that?"

But the point is we are not ever going to get to that issue the way this doctrine is being applied. I would emphasize first of all that in criticizing D'Oench Duhme as currently applied, and in advocating these kinds of changes, I am certainly not assuming nor would I endorse the position that the rule ought to be that the FDIC always loses, any more than the rule ought to be that the FDIC always ought to win. But the fact that there is room for some discussion on the merits in a case where you are dealing with a party who genuinely acted in good faith—perhaps naively, but in good faith—I think that would benefit from the public light of day that you get in a courtroom.

Mr. ECHEVARRIA. The other comment I would like to make about the Langley case is that Scalia's opinion by and large turned not on those representations, but on the nonpromissory representations with respect to acreage and——

Senator LEVIN. Mineral rights.

Mr. ECHEVARRIA [continuing]. Mineral rights. And the reason it turned on that is it was a little more than difficult to say that that becomes part of an agreement, but he somehow managed to say that warranties and their terms and conditions are part of the agreement.

What Scalia was doing in Langley, I think, was taking a worst case scenario, that is, suppose we did not have these other representations, that all we had was the bank lying about the size of the acreage and the encumbrances on the land. His position is that 1823(e) would still apply.

Senator LEVIN. Yes. Thank you.

Thank you, Mr. Chairman.

Senator COHEN. Thank you both very much.

Senator COHEN. We are now going to move to our third panel. Today, we have representatives of the FDIC and the RTC. John Bovenzi is director of the Division of Depositor and Asset Services at FDIC. William Dudley is the vice president of RTC in Atlanta, and he is accompanied by RTC's counsel, Mark Hileman.

Gentlemen, welcome. Mr. Bovenzi, I believe you are going to begin.

TESTIMONY OF JOHN F. BOVENZI,[1] DIRECTOR, DIVISION OF DEPOSITOR AND ASSET SERVICES, FEDERAL DEPOSIT INSURANCE CORPORATION, ACCOMPANIED BY MICHAEL KRIMMINGER, COUNSEL

Mr. BOVENZI. Thank you. Mr. Chairman, Senator Levin, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation about our policies for application of the D'Oench doctrine and section 1823(e). I welcome the opportunity to discuss these important public policy issues with you.

I would like to introduce Michael Krimminger on my right, senior counsel at the FDIC, who is with me today; since many of the issues that are being raised are legal issues, and I am not an attorney, I have asked Michael to join me.

I would like to just briefly summarize my written testimony and would ask that my full statement be made part of the record.

Senator COHEN. It will be included in full.

Mr. BOVENZI. As you have heard, what is commonly referred to as the D'Oench doctrine is a principle of law applied by the courts to bar enforcement of secret agreements against the receiver of a failed bank. This legal principle states that an agreement with the bank is not binding after the bank fails unless it is in writing and recorded in the bank's files.

The D'Oench doctrine arises from a 1942 U.S. Supreme Court decision. The related statute, referred to as section 1823(e), was enacted as part of the Federal Deposit Insurance Act in 1950. It specifies certain requirements for agreements to be binding when a bank fails.

The legal principles behind the D'Oench doctrine and section 1823(e) are important for a number of reasons. These principles allow the FDIC and other bank regulators to effectively supervise open banks and to expeditiously handle the closing of and payment of claims at failed banks.

The ability to rely upon the records of a bank whether it is open or closed is essential to protect the deposit insurance funds and the public interest in a sound banking system.

By allowing the Federal regulators to rely on the accuracy of a troubled institution's records, the D'Oench doctrine permits them to quickly and accurately evaluate an institution's assets and liabilities and, hopefully, to avoid its failure.

Should an institution ultimately fail, the D'Oench doctrine is critical to the FDIC's ability to quickly and accurately determine the most efficient and least costly resolution for that institution.

The FDIC's ability to properly value the assets and liabilities also assists in providing depositors and other creditors prompt access to their money. The FDIC often advances funds to uninsured depositors or creditors based on the recovery it anticipates from the liquidation of the institution's assets. The efficient resolution of a failed bank and the prompt availability of funds are important in local communities that are subject to the disruption caused by the failure of the local bank or savings association.

Without the ability to rely on the failed bank's books to value the assets and liabilities, it would be considerably more difficult for the

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[1] The prepared statement of Mr. Bovenzi appears on page 141.

FDIC to achieve prompt resolutions or a timely payment of funds owed to a failed institution's customers.

While we believe that the FDIC's application of D'Oench and section 1823(e) over the past 40 years has been appropriate in the great majority of cases, we recognize there is a necessary balance of the public interest against private interests. Questions about the application of D'Oench and section 1823(e) were raised by you, Mr. Chairman, and some of your colleagues during Chairman Helfer's confirmation process and during testimony by Vice Chairman Hove last year. Chairman Helfer committed during her confirmation process to reexamine the FDIC's policies for the use of D'Oench and section 1823(e).

Chairman Helfer and the FDIC have followed through on this commitment by reviewing existing policies and preparing new guidelines to govern the appropriate use of D'Oench and section 1823(e). We believe that these changes strike an appropriate balance by preserving the important public policy goals accomplished by D'Oench and section 1823(e), while addressing concerns about fairness as it applies to individual circumstances.

The guidelines were implemented last November. All FDIC staff, outside law firms and contractors are now subject to these guidelines. The FDIC has been conducting training for its staff across the country and has completed the relevant training at our New England offices.

The guidelines provide a structure for the FDIC to promote the exercise of sound discretion and consistency in the application of D'Oench and section 1823(e). Critical to the guidelines is a recognition that a case-by-case review is necessary in order to protect against unfairness while ensuring that secret agreements remain barred. The guidelines require FDIC attorneys, outside attorneys, asset-servicing contractors and other staff to obtain approval from FDIC headquarters in Washington before asserting D'Oench or section 1823(e) in any case within seven specific categories.

Mr. Chairman, you and others have expressed particular concern about claims by vendors. One of the clearcut examples where application of D'Oench and section 1823(e) generally is prohibited by the guidelines involves claims by pre-receivership sellers or providers of goods and services to the failed bank. As Chairman Helfer and Vice Chairman Hove confirmed to Congress, D'Oench will not be asserted to bar claims where the goods or services were received by the bank, regardless of the existence of a written agreement.

We believe that the requirement of prior review and approval will promote a consistent, careful approach to application of these powers. In addition, the flexibility contained in the proposed guidelines permits a careful examination of the unique facts of a proposed case and avoids discouraging use of these powers to prevent secret agreements.

Although the FDIC believes the guidelines will address many of the concerns about the application of D'Oench, we also have attempted to develop legislative language consistent with the guidelines. That is being presented for the Subcommittee's review. A copy of our proposed legislative changes is attached to my written testimony for your consideration. In our view, the proposed amendments do preserve the important public purpose served by permit-

ting bank examiners and receivers to rely on a bank's records, while addressing those cases where an overly strict application of the current statute could result in unfairness.

Statutory changes that completely eliminate the requirement of a written or recorded agreement, or which include a blanket exception if a misrepresentation or some deception is claimed, will not permit section 1823(e) to fulfill its important public policy goals.

In conclusion, the D'Oench doctrine and section 1823(e) do serve important public interests in the supervision, the resolution and the liquidation of banks. They involve a balancing of public and private interests. The FDIC has implemented guidelines and is offering legislative language in an attempt to achieve an appropriate balance between these competing interests.

Mr. Chairman, this concludes my testimony, and I would be pleased to respond to any questions.

Senator COHEN. Thank you.

Mr. Dudley, would you care to proceed?

TESTIMONY OF WILLIAM M. DUDLEY,[1] VICE PRESIDENT, RESOLUTION TRUST CORPORATION, ATLANTA OFFICE, ACCOMPANIED BY MARK HILEMAN, ASSISTANT GENERAL COUNSEL FOR LITIGATION

Mr. DUDLEY. Mr. Chairman and members of the Subcommittee, my name is William M. Dudley, and I am the vice president of the Resolution Trust Corporation's Atlanta office. Appearing with me here today is Mark Hileman, assistant general counsel for general litigation.

I appreciate the opportunity to present testimony on behalf of the RTC regarding our experience with the legal principle concerning claims against failed financial institutions commonly referred to as the D'Oench doctrine.

I have worked as a banking regulator for over 25 years and am very familiar with the use of the D'Oench doctrine from the regulatory perspective.

The D'Oench doctrine and its statutory counterpart, 12 U.S.C. 1823(e) establishes that the RTC and the FDIC are not subject to claims and defenses premised upon agreements allegedly made with a failed financial institution which are not properly recorded in the institution's official books and records.

The D'Oench doctrine has provided a safeguard for taxpayer funds, and without it, the final cost of the RTC's mission would be significantly higher.

The RTC was created by FIRREA. This legislation and subsequent funding bills provided the RTC with $89 billion of taxpayer funds which have been expended thus far in the resolution of 744 institutions and the protection of over 24 million deposit accounts. In providing these funds, the Congress directed the RTC, in addition to other important mandates, to conduct its activities in a matter that results in the greatest return to the United States on the sale of institutions and assets.

The Congress bestowed important tools upon the RTC to maximize the return on assets, including an explicit authority to utilize

[1] The prepared statement of Mr. Dudley appears on page 164.

1823(e), the statutory counterpart of the D'Oench doctrine. The D'Oench doctrine promotes the Federal policy of protecting taxpayers, depositors and creditors of failed financial institutions and Federal deposit insurance funds from absorbing the losses resulting from unrecorded defenses and liabilities that would tend to diminish such institutions.

In the past, the D'Oench doctrine has also guarded against the haphazard or collusive restructuring of loans to the detriment of the institution and its creditors. As an institution nears failure, borrowers can bring pressure on individual employees or officers of the institutions to alter the terms of their loans to the advantage of the borrowers. This problem can be particularly acute when the borrowers are major customers or directors of the institution.

Moreover, for regulatory reasons, it can also be to an institution's advantage to restructure a nonperforming or poorly performing loan to mask its true condition.

D'Oench is also helpful in defeating borrower defenses in cases in which secret side agreements were intended to aid in the fraudulent schemes of thrift insiders. For example, the RTC recovered $50 million in settlements with certain developers and borrowers who acted in collusion with Charles Keating to defraud Lincoln Savings.

The D'Oench doctrine served to eliminate arguments that Lincoln was bound by Keating's unrecorded promises not to collect on the indebtedness. Should an institution ultimately fail, the D'Oench doctrine enables the FDIC and RTC to evaluate the institution's assets and liabilities quickly and accurately to determine the most efficient resolution for that institution. This is important since the longer the failed institution remains in Government control, its value diminishes.

Application of the D'Oench doctrine arises in the receivership claims process and in the context of litigation, where it is used in responding to claims and counterclaims by debtors. Virtually all claims against the failed institution are processed, and most are resolved, through the administrative claims process. Decisions to employ D'Oench in a particular claim are carefully made on a case-by-case basis in accordance with applicable law. In the course of this process, RTC receivership claims personnel work closely with legal division staff.

The RTC's procedure is that every lawsuit involving D'Oench and 1823(e) undergo review and monitoring by an RTC attorney. That monitoring is most extensive in cases where the proposed application is novel or expanded, or where the law is unsettled.

The RTC understands the Chairman is particularly interested in the treatment of claims by vendors and general trade creditors. These claims are governed by written guidelines in the RTC's claims manual, conservator's operations manual and directives. It is the RTC's practice to pay small vendor claims whether or not a written contract was approved and on the records of the institution, provided it can be established that the services were performed to the satisfaction of the receiver, or the goods were delivered and accepted.

The RTC recognizes that agreements with small vendors and general trade creditors are often not, in the normal course of busi-

ness, reduced to writing. However, in instances where a written contract would be a normal part of a business transaction, then RTC generally does require that the institution have a copy of the written contract.

Mr. Chairman, your letter of invitation asked us to discuss the public policy implications for the continued application of the D'Oench doctrine. If the D'Oench doctrine and 1823(e) were eliminated, collusive side deals made on a wink or a handshake would flourish in a manner that could not be discovered by Federal regulators, possibly encouraging the impairment of an institution's financial condition.

Mr. Chairman, we agree with your floor statement of August 5, 1994 that "It, D'Oench, legitimately exists to prevent bad actors from using secret informal agreements that were clearly meant to defraud the failed bank, to defraud the Government."

Without D'Oench and 1823(e), there also could be a substantial increase in litigation against failed banks and thrifts. Innumerable claims which otherwise might not have been brought, based upon the strength of the D'Oench doctrine and 1823(e), would likely be instituted. In addition, the RTC's ability to recover on assets of a failed institution, such as defaulted loans, would be greatly diminished because defenses which would have been ineffective as a result of D'Oench and 1823(e) would then be available.

In its deliberations on this subject, Congress should consider some of the cases in which D'Oench and 1823(e) have had a significant impact on the outcome. For example, in one case in which the FDIC sued to collect on notes and guarantees, the D'Oench doctrine precluded the defendant, who previously had been criminally convicted of bank fraud, from asserting, solely through oral testimony, that the bank had fraudulently induced him to enter into further loan transactions to satisfy his indebtedness. Based on D'Oench, the district court vacated a jury award in favor of the defendant and ordered a new trial which resulted in a verdict in favor of the RTC and FDIC of $11.9 million. Without recourse to the D'Oench doctrine and 12 U.S.C. 1823(e), the FDIC and RTC would have been at the mercy of whatever undocumented representations a convicted felon could have fabricated in order to further enrich himself at the expense of the taxpayers.

In enacting 1823(e), Congress sought to balance the interest of the public in the integrity of its financial institution regulatory system and the interest of people with legitimate claims against failed institutions. For the reasons stated earlier in this testimony, we believe that D'Oench has served the insurance funds and the taxpayers well. After more than 40 years of experience, we believe it is appropriate to reexamine and perhaps refine the balance that was struck in 1950. At the same time, however, we urge caution in amending such a time-tested doctrine.

Certain categories of claims could be exempted from 1823(e) without creating a significant risk of an increase in illegitimate claims or litigation. The RTC would support an amendment to 1823(e) exempting claims for goods and services of $20,000 or less.

In certain respects, the requirements of 1823(e) do not entirely reflect the manner in which many institutions legitimately operate today. Individual officers and employees often have specific written

authority to approve certain types of transactions. 1823(e) could be expanded to permit claims based on agreements approved by such persons, provided those claims otherwise meet the statute's requirements.

Finally, the requirement of 1823(e) which mandates that a claim must be based on a writing executed contemporaneously with the institution's acquisition of the associated asset fails to recognize that lenders and borrowers frequently adjust their agreements and renegotiate loans. This requirement could be eliminated from 1823(e) to reflect this commercial reality.

The RTC believes that amendments such as these would permit fair consideration of legitimate claims while protecting the interests of the public. A more dramatic shift, however, could lead to more litigation and more costly resolution of failed financial institutions. Similarly, any retroactive changes to the statute could impede the imminent completion of the RTC's mission, foster litigation, and increase the cost of the thrift cleanup effort.

Mr. Chairman, thank you very much for the opportunity to appear today to present RTC's views. I would be happy to answer any questions you or any member of the Subcommittee may have. Also, we have sent a written statement, and we would like that to be made a part of the record.

Senator COHEN. It will be included in its entirety.

Does anyone else have a statement?

[No response.]

Senator COHEN. Mr. Dudley, let me pose a couple of questions to you first. You testified that virtually all claims against failed institutions are processed, and most are resolved through the administrative claims process. For the record, I would like to have you submit for me a breakdown of how many of these claims were paid, partially paid and rejected, and also a list of the cases in which D'Oench Duhme was invoked during the past 5 years.

Mr. DUDLEY. Yes, sir.

Senator COHEN. You also indicated just a moment ago that claims almost routinely include fraud, misrepresentation or deception as part of a defense or a counterclaim and that these cases are not based on any written documentation. I may be naive, but I do not know if acts of fraud, misrepresentation or deceit by their very nature are ever committed to writing. I do not know how you reconcile the fact that allegations of fraud and misrepresentation need to be in writing. Ordinarily, they are not in writing; that is part of the fraud and the deceit. And for the RTC or the FDIC to maintain you have got to have all of these fraudulent representations in writing is pretty much inconsistent with common day experience, is it not?

Mr. DUDLEY. What we are saying is that in the vast majority of the claims where people have come forward with the secret agreement, they have also at the same time claimed fraud and the other——

Senator COHEN. What I am asking you is, if an allegation of fraud or deceit is alleged, are you saying that the action based on that misrepresentation or fraud would have to be in writing in order to be protected under D'Oench?

Mr. DUDLEY. I do not believe that that is what I am saying.

Senator COHEN. You are not saying that. So in other words, in the matter of the Sweeney case, which I am going to focus on, representations were made to the Sweeneys about a pledge to continue the financing of this particular construction project, and then it was reneged upon or revoked after they had already taken out the loan, and then there was a promise made that if they would just catch up on the arrears, pay the $60,000, they would continue the project. Again, that was breached.

You cite the one case of a convicted felon who claimed fraud and got a jury verdict. Thankfully, RTC had D'Oench Duhme to rely upon. I asked Jack Ryan, then the acting CEO, and Michael Condon, who was the general counsel for RTC at the time, to give me a list of cases which were similar to the Sweeneys' in which the RTC removed a case from the State court that had already been litigated and had the State court verdict overturned by invoking D'Oench. I was told there were hundreds of such cases. That is the representation that was made to me. In fact, since that meeting, which took place 5 or 6 months ago, they have given me six cases, and you have cited one in your testimony today. I am concerned about the people who are innocent, who go into a bank and assume they are dealing with a legitimate bank. They take out loans, they mortgage their property, representations are made, and those representations are false, misleading, deceitful. A State court makes a judgment that the Sweeneys were in fact defrauded, that severe emotional harm was inflicted upon them, and enters a judgment which would have clearly exceeded whatever was owed on the property by in excess of $1 million. RTC comes in and hires the same counsel who was counsel to the bank in the litigation at the State level. I want to ask you about that, or maybe Mr. Hileman, since you are the attorney representing RTC. How do you remove a case to the Federal court from State court?

Mr. HILEMAN. You file a notice of removal with both the Federal and State court, sir.

Senator COHEN. Is it customary for the attorney to take possession of the court documents from the State court and take them into his law office?

Mr. HILEMAN. In general, no, sir. I can tell you that in this particular case I am informed that at the time—this was in the early time after FIRREA had started—there were a lot of cases being removed from State court to Federal court. The court clerk's office was overburdened, and instead of giving the attorney removing the case to take over to Federal court certified copies, as is the normal practice, the original documents were handed over.

Senator COHEN. They were handed over, and they were kept in the attorney's files in his office, I believe, for some 25 days.

I talked to the judge yesterday, who had no notice whatsoever of the removal—none—and was in the process of writing her opinion. The attorney was calling on almost a daily basis to find out when the decision was coming down, and removed the case, physically took it out of the court, took it to his office, and kept it for 25 days. The RTC comes in and then goes to court and files D'Oench Duhme. And a couple of days later, down comes the written opinion, awarding a multi-million dollar award to the Sweeneys. That is cut off at the knees; D'Oench Duhme applies.

That is wrong. It is inequitable. It was never intended by any application of the D'Oench doctrine to apply to cases like that, and that is what I am concerned about. The Sweeneys have been dealt a blow from which they cannot recover now. They have tried every which way to save their family property based on a fraud and a deceit that was perpetrated against them by a bank. And RTC comes in and says, "We have got D'Oench Duhme." It is "stench Duhme," as far as I am concerned. This stinks in terms of how Federal officials have dealt with this couple.

And frankly, as a result of that case and others that I have been hearing about, it has prompted me to call this hearing, and there will be more hearings. I intend to raise this with the Banking Committee, and I intend to go to the floor to reiterate the kinds of cases that come up with small people being hurt. They are not the Keatings, but small individuals who rely upon representations but have no voice; they are completely cut out, even after they have gone through State litigation. We heard testimony from the first panel. One man had to spend $250,000 before he could even get the case remanded for a hearing.

There have been others. I have a small vendor in Maine who would not qualify under the new regulations. His contribution to improving the bank's physical appearance was in excess of $20,000. He fought it all the way to the First Circuit and finally got relief, after spending thousands of dollars.

So what has happened is that the Federal agencies have been applying a rule of thumb instead of a rule of reason. There is no discretion being exercised here to say these people have been legitimately defrauded and cheated, and we ought to take that into account. Mr. Dudley, in your statement, you say "FIRREA directed RTC to take all reasonable steps to maximize return." I do not think you have a "reasonable" situation when you have an attorney who has gone through litigation at the State level, who knows every facet of it, who knows that a court is about to render an opinion, and takes that case, physically removes it, to the Federal court and immediately invokes D'Oench Duhme to cut off any hope on the part of those people. That is not right. That is, I think, a violation of the spirit of what D'Oench was all about.

I am not trying to revoke D'Oench. I want to go back to what D'Oench was originally intended to accomplish and not see it extended to lines of credit or other types of fiduciary obligations. We ought to go back to protecting the assets from secret side agreements made by corrupt individuals, people who are trying to gain some kind of an advantage. That is not what was done in the Sweeney case, and the first panel gave us example after example. I am sure there are hundreds more, and I am going to collect all of those hundreds to say this is not what the Federal Government should be in the business of doing.

There ought to be some forum where you can filter out the fallacious cases or the fictitious cases or the fraudulent cases on the part of people who are working secret deals. When we are talking about honest citizens dealing with a bank, to simply cut them off after they are in litigation and about to receive a favorable judgment—there is no way you can represent to me that that is consistent with the spirit of a Federal-State relationship and that it is

consistent with the spirit of "doing no harm" as the phrase was used before.

So that is my concern, the way in which the Sweeney case was handled, but it is only representative of others. We heard testimony about the elderly couple who were defrauded; their claim was cut off. There was the couple that I mentioned from Illinois who had an S and L plaster over the cracks in the walls, and the house is now sinking; they are cut off at the knees. This is not consistent with Federal policy. You say it is what Congress has mandated. I will represent this to you. I do not think 10 people in the Senate know anything about D'Oench Duhme. There may be a few on the Banking Committee. But they are going to hear a lot about it in the coming weeks and months, and I am hoping that we can formulate some kind of working agreement here to deal with these issues. As you quoted correctly from my statement, I am not out to revoke D'Oench Duhme, but I think substantial modification has to be made along the lines that were suggested by both of the professors who testified today.

How about claims for civil rights? That was one of the cases that you mentioned before where we have a Federal statute on the books saying that women should not have to be forced to sign promissory notes when they have no interest in the husband's dealings. That was specifically adopted to protect women from being forced to cosign on notes and mortgages where they have no interest in the property. Along comes D'Oench, saying we do not care whether you have valid Federal civil rights that have been granted by Congress; D'Oench is all-dominant. Does that sound right and fair to you? Should there be some exceptions, where you find D'Oench in conflict with Federal statutory law or State statutory law?

Mr. Dudley, Mr. Bovenzi?

Mr. DUDLEY. If you come into an institution, and you have a husband and wife's signature on a promissory note, I do not know how you would ever be able to evaluate whether in fact it was induced in some fashion by one of the bank officers. I do not see how you could examine an institution under those circumstances.

Senator COHEN. But that is what triers of facts are all about. The husband goes into the bank to apply for a loan. The loan officer said, "We would like to give you the loan, but we want your wife on the note as well, and we will not give you the loan unless she does sign." This is completely inconsistent with the Federal law. The husband needs the loan, so he brings his wife in and says, "You have got to sign. Even though it is not required, you have now got to sign. In fact, it is in violation of the Federal law, but you have got to sign, or we do not get the loan."

Now, how do you figure that out? You have to go to trial or you have to have an administrative judgment made. That is how we resolve these kinds of disputes. Now, you cited the felon who claimed he had been defrauded, and you were successful in getting that set aside with the use of D'Oench. That is part of the character analysis. That is why the lawyers would go after somebody's character and say this person is not credible, or that representation was never made, and I believe the loan officer and not the person who

is claiming that his or her rights were violated. That is what we go through every day in court.

What we are basically saying is that in the overall policy of expediting the processing of these claims, we really do not care how much inequity is inflicted on innocent individuals. We are protecting the fund. That is the overriding policy, so we are saying we do not care about inequity.

What I am saying is we had better start caring about the equities involved in a number of specific cases. That is not to say we throw it open to anybody who comes in with the wildest claim, saying I was defrauded, or there was some deceit practiced upon me. There has to be a mechanism whereby you protect people like the Sweeneys. You do not seek an upper hand by removing a case being litigated, snatching it out of the court's jurisdiction just as a decision is about to come down, and then invoking D'Oench. That is not a fair resolution of that case.

Now they have been told they are going to be evicted. Frankly, I do not understand why you want to evict somebody from a home, as you say, to make it more saleable. I would think that a home that is occupied is more saleable than an empty one in the middle of the winter. But that is another matter altogether. There seems to be an element of personal vindictiveness involved in all of this. It has been going on for 4 or 5 years now, and I think the way in which it has been handled exhibits a level of vindictiveness that is inconsistent with what I think is the obligation of Federal agencies.

That is a personal judgment. But I think anyone reviewing the Sweeney case would have a hard time saying this is in the overall National interest. I do not think it is in the National interest to treat people like this, to tell them that they are out on the street tomorrow in view of the fact that a State court has come down with a judgment in their favor which would put $1 million in their pocket. They are now being put out in the street, and they have no recourse whatsoever.

Now, that is a case which I think you cannot justify. No one can justify this case in my mind and I would be happy to hear your arguments on the other side.

Mr. BOVENZI. I cannot speak to the particulars of the Sweeney case. I can speak to the fact that we are trying to draw a balance of what is fair, and that we are not just trying to look at the deposit insurance funds in that sense, that what we represent are people on both sides of an issue, and the other side of an argument is if somebody can come forward and claim fraud——

Senator COHEN. They proved it.

Mr. BOVENZI [continuing]. And based upon a claim that somebody said something——

Senator COHEN. No. They proved that they were defrauded.

Mr. BOVENZI. I am speaking in general; I am not speaking to this——

Senator COHEN. I know, but you see, that is the problem with generalities. All of the people get lost in generalities. I would like to know how much the RTC, for example, spent on litigation costs in this case, in both RTC staff time and fees paid to outside counsel. Can anyone tell me that?

Mr. DUDLEY. It is my understanding that the fees to outside counsel were $324,000.

Senator COHEN. And what about the allocation for legal fees for in-house counsel?

Mr. DUDLEY. We have no figures on that.

Senator COHEN. My understanding is the Sweeney property was auctioned. Do you know how many people bid on the property?

Mr. DUDLEY. No, I do not, although it is not normal that there would necessarily be bidders other than the financial institution. So in most instances, there are not competitive bidders in those kinds of sales.

Senator COHEN. So it is fair to say that RTC was the only bidder on this property?

Mr. DUDLEY. I cannot answer that because I do not know, factually.

Senator COHEN. If you could get that information for me, I would like to know what amount, if any, the second-highest bidder offered on the property. Even in this case, the Sweeneys said give us a chance—30 days—to come up with 70 percent of the appraised value of that property. The answer was no. On each and every case along the way, the answer has been no. When they were defrauded in the first instance, the bank said, come up with the $60,000, and we will continue with the loan. The Sweeneys came up with the $60,000, and there was no continuation of the loan. They had a buyer, $1.1 million for about four acres or so of the 14 acres. The bank said no deal. They came back with a $770,000 offer, and the bank said no deal.

You have now picked up the property for how much?

Mr. DUDLEY. It was $700,000.

Senator COHEN. Seven hundred thousand. And they had an offer of $700,000 for a small portion of the land, and the bank said no. So they have been had all the way down the line, including up to today.

They had to go to court, and the court awarded them a judgment in excess of $3 million, and you nullify that by invoking D'Oench. Now they are about to be evicted, and they have asked for 30 more days, and you say, "No." They have asked for 30 days to try to find the funds. They cannot guarantee, but they will try to find 70 percent of the value. Will you take it? The answer it no.

That is not consistent, I think, with the obligation of Federal officials who are there to serve not just their specific agency, but all of the people, including people who have been deliberately harmed. That is what is troubling to me about this whole case. I am using them as an example, but there may be many others.

I was told, Mr. Hileman, that you are familiar with the Sweeney case, and that you might answer specific questions about the Sweeney case.

Mr. HILEMAN. If you have any specific questions, I will try to answer, sir. I have not been directly involved for a great deal of time.

Senator COHEN. How have you familiarized yourself with the Sweeney case?

Mr. HILEMAN. I have reviewed the file. I have spoken with the lawyer in our office who has been primarily handling it.

Senator COHEN. Do you still have the same counsel from Boston who was hired by RTC to handle it?

Mr. HILEMAN. The firm that was handling it on behalf of the bank withdraw shortly after the RTC came in, and we have another law firm that has been handling it for I believe the last 3 years.

Senator COHEN. Were any of the bank officers to your knowledge prosecuted for fraudulent behavior in the Massachusetts courts?

Mr. HILEMAN. Out of ComFed, I do not know, sir. I can find that information out.

Senator COHEN. I was told by the court that that was the case, and that even some attorneys were involved. This was an operation in which ComFed was making loans without having accurate appraisals, or even any appraisals. They were inflating the property values so they could get higher commission, as high as $500,000 in individual cases. And yet the firm that was hired apparently to defend the bank against the Sweeneys' claim was then hired by RTC, and I think in a very unusual move, took personal possession of the file, which I have never heard of before.

Do you know the facts? Have you spoken to the court?

Mr. HILEMAN. Have I spoken with the court? No, sir.

Senator COHEN. I did yesterday, and I was surprised to find the court so easily accessible and so quick in the recollection of the facts of this case. And the facts are that the Sweeneys were mistreated, they were fraudulently deceived. They were entitled to in excess of a three-plus million-dollar award, and that decision was on its way down at the time the case was removed, and immediately D'Oench Duhme was invoked.

Mr. HILEMAN. Senator, one comment on that if I may, and that is that that was the view of the State court judge who rendered that opinion after she no longer had jurisdiction. The jury in the case, after hearing the exact same evidence, did determine—and the State court judge noted in her finding—"that there was no breach by ComFed of any obligation owed to plaintiffs under any agreement, whether oral or in writing. The jury found that neither ComFed, nor its employees or officers, committed fraud or interfered with any business relationships that plaintiff may have. Although I have considered essentially the same evidence that the jury considered, I have come to the opposite conclusion in most areas." There was a difference there, Senator, between the jury and the State court judge.

Senator COHEN. There was a jury decision, but there were also two counts in which the court had jurisdiction.

Mr. HILEMAN. Yes, sir.

Senator COHEN. And by the way, even the jury decision found that the bank had engaged in harassment of Mrs. Sweeney, did they not?

Mr. HILEMAN. Yes, they did, and they awarded her $65,000, and that determination was not appealed. But the evidence that the jury ruled on and the evidence the judge looked at was the same; they simply came to opposite conclusions.

Senator COHEN. But the judge ruled on a consumer fraud statute. She found under a consumer fraud statute that there was in fact a violation.

Mr. HILEMAN. Yes, she did, after she no longer had jurisdiction in the case; that is correct.

Senator COHEN. The opinion came down after it had been removed, unbeknownst to her.

Mr. HILEMAN. Removal strips the State court of jurisdiction as a legal matter.

Senator COHEN. I understand. But I also talked to the court, and the attorney for RTC or the attorney for the bank was calling every day to find out when the court decision was coming down, knowing it was in the process of coming down adverse to the bank's interest.

Mr. HILEMAN. I do not know that the attorney knew it was coming down adverse. I do not doubt that he was calling.

Senator COHEN. You do not doubt he was calling. I do not doubt he was calling, either, and frankly, I think there was a pretty good indication that the court was going in a different direction than the jury on the other two counts.

I will not belabor this particular case, but I think I am going to use it as a classic case of why D'Oench has to be reformed. It will go much further in terms of its reform than has been suggested by you. I am going to look along the lines of what the two professors have recommended and look at the issues dealing with "holder in due course."

I must say that I am not satisfied or happy with the way in which Federal agencies have treated their citizens. I am running out of adjectives to apply to this, but I have been at this for several years now, and my experience goes back to Recoll Management in Maine and Massachusetts. I do not know whether you are familiar with Recoll's activities up there, but I could give you horror story after horror story of people being put out of business for no reason.

In any event, thank you for your testimony. As you have probably gathered, I have a somewhat biased opinion in terms of how this doctrine has been invoked, and I intend to urge my colleagues to work to change it.

I would hope that we could establish some kind of a dialogue where, if you think that I am being excessive in my recommendations, you can call attention to it, and I will be happy to try to work through it with you. But I would also request some reciprocal action on the part of RTC. I would still renew my call for some relief in the case of the Sweeneys, rather than having them put out on the street as of midnight tonight. I think this is a case that cries out for relief, and if it is not going to be through administrative relief, then I intend to try to do something statutorily, if at all possible. So I would hope that you would give that some consideration.

With that, gentlemen, thank you. I may have some more questions for the record, and we will give you plenty of time to respond to them. The Subcommittee will now stand adjourned.

[Whereupon, at 4:52 p.m., the Subcommittee was adjourned.]

APPENDIX

WRITTEN TESTIMONY OF

DAVID S. HESS

for

CITIZENS AND BUSINESS FOR D'OENCH DUHME REFORM

FOR THE SENATE SUBCOMMITTEE ON OVERSIGHT OF GOVERNMENT MANAGEMENT

JANUARY 31, 1995

My name is David Stephen Hess and I am here to testify on behalf of Citizens and Business For D'Oench Duhme Reform on the misapplication of the D'Oench Duhme Doctrine by the FDIC and RTC when they become receivers of failed financial institutions. My testimony has three main points

1. The D'Oench Duhme Doctrine in its present application is unfair and causes real harm to borrowers, guarantors, vendors, and small businesses

2. The current application of the D'Oench Duhme Doctrine is inconsistent with its origins in the Supreme Court and Congress.

3. The solution to the misapplication of the D'Oench Duhme Doctrine is to adopt clarification legislation which will return the Doctrine to its original intent

Citizens and Business For D'Oench Duhme Reform was established in 1993 when I found myself a "victim" of the misapplication of the D'Oench Duhme Doctrine by the FDIC. The organization's mission is to educate Congressional members and staff as to the original intent of the D'Oench Duhme Doctrine and the need for legislative clarification to prevent its misapplication by the FDIC and RTC. In addition, the organization became a "clearing house" for other "victims" of the D'Oench Doctrine In the past two years the organization has been in contact with approximately

150 attorneys across the United States who have dealt with multiple D'Oench cases The organization has been contacted by many victims directly after they became aware of the organization through the media. The organization has provided educational materials to the offices of over 65 members of the House of Representatives and the Senate. The organization has supported legislation during the 103rd Congress that would clarify the "asset" requirement of the D'Oench Duhme Doctrine. Although the legislation (S.1725 and H.R.4146) was not adopted by the 103rd Congress, it served to highlight the current problem with the D'Oench Duhme Doctrine.

The Unfairness of the D'Oench Duhme Doctrine

In essence, there are two separate but unequal sets of law that apply to banks in their dealings with borrowers, guarantors, and vendors. One is everyday common law that applies to solvent banks and allows for standard defenses against collections and valid assertions of claims, with the merits being decided in a court of law. The other (D'Oench Duhme Doctrine) is unbeknownst to the bank's borrowers, guarantors, and vendors. This ominous sounding Doctrine applies when a bank becomes insolvent and disallows otherwise valid defenses against collections or assertion of claims. In short, the Doctrine slams the courthouse doors on the fingers of innocent claimants seeking to open it against the FDIC or RTC. With the broad interpretation of the D'Oench Duhme Doctrine by the courts in the late 1980s, the "rules of the game" essentially changed and the potential for unfairness expanded The FDIC and the RTC now deploy D'Oench in a wide number of situations. They have too frequently been successful in having otherwise valid claims against failed banking institutions barred throughout the country.

So unjust and unfair is the D'Oench Doctrine's application that courts from every region

became apologetic when handing down their decisions. Listed below are examples from various courts of this apologetic approach to decisions concerning the D'Oench Doctrine:

1. In FDIC v. Bathgate, 27 F.3d 850, 877 (3d Cir. 1994) the Court stated· "In reaching our result we have not overlooked that the D'Oench Duhme Doctrine and Section 1823(e) can lead to what might be considered a harsh result. Nevertheless it seems to us that the federal precedence have compelled our outcome."

2. In FDIC v. Kasal, 913 F.2d 487, 492 (8th Cir. 1990) the Court stated: "We agree that the result in the instant case may appear harsh or inequitable to some, we nevertheless are constrained by both the statute and federal common law".

3 In American Fed'n of State, County and Municipal Employees v. FDIC, 826 F.Supp 1448, 1476 (D.D.C. 1992) the Court stated: "The Court is not ignorant of the unusual results which the D'Oench Doctrine generates nor is the Court enamored of them".

4. In L & R Prebuilt Homes, Inc. v. New England All Bank For Savings, 783 F.Supp. 11, 14 (D.N.H 1992) the Court stated: "The Court has full empathy with the plaintiff's position and dilemma but of course is powerless under the law to grant remedial relief. The Court does not quarrel with the D'Oench Doctrine but it is appalled by the manner in which the FDIC reacts to situations such as these"

5 In Webb v. Superior Court, 275 Cal Rptr. 581, 589 (Cal. Ct.App. 1990) the Court stated· "We sympathize with Webb. The D'Oench Duhme Doctrine is quite harsh and in this case, where he as the borrower has made a prima facie showing that he was not at fault, the severity of the rule is heightened. Nevertheless, we have no choice but to apply it".

The above examples are but a few which demonstrate that judges fully recognize that the D'Oench Duhme Doctrine is unfair and inequitable. However, in its current form and interpretation these courts and judges have no choice but to apply the Doctrine as is sought by the FDIC and the RTC The broad interpretation of the D'Oench Duhme Doctrine and its harsh application by the FDIC and RTC is probably a result of the sheer volume of litigation associated with the banking and thrift crisis coupled with a lack of guidance from Congress. The courts have adopted an attitude that it is their duty to minimize the losses of the financial crisis and to protect the banking system to the

detriment of the "innocent victims". This is evident in the Court's statements in Milligan v. Gilmore Meyer Inc., 775 F.Supp. 400 (S.D. Ga. 1991). The Court stated: "The result is harsh. Nevertheless, as pitiful as the plaintiff's situation may be, a more compelling consideration, in view of the monstrous national debt burden imposed by the spate of recent bank failures, is the sanctity and uniform application of the D'Oench Doctrine and 12 U.S.C. and 1823(e)."

With the broad interpretation of the D'Oench Doctrine by the courts, the FDIC and RTC have been successful in employing the Doctrine not only as an "invincible force" to liquidate assets of failed financial institutions, but also as an "impenetrable fortress" against cross-claims and counter defenses. In Beighley v. FDIC, 676 F.Supp. 130, 132 (N.D. Texas 1987) the Court held that: "To allow a claim against the FDIC asserting the very grounds that could not be used as a defense to a claim by the FDIC is to let technicality stand in the way of principle." With this ruling the courts empowered the FDIC and the RTC to employ the D'Oench Doctrine to bar claims that would otherwise have been considered valid against a solvent financial institution. Therefore, claims for fraud or negligent misrepresentation, negligence, unjust enrichment, fraud in the inducement, and want of consideration are a few of the affirmative claims that have been defeated by the D'Oench Doctrine.

The overwhelming power of the D'Oench Duhme Doctrine allows the FDIC to defeat almost all claims against a failed banking institution. As a result many individuals and small businesses have been "victimized" by its application. These parties have had what would otherwise be considered a valid claim dismissed or barred because of the unusual circumstances of the D'Oench Duhme Doctrine. For instance, there are many cases of subcontractors who had completed work on properties financed by failed banking institutions who were never paid for their services and goods. When these properties were subsequently liquidated by the RTC, these subcontractors have had their

claims for payment barred by the D'Oench Doctrine. In addition, many "victims" of the D'Oench Doctrine are borrowers or guarantors of loans that were fraudulently misrepresented by banking officials The application of the D'Oench Doctrine has barred these individuals from bringing this defense against the collection of these loans. In many of these instances the actual banking officers have been found guilty of these fraudulent acts; yet the "innocent victims" cannot use this as a defense against the FDIC and RTC. If these banking institutions had been solvent, these claims would be valid defenses allowed by Common Law. It appears that the only "crime" committed by these "victims" was to conduct business with a financial institution that subsequently became insolvent.

In 1993 a report by the Scripps Howard News Institute estimated there were approximately 30,000 to 40,000 lawsuits pending against the FDIC and the RTC. Based on a sample of these cases, the FDIC and the RTC use the D'Oench Duhme Doctrine in at least 50% of these lawsuits. In the majority of cases, the Doctrine is used outside of its original intent as described in the 1942 Supreme Court decision and the 1950 codification of the D'Oench Doctrine. In most instances, the Doctrine is used in its expanded interpretation These estimated figures do not include the individuals and small business owners who have been advised by their counsel not to pursue their claims because of the futility and expense of "fighting" the D'Oench Duhme Doctrine. Citizens and Business for D'Oench Duhme Reform has recently contacted over 100 plaintiff's attorneys in the New England area in an attempt to approximate the number of "victims" who have not sought legal recourse against the FDIC or RTC because of the "chilling" effect of the D'Oench Doctrine. These attorneys estimated that for each case they represented there were approximately 5 cases in which they advised the client not to pursue their claims because of the overwhelming power of the D'Oench Duhme

Doctrine. In the majority of these unfiled cases, the attorneys felt the clients had valid claims were it not for the broad interpretation and application of the Doctrine. If this small sample can be applied to a wider population, the current case load of 15,000 to 20,000 D'Oench cases would imply that there are 75,000 to 100,000 valid cases against the FDIC that are not being pursued because of the "chilling effect" of the D'Oench Duhme Doctrine.

The History and Origins of the D'Oench Duhme Doctrine

In order to understand the misapplication of the D'Oench Duhme Doctrine by the FDIC and RTC in their role as receivers of failed financial institutions, the origins of the D'Oench Doctrine in the Supreme Court and Congress must be reviewed. Common Law D'Oench originated in the Supreme Court case of D'Oench, Duhme, and Company v. FDIC (315 U.S. 447, 1942).[1] Specifically, the Supreme Court stated that a party who lends itself to a scheme likely to mislead the FDIC by means of a "secret agreement" not shown on the records of the bank, is forbidden to raise that secret agreement as a defense against the FDIC once the bank has been taken over. It is evident from the wording of the Supreme Court decision that the D'Oench decision specifically dealt with the assets of a failed banking institution, and schemes or acts by parties seeking to deliberately mislead the FDIC

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[1]D'Oench, Duhme, and Company, Inc. was a Missouri bond house which had sold a bond to Belleville Bank & Trust Company, an Illinois Bank. This bond subsequently went into default. Being dissatisfied with this result, Belleville Bank & Trust Company asked the D'Oench Company to deliver to the bank a note in the amount of the bond to keep the bank's balance sheet artificially inflated. In return, the bank delivered to D'Oench a receipt in which it promised not to enforce payment of the note. The D'Oench note was subsequently charged off in 1935. After Belleville Bank & Trust Company became insolvent, the bank pledged the D'Oench note to the FDIC. When the FDIC sued to enforce payment of the note, D'Oench, Duhme, and Company asserted lack of consideration and the receipt agreement as a defense. The Supreme Court held in favor of the FDIC.

as to the value of the bank's assets as recorded in the official bank records. The Supreme Court ruling did not address issues related to defenses or claims against the FDIC as a receiver of a failed banking institution.

In 1950 Congress passed the Federal Deposit Insurance Act, Section 2(13)(e) which was codified as 12 U.S.C. 1823(e). In contrast to the Supreme Court Decision, Section 1823(e) was a statute of frauds that applied execution, approval, and recording requirements to any agreement that would diminish the right, title or interest of the FDIC in any assets acquired by it. Review of the congressional records reveals that the original intent of Congress in codifying the Supreme Court decision could be found from the floor statement of Representative Francis Walter during the House floor debate in 1950. During this debate, Representative Walter stated:

> **"It was never the intention of Congress to give the [Federal Deposit Insurance] corporation a stronger position than that of the bank, and the adoption of the amendment, my amendment, is offered to prove heretofore it was the intent of Congress that any agreement in the absence of fraud is binding on the corporation."**

Representative Walter stated clearly that this codification did not grant protection to the FDIC from defensive assertions or claims that otherwise had a basis in common law.

Although the interpretation of the D'Oench Doctrine and its application has broadened significantly since it was last debated on the floor of Congress in 1950, the original intent of the legislation and of the Supreme Court decision is clear and should not be dismissed when this complicated issue is reviewed. Namely, the Doctrine was adopted to protect the FDIC from secret side agreements that were created to falsely and purposefully mislead the FDIC as to its claim on an asset of a failed banking institution for which the FDIC had become the receiver. The evolution of

the D'Oench Doctrine from these humble beginnings 45 years ago has been the subject of a number of legal reviews which are beyond the scope of this testimony by Citizens and Business for D'Oench Duhme Reform.

The thrift and banking crises of the 1980s resulted in the collapse of over 1000 financial institutions throughout the United States. Because the Supreme Court decision of 1942 and the codification of the D'Oench Doctrine by Congress in 1950 could not foresee the multiple situations that would develop with such a banking crisis, the courts began to interpret the D'Oench Doctrine in a broad and ever expanding fashion in favor of the FDIC to the detriment of borrowers, creditors, and vendors of failed financial institutions. After the Langley decision of the Supreme Court in 1987 and the adoption of FIRREA by Congress in 1989, the application of the D'Oench Doctrine by the FDIC and RTC became more severe and harsh. Under the expanded D'Oench Doctrine, borrowers, guarantors, and vendors lose their ability to protect or vindicate their rights when a bank becomes insolvent.

In my own case (please see attached decision from the United States Court of Appeals, Eleventh Circuit) claims were asserted against Southeast Bank of North America for negligence and breach of fiduciary responsibility one year prior to the bank becoming insolvent. After the FDIC became the receiver for Southeast Bank, the case was transferred to Federal District Court. Although my legal counsel recognized that the D'Oench Duhme Doctrine did not apply to the facts of my case, the FDIC nevertheless used the D'Oench Duhme Doctrine as a defense. The FDIC was initially successful in having the Federal District Court dismiss the charges on the grounds that the D'Oench Doctrine "barred my claims". Finally, on December 5, 1994, the United States Court of Appeals, Eleventh Circuit, ruled unanimously that the D'Oench Duhme Doctrine did not apply to my case and

the action was remanded to State Court.

For a period of over three years, from September, 1991, until December, 1994, I expended approximately $250,000 to defeat the misapplication of the D'Oench Doctrine by the FDIC. My victory in the United States Court of Appeals restores my Constitutional right to a trial by jury where the merits of the case will be judged. It seems unreasonable and unfair that a claimant such as myself should be required to expend this sum of money simply to "get a day in court" Fortunately, I had the resources and resolve to "fight" the FDIC over the misapplication of the D'Oench Doctrine and to be vindicated by the Eleventh Circuit. Many "victims" lose their cases not because of lack of merit but because of lack of resources. The courts' broad interpretation of the D'Oench Duhme Doctrine coupled with the FDIC's seemingly unlimited legal resources, produces an obstacle that many innocent victims simply cannot overcome.

The Solution

Citizens and Business for D'Oench Duhme Reform has discussed the adverse effects of the D'Oench Duhme Doctrine with legal experts throughout the country After careful review, there appears to be one solution to the current problem of the Doctrine's widespread misapplication by the FDIC and the RTC This solution is to recognize the original intent of the D'Oench Duhme Doctrine as set forth by the Supreme Court in 1942 and as was debated in both Houses of Congress in 1950 To reiterate, the Supreme Court held that a party who lends itself to a scheme likely to mislead the FDIC by means of a "secret agreement" not shown on the records of the bank is forbidden to raise that secret agreement as a defense against the FDIC once the bank has been taken over In addition, when these issues were debated in Congress it is clear from the remarks of Representative Francis

Walter that the codification by Congress in 1950 was meant to uphold this interpretation. Specifically Representative Walter stated that, "It was never the intention of Congress to give the FDIC a stronger position than that of the bank, and the adoption of the amendment, my amendment, is offered to prove heretofore it was the intent of Congress that any agreement in the absence of fraud is binding on the corporation." The historical roots of the D'Oench Duhme Doctrine are founded in common sense, fairness, and equitable justice. The D'Oench Doctrine was designed to protect the FDIC from fraud by the borrower, not to protect the FDIC from valid claims brought by the "victims" of negligent and fraudulent banking practices. Citizens and Business for D'Oench Duhme Reform urges Congress to carefully re-examine the D'Oench Duhme Doctrine with its ramifications and to return it to its original intent by means of a legislative clarification Specifically Congress should ensure that claims that would otherwise be valid against a solvent financial institution are not barred or summarily dismissed just because a thrift or bank has become insolvent. In addition, restitution for the thousands of "victims" of the misapplication of this Doctrine should be an integral part of whatever reform legislation is considered by Congress

WRITTEN STATEMENT OF RHETTA B. SWEENEY before the UNITED STATES SENATE HEARINGS of the SUB-COMMITTEE OF GOVERNMENT OVERSIGHT, January 31, 1995, at 2 p.m.

Mr. Chairman, distinguished members of the Sub-Committee of Government Oversight Management, may I take this opportunity first to thank you for allowing me to appear before you today to testify from my personal knowledge and experience about abuse by the Resolution Trust Corporation, (RTC) and the misapplication of the doctrine of D'Oench, Duhme against me and my family as borrowers of a failed S&L, ComFed Savings Bank. Secondly, although the focus of these hearing is D'Oench I am providing you additionally with a list of factual information which details an extensive and an apparently repetitive pattern of abuse by the RTC against me and the American people and a waste of their tax dollars; in my case, **after** the RTC took over ComFed Savings Bank and ComFed Mortgage Company for reasons of unsafe and unsound lending practices. Finally, the patent and continuing resistance and failure of the RTC to prosecute the RICO action against the individuals who ran the S&L ComFed, and are responsible for its failure, has resulted in further devastating losses to the American taxpayer to this very day.[1]

Pursuant to your letter of January 24, 1995, Mr. Chairman, you

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[1] See C.A. 90-6712, ComFed Savings Bank, ComFed Mortgage Co. Inc., v. Baldini, et al., Middlesex Superior Court, Cambridge, MA. -- NB: --this case was removed by the RTC, and subsequently became C.A.10132-S, ComFed/RTC, et al. v. Baldini, et al., U. S. District Court for the District of Massachusetts. (See Appendix B)

requested that I provide the following information: (1) the events which resulted in my filing suit against my lender, ComFed Savings Bank; (2) the history of the state court's involvement in my case and any state court judgments; (3) the status of my case at the time of the ComFed failure; (4) the RTC's application of the D'Oench, Duhme doctrine and how it affected my claim against ComFed; and (5) the current status of my case.

I will also speak with particular references to the judiciary in an effort to illustrate for you that the federal courts have shown themselves insensitive to the plight of those similarly situated like me, and are not inclined to provide any relief in this instance when there has been a clear misapplication of the D'Oench, Duhme doctrine by the RTC or FDIC.

In addition, borrowers cannot expect fair and equal treatment by an executive branch which is operating on its own agenda pursuing goals which appear at cross-purposes with the equitable interests of every man, woman, and child to be treated fairly and squarely by its government. The executive branch is not pursuing relief for the little guy. The RTC, is actually, in fact clearly, intent on destroying the little guy with an overzealous and cross-eyed purpose to implement a mandate which it does not have, and which it cannot conceivably have been given by this legislative branch. When CNN World Head Line news covered our story of the abuse we were suffering at the hand of the RTC in July, 1994, the

RTC's response was, "We are only doing what Congress told us to do."[2] When NPR[3] requested the RTC to explain their actions against me and my family and their failure to prosecute the bank directors and officers, the RTC declined to comment.

BACKGROUND

The background of my story begins in 1987 when I entered into a commercial loan agreement with ComFed Savings Bank to develop a real estate project in Hamilton, MA.

During the spring of 1987, I began preliminary work on a real estate plan with the Hamilton Planning Board seeking to sub-divide a 14 acre piece of property including our home which has been in the family for five generations.

In July of 1987 I was introduced to S&L ComFed Savings Bank as a potential real estate lender. Four loan commitment letters were issued by ComFed during July and August, 1987. The original commitments proposed a loan amount of $600,000 or $725,000 which was to refinance the four acre parcel of land, and included an 18 century home and two barns located at 776 Bay Road. On August 10, 1987 ComFed issued a third commitment letter for $1,600,000 which would have held a first position mortgage on the four acre 776 Bay

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[2] July 1 & 2, 1994, CNN WORLD HEADLINE NEWS - Sweeney story.

[3] July 5, 1994, NATIONAL PUBLIC RADIO, WBUR BOSTON FM 90.9 reporting the Sweeney story and the broad based abuse of the misapplication of the D'Oench doctrine by the RTC and FDIC.

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Road property and a second mortgage on the larger 10 acre piece of property which included our home. The August 10, 1987 commitment letter detailed the pay back provision, but was later omitted in the fourth commitment. On August 20, 1987 ComFed issued a fourth commitment letter for $1,600,000 which was to refinance the mortgages for both pieces of real estate, putting ComFed in first position for the entire asset. The mortgage of $350,000 held on 776 Bay was in danger of foreclosure because the mortgage payments were in arrears, but the mortgage on the 10 acre piece of property at 24 Meyer Lane, which included our family home, was current -- posing no threat to our home and the larger 10 acre asset.

During July and August of 1987, the S&L ComFed requested and received many of my documents, to include deeds, trusts, financial statements, mortgages, list of debts. The documents supplied to the S&L ComFed -- on their face -- clearly showed there was not an approved sub-division in place at the time.

After the bank learned of my preliminary sub-division work, they stated that they would like to be comprehensive lenders of the entire real estate project, to include development, construction, and sales. At this point I agreed to borrow $1,600,000 rather than the initial loan amount of $600,000, as a means of guaranteeing the future financial support for the entire project. I did not know that our loan officer was operating on a commission basis, and had not been made aware in any way by the lender of this significant

and material fact. The bigger the loan, the bigger his commission would be.

The S&L suggested that their lawyer could represent both parties at the closing. On August 27, 1987 the loan of $1,600,000 closed. I had not seen the documents prior to the closing. Discovery in our action produced further proof that the lawyer misrepresented in letters to the Bank that real estate approvals were in place in 1987. This was an intentional false statement by the bank and their lawyer which would serve the lawyer's and banker's self-dealing purpose of over-valuing the loan.

Because ComFed Savings Bank was a federally regulated state chartered, FSLIC S&L, I believed I was dealing with a trustworthy lender, not questionable back street loan sharks.

After the closing of the August 27, 1987 loan, I hired a team of professionals to include a real estate lawyer, engineer, landscape architect, architect, land use planner, and the development work to get sub-division approval from the Hamilton Planning Board began.

Between the period of September, 1987 and May, 1988 I, with the support of the real estate lawyer and engineer, attended every planning board meeting seeking to gain speedily the necessary development approvals. Dennis Furey, our loan officer from ComFed, was informed regularly of the progress of the development work through letters, copies of preliminary engineering plans, estimates

for construction work, and all other relevant reports, orally and in writing.

Preliminary approvals for the sub-division project were in place by January of 1988 and the Flexible Sub-Division Plan was signed in February, 1988 -- subject to Special Permit approvals. When the Special Permits were in place -- with the exception of a Conservation Easement -- on May 23, 1988 construction and sales were ready to start. Suddenly on May 24, 1988, the bank officer Dennis Furey wrote a letter to me stating the S&L was "suspending lending."

Between June, 1988 to April, 1989 the bank refused to accept sales from a qualified buyer, refused to honor their commitment of construction financing, and filed foreclosure proceedings on November 30, 1988.

After months of unfair business dealings by the bank and our bank officer, Dennis Furey, surrounding the work on the real estate project, I filed a complaint for reasons of violations of state laws against ComFed Savings Bank, ComFed Mortgage Company, Inc., ComFed Advisory Company, Inc., and my loan officer, Dennis Furey, in Middlesex Superior Court, Cambridge, MA, the district in which ComFed did business. The claims against the bank were for

violation of their own rules,[4] violation of state law,[5] violation of federal laws[6] as they applied to a state chartered institution, violations of code of federal regulations,[7] and, perhaps most importantly, violation of the Massachusetts Consumer Protection Act for "unfair trade practices." **THE BANK LOST**.

I was awarded a $4 million dollar judgment for "the bank's

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[4] See commitment letter of August 20, 1987, stating a FHLBB, R41C appraisal was required by the federally insured, federally regulated bank's own rules. (See Appendix C)

[5] See Massachusetts Consumer Protection Act, Mass.Gen.L.c.93A, the law of 93A-- Commonly referred to as the "unfair and deceptive trade practices." The statute states; ....such rules and regulations and decisions of the Federal Trade Commission and the Federal Courts interpreting the provisions of 15 U.S.C. 45

[6] See, U. S. House Report of 1987, Fraud and Abuse. . .-- "The following Federal criminal statutes are usually the principal ones violated by insiders and outsiders: (i)18 U.S.C. 215; kickbacks; (ii)18 U.S.C. 656; misapplication of bank funds; (iii)18 U.S.C. 1344; financial institution fraud; scheme or arrangement to defraud a federally insured institution to take money, funds, credits, assets, securities, or other property by misrepresentation; (iv)18 U.S.C. 1001; general false statements. . .; (v)18 U.S.C. 1005; false entries in bank documents including material omissions; (vi)18 U.S.C. 1014; false statement (oral or written), . . .which would include an intentional overvaluing of real estate; (vii)18 U.S.C. 1341 and 1343; mail and wire fraud. .scheme that makes use of either the U.S. mail or electrical transmissions; (viii) 18 U.S.C. 2 and 371; the general Federal aiding and abetting statute and the general Federal conspiracy statute, often applicable when two or more persons are involved in the commission of an offense. NB: See FIRREA amendments, 12 U.S.C.1833. (See Appendix P)

[7] ComFed exceeded the applicable maximum loan-to-value ratio of 75% prescribed by its Board of Directors, in violation of 12 C.F.R. Section 545.32

unfair and deceptive trade practices." The press reported the stunning bank loss as "Lender Ruling May Be A First In The U.S."[8] Lawyers from all over the country, for several successive months, ordered the state court opinion from Lawyers Weekly who sells court opinions.

After a three week trial in February and March, 1990, the jury entered a verdict finding for ComFed on its counterclaim and awarded ComFed $2,069,580.33 on the $1.6 million dollar note, costs, and legal fees. The jury also found for ComFed on all of my claims, with the exception of the claim of "intentional infliction of emotional distress" which was decided in my favor against ComFed and Furey, as to which the jury awarded me $65,000. The claims of "unfair and deceptive trade practices" and for specific performance regarding pay back of the note were reserved for determination by the trial judge as state law requires the state court judge to hear and rule on the claim of "unfair and deceptive trade practices."

On January 30, 1991, after further hearings and deliberation on the "unfair and deceptive trade practices" claim, the state court judge entered final judgment for my case in Middlesex Superior Court, Cambridge, MA. The state court judge stated, "although I have considered essentially the same evidence that the

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[8] See Lawyers Weekly, "Lender Ruling May Be A First In The U.S.," March 11, 1991). See also Boston Globe, "Ex-ComFed Customers Win $4m 'Lender-Liability' Suit," February 26, 1991

jury considered, I have come to the opposite conclusion in most areas. The jury's verdicts on the other claims will stand."

The judgment against the ComFed defendants for "unfair and deceptive trade practices" was not based on "secret side agreement" but on "written documents" which -- on their face -- intended to defraud, and in fact did defraud me. The following violations of law were found by the state court judgment one year prior to the RTC raising a D'Oench, Duhme question.

Please listen to the words of the state court trial judge who found as follows:[9]

[1.] "The conduct undertaken by the defendants in this action constitutes violations of the Federal Home Loan Bank Act, 12 U.S.C. 1421 Section 216. . "[10]

[2.] "Furey was on an incentive program to close loans. He was one of three vice-presidents who received commissions as a loan originator; this was incentive for loan originators to close loans."

[3.] "The said actions and inactions of ComFed were unconscionable and oppressive and breached the bounds of substantive fairness in that ComFed:

. . . .

c. Had the Sweeneys execute a Construction Loan Agreement without the benefit of independent counsel, which Construction Loan Agreement contained provisions which by their nature would tend to deceive the

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[9] The Opinion and Order On Post-Trial and Post-Judgment Motions and Findings of Fact, Rulings of Law and Order Relative to Count II and Count VIII of Plaintiffs' Complaint, Middlesex Superior Court, Cambridge, MA, dated January 30, 1991, (Izzo, J.)

[10] (See Appendix A, pp. 40, paragraph 9).
(See Appendix D, Trial Exhibit 80).

Sweeneys into believing that their anticipated construction financing would be forth coming. The statement by Furey during his testimony suggesting that the use of this document was in error or mere happenstance occasioned by the time constraints of the closing is not credible."

[4.] "ComFed promised to provide partial releases in exchange for payments of 80 percent of the value or sales price of any home or lot sold within the subdivisions once approved. This promise was contained in ComFed's initial commitment letter but removed in the subsequent letter. . ."

[5.] "After bringing of this instant action, the defendant ComFed refused to give the plaintiffs a partial release on the sale of one parcel with the house thereon on Meyer Lane, when an offer was received for $775,000. I find that ComFed's refusal to do so was unfair and deceptive trade practices."

[6.] "ComFed's behavior in its dealings and practices with the plaintiffs from the inception of these dealings was to doom the plaintiffs to become financially bereft and to lose their property."[11]

Motivated by greed, the loan officer Furey admitted that he was being paid commissions on the loans he closed in violation of 18 U.S.C. 215.[12]

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[11] (*See* Appendix A, Judge Izzo's Opinion, pp.32, paragraph 97).

[12] 18 U.S.C. 215, kickbacks and bribes prohibition: making it unlawful for any officer, director, employee, agent, et al, (hereafter "insiders") of a financial institution to solicit, accept, or give anything of value in connection with an transaction or the business of the institution.
(*See* Appendix A, pp. 16, paragraph 42).
(*See* Appendix E, Trial Exhibit 9).

Motivated by greed, the bank and its loan officers, made intentionally false statements in an effort to close the loan of $1,600,000 in violation of 18 U.S.C. 1001.[13]

Motivated by greed, the bank and their lawyers intentionally omitted the partial agreement clause which detailed the business agreement for pay back of the loan, a violation of 18 U.S.C. 1005.[14]

Motivated by greed, the bank and their lawyers, willfully, and intentionally violated the Massachusetts "unfair and deceptive trade practice statute by obstructing the pay back of the loan for reasons of self-dealing -- clearly they wanted and intended to take the whole pie from the outset of the loan closing in 1987, a violation of the Massachusetts Consumer Protection Act;[15]

Motivated by greed, the bank intentionally and willfully,

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[13] 18 U.S.C. 1001; general false statements statute: knowingly and willfully falsifying or concealing a material fact or making a false statement, etc.
(See Appendix A, pp. 18 & 19, paragraph 49).
(See Appendix F, Trial Exhibit 7).

[14] 18 U.S.C. 1005; false entries in bank documents including material omissions, with intent to injure or defraud the commercial bank regulatory agencies or other individuals or companies.
(See Appendix A, pp. 21, paragraph 55(b).
(See Appendix G, Trial Exhibit 114).

[15] See Massachusetts Consumer Protection Act, Unfair and Deceptive Trade Practices, Mass.Gen.L.c.93A.
(See Appendix A, pp. 32, paragraph 96).
(See Appendix H, Trial Exhibit 41).

overvalued our property in violation of Title 12 and 18 U.S.C.1014.[16]

This vicious and mean-spirited course of dealing has driven me into bankruptcy.

ComFed Savings Bank was taken over on December 13, 1990 by the RTC for reasons of unsafe and unsound lending practices.

AND NOW COMES THE RTC -- Kicking, clawing, elbowing their way to their weapon called D'Oench in an attempt to wipe out our state court judgment.

January, 1991 began a four year ordeal and period of cover up, including fraud, obstruction of justice, and conflict of interest by the federal regulator, RTC, against me and my family, which has been worse than what we had experienced at the hands of the failed bank ComFed and continues to this day.

Since January of 1991, the RTC has disregarded its own rules, violated the Massachusetts Rules of Civil Procedure,[17] the Federal Rules of Civil Procedure,[18] the Code of Federal Regulations,[19]

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[16] 18 U.S.C.1014; false statement (oral or written), such as a loan application, an agreement with the financial institution or another document, made knowingly for the purpose of influencing any federally insured institutions (which would include an intentional overvaluing of real estate). (See Appendix I, Trial Exhibits 58, 59, 60).

[17] See Massachusetts Rule of Civil Procedure 25. (See Appendix J, K, L).

[18] See Federal Rules of Civil Procedure 63.

violated state law,[20] violated federal statutory law,[21] federal criminal statutory law,[22] and ignored every rule of common decency, fairness and justice, all under the guise of a court created federal common law doctrine known as **D'OENCH, DUHME**.[23]

The RTC, in violation of their own Conflict of Interest rules, hired the same law firm, Hanify & King, which had been counsel to ComFed and its subsidiaries, to represent the RTC as an independent legal contractor. Bear in mind, this is the same law firm that was counsel for years to the bank prior to the failure of the S&L ComFed, and whose representation included acting as defense lawyer to the defendants in my case. John Hanify and his law firm of Hanify & King defended the officers and directors whose business

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[19] See 12 C.F.R. Section 1606. Conflicts of Interest, Government Contracts.

[20] 12 U.S.C. Section 1819 (b)(2)(D) State actions. (See Appendix M).

[21] See 12 U.S.C. Section 1441a(l)(1)(2)(3)- Removal

[22] 18 U.S.C. Section 2071. Concealment, removal, or mutilation generally (a)whoever willfully and unlawfully conceals, removes, mutilates, obliterates, or destroys, or attempts to do so, or, with intent to do so takes and carries away any record, proceeding, map, book, paper, document, or other thing, filed or deposited with any clerk or officer of any court of the United States, or in any public office, or with the judicial or public officer of the United States, shall be fined not more than $2,000 or imprisoned not more than three years, or both.

[23] (See, D'Oench, Duhme & Company, Inc. v. FDIC, 315 U.S. 447 (1942).

practices had contributed substantially to the failure of ComFed. To this day the RTC refuses to acknowledge any conflict of interest, yet at the same time refuses FOIA requests for the Legal Service Agreement between the RTC and Hanify & King.

In the context of the so-called S&L clean up, the RTC and ComFed had a potential or real adversarial relationship; at a bare bone minimum, there had to have existed a conflict of interest on the face of it, and, at worse, it was collusion to defraud.

The RTC, in their rush to get out of state court and avoid our judgment, violated Massachusetts Rules of Civil Procedure by failing to substitute the proper parties when they succeeded as Conservator to the bank. The proper parties have not been substituted in our case to this day, and three federal courts ignored this material violation.

The RTC, in violation of the federal removal statute failed to remove the case to the proper court of jurisdiction, the U. S. District Court for the District of Columbia; instead they went "forum shopping" to the U. S. District Court for the District of Massachusetts.

The RTc's use of 12 U.S.C. Section 1819 (b)(2)(D) further illustrates the misapplication of D'Oench to the subsidiaries of ComFed which were not federally insured institutions; rather, they were state chartered mortgage companies operating under state law.

The RTC's counsel Hanify & King, when learning of the state

court judgment, removed my entire original file from state court, kept it hidden in their offices for 25 days, and never informed our counsel either of the existence of the judgment, or of the whereabouts of the case file.[24]

Furthermore the RTC, never received the necessary writ from the federal court allowing the removal of my files.

Incredibly, the U. S. District Court for the District of Massachusetts in an order issued on June 7, 1991, allowed the above described violations and refused to return our case to state court.

Meanwhile, with a state court judgment against the failed bank which had been taken over, incredible as it might sound to your ears, in January, 1992 the Resolution Trust Corporation moved for Summary Judgment in federal court on grounds of D'Oench. The RTC requested of the federal judge that **only** the jury verdict be entered, and the state court judgment on "unfair and deceptive trade practices" and the claim of "partial release," (pay back) be expunged (struck from the record). The RTC also requested the court to lift the "stay" (preliminary injunction) which had been entered by the state court Judge on October 25, 1989, allowing the RTC to proceed immediately with foreclosure of our project, home, and property. The federal court allowed all of the above and implicitly countenanced such conduct and in the process completely

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[24] See John Hanify Affidavit filed in U.S. District Court for the District of Massachusetts.

rendered moot the findings and ruling of a state court judge -- **all** -- on grounds of D'Oench.

THE RTC'S MISAPPLICATION OF D'OENCH AGAINST ME

In raising the federal question of D'Oench the RTC has not only misapplied a doctrine which does not lie in this case, and cases similarly situated, it blatantly abused the doctrine to bludgeon the opponent for the following reasons:

PAY BACK OF THE LOAN

The key element of D'Oench is, did the borrower have a secret side agreement with the bank that the loan would not be called for repayment which would hurt the taxpayer when the bank fails?

The record is clear that I have never asked that the **pay back** of the note borrowed from ComFed be forgiven. In fact, the record is clear that I have tried to pay back the loan as many as four different times only to be obstructed by the bank and subsequently by the RTC. I have been unable to this day to gain release from the bank or the RTC of my property in any fashion. The following examples detail my attempts to pay back.

In June of 1988, a Purchase & Sales agreement was offered by a potential buyer (Mammola) in the amount of $1,100,000 for the Meyer Lane house and three acres.[25]

In January, 1989 a P&S was offered in the amount of $775,000

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[25] See Appendix N (Trial Exhibit 144, and 9).

for the Meyer Lane house and three acres, note that this was the same potential buyer who now knew ComFed had started foreclosure proceedings. (See the letter from ComFed counsel, Hanify & King, refusing to allow the release of that portion of the real estate project.)[26]

In January, 1991, the final judgment issued in the state court allowed the jury finding of ComFed's counterclaim to stand and the judgment, in fact, incorporated a pay back of the note within the damages. The amount of $2,069,580.33 paid back the loan in dispute plus interest, legal fees, and costs. (See Judge Izzo's judgment detailing the damages owed).[27]

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[26] The counsel for ComFed, Hanify & King, refused to allow a partial release for the house at Meyer Lane and three acres, stating: "This confirms my recent telephone conversation with you and responds to Rhetta Sweeney's letter to Dennis Furey dated January 12, 1989. The Bank believes that the price proposed for the house and lot at 24 Meyer Lane, Hamilton of $775,000 is well below market value. Accordingly, on the basis of information known to the Bank, ComFed is not prepared to consent to the sale.
NB: The November 29, 1994 **RTC AUCTION** price of $344,000. for the 776 Bay Road property and $450,000. for the 24 Meyer Lane property totalling $794,000. -- for the entire property themselves -- using tax dollars. (See Appendix H).

[27] See Judge Izzo's judgment; In favor of Plaintiffs: (i)jury verdict for emotional distress: $65,000; (ii)Judge's verdict -- additur for emotional distress: $250,000; (iii)interest to which ComFed is not entitled since 93A notice on 6/7/89 (19mo. @ $20,666.70) $392,667.30; (iv)punitive doubling of above item: $392,667.30; (v)damages for closing fees of ComFed $79,651.92; (vi)punitive damages doubling of closing fees: $79,651.92; (vii)loss of opportunity to develop property: $1,009,964; (viii)punitive damages doubling the loss of opportunity to develop property: $1,009,964.; interest arrearage, induced to obtain additional financing commitment: $11,455.00;

In November of 1994, we attempted yet again to pay back the note by making the RTC a settlement offer of 70% cash of the appraised value for the two original pieces of property which ComFed and subsequently the RTC held as collateral, as security on the $1,600,000 note. This offer was rejected.[28]

At all times, the **PAY BACK** of the note was **OBSTRUCTED**, for now obvious motives, by the S&L ComFed and subsequently by the RTC.

WRITTEN AGREEMENTS

In raising the federal question of 12 U.S.C. Section 1823(e), through which Congress had meant to clarify the use of D'Oench some 45 years ago, the RTC has blatantly abused the federal statute for

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punitive trebling of above item: $22,910; Sub-total (with interest from date of filing and costs, $3,313,931.44; Attorneys' fees and costs: $97,704.00; **Total --$3,411,635.44.**
In favor of Defendants: Jury Verdict on Counterclaim on promissory note with interest: $2,069,580.33

[28] John Ryan, acting head of the RTC, after representing for several months that he would be interested in finding a resolution which would bring closure to the dispute between the Sweeneys and the RTC, in fact -- acting in apparent **BAD FAITH** -- rejected the Sweeneys' good faith efforts to end the seven year period of fraud, abuse and mismanagement by the RTC and ComFed against me. It is important to note that the "RTC has often netted less than **one cent** on the dollar." (See RTC report titled: RTC's JDC Program (INS94-006 -- paragraph 1, pp.5) See also RTC National Loan Auction VI, December 14-15, 1994, note the RTC's qualification of bank fraud law under, 18 U.S.C. 215; 656; 657; 1005; 1006; 1007; 1008; 1014; 1032; 1341; 1343; 1344. **NB: The RTC has cited the same criminal statutes which the state court judge had found ComFed and their employees had committed against us -- resulting in a state court judgment for "unfair and deceptive trade practices" in our favor.** (See Appendix O, correspondence between the RTC and Sweeneys, and Appendix P, laws).

the following reasons:

The dispute between the parties in this case was never about a "secret side agreement" but rather, written agreements which were intended to defraud and <u>did</u> defraud me. The agreements have at all times met the four predicates required under 1823(e). The RTC has known at all times, the agreements were;

(1) in writing;

(2) signed by both parties;[29]

(3) recorded in the loan committee report;[30]

(4) and, have been continuously recorded in the MA Essex County Registry of deeds.[31]

However, the RTC was in effect given blanket immunity by the judiciary from all of the above violations of rules and laws, all for reasons of <u>D'Oench.</u> <u>Why?</u>

<u>THE REAL DAMAGE TO THE TAXPAYER BECAUSE OF COMFED FAILURE</u>

Why should the American taxpayer care about the abuse of the financial industry or federal regulators who are charged with overseeing the industry and who are paid by their tax dollars?[32]

The RTC, using the D'Oench, Duhme doctrine, has also spent

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[29] (<u>See</u> Appendix Q, Loan documents).

[30] <u>See</u> Appendix R, Loan Committee Report).

[31] <u>See</u> Appendix S, Essex Country Deeds, Book and Page).

[32] <u>See</u> Appendix T, Freedom of Information Act

tens of millions of dollars in legal fees. From 1991 through June 1994, the RTC has paid a total of $1,062,060.85 in legal fees to the three Boston law firms involved with my case, after the state court judgment was entered.[33]

The RTC's misapplication of D'Oench Duhme to borrowers whose assets were held as collateral by failed S&L ComFed has resulted in further abuse and loss of tax dollars,[34] because of the tens of millions of dollars in legal fees spent when a course of equitable and fair dealing designed to work out a dispute would have prevented the continued legal expenses in cases such as ours.

The financial industry acting in concert with the federal regulators appears to have defrauded the American taxpayer and borrowers of the failed S&L ComFed as follows:

On October 1, 1990, after an internal bank investigation, lengthy investigations by a grand jury, the FBI, and an audit by Peat Marwick -- auditors for ComFed, -- the bank filed its own RICO law suit against 35 past employees, including Baldini, Miller, Porter, Maloof[35], in Middlesex Superior Court, Cambridge, MA and

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[33] See Appendix U, Freedom of Information Act Report
Hanify & King in the amount of $155,402.07;
Nutter, McClennen & Fish in the amount of $884,527.63;
Ropes & Gray in the amount of $22,131.15.

[34] See CNN NEWS -- U. S. Senate Whistleblower Hearings, September 23, 1993.

[35] C.A. 90-6712, ComFed Savings Bank, ComFed Mortgage Co., Inc., v. Baldini, et al., Middlesex Superior Court, Cambridge, MA.

not in federal court. However, Dennis Furey, our loan officer was conspicuously absent from the list of defendants, despite the fact that he was cited in the body of the complaint for violations previously charged in our lawsuit. Also cited in the complaint was appraiser Peter Reilly, who had performed the illegal appraisal for the underwriting of our loan. A similar pattern of willfully overvaluing real estate in violation of law has been reportedly admitted by individuals in the course of the Whitewater investigations who are responsible for the Madison S&L failure.[36]

On August 9, 1991, a mere seven months after the RTC removed the ComFed case to the U. S. District Court for the District of Massachusetts, the racketeering case which had been filed by ComFed against their very own officers for insider abuse was hurriedly and mysteriously dismissed when the RTC filed a "Stipulation of Dismissal" for the entire case.[37]

By dismissing the claims against 35 defendants of the failed bank, the RTC has implicitly given those individuals immunity and career protection within the financial industry to the officers, directors, lawyers, accountants, and appraisers, when the S&L had

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[36] See Washington Post, "S&L Figure Pleads Guilty In Arkansas," December 5, 1994.

[37] See C.A.91-10132.S, RTC, et al., v. Baldini, et al., U. S. District Court for the District of Massachusetts, "Stipulation of Dismissal." NB: The charges by ComFed against Baldini, included, but were not limited to, violations of RICO (Racketeering Influenced Corrupt Organization)

admitted in the verified filing of C.A. 90-6712 that these individuals used ComFed as their own personal piggy bank.

The RTC sold part of the assets of the subsidiary, ComFed Mortgage Company, Inc. in the amount of $1,238,105,000. to Goldman Sachs, N. Y. for $182,000,000.[38]

The RTC sold the balance of the assets of the subsidiary, ComFed Mortgage Company, Inc. in the amount of $2,420,457,000. as a portfolio to Lomas Mortgage USA, in Dallas, TX for a mere $218,500,000.[39]

The judiciary appears to have become a ready and willing handmaiden to the arrogant conduct of the RTC.

On **April 14, 1992**, the U. S. District Court for the District of Massachusetts entered summary judgment in favor of the RTC on grounds of D'Oench.[40]

On **January 31, 1994**, the U. S. Court of Appeals for the First Circuit affirmed the Summary Judgment order of the U. S. District

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[38] NB: This is the equivalent to fifteen cents on the dollar. See Appendix V, Freedom of Information Act Report

[39] NB This is the equivalent to nine cents on the dollar. See Appendix V - Freedom of Information Act Report

[40] C.A. 91-10098-H, Rhetta B. Sweeney, Individually and as Trustee of the MAPLE LEAF REALTY TRUST and of the MAPLE LEAF REALTY TRUST and of the CANADIAN REALTY TRUST, and JOHN SWEENEY, v. RESOLUTION TRUST CORPORATION, in its capacity as Conservator of COMFED SAVINGS BANK, COMFED MORTGAGE COMPANY, INC., COMFED ADVISORY COMPANY, INC., and DENNIS FUREY, U. S. District Court for the District of Massachusetts.

Court for the District of Massachusetts and compounded the injury when the panel of three judges ignored the errors in the lower court's representation of facts in addition to the above described errors of law which were brought to their attention.[41]

On **October 3, 1994**, the Supreme Court of the United States denied our writ of certiorari and on **January 9, 1995** the court denied my Petition of Rehearing, turning a deaf ear and would not touch the case.[42] The doctrine had become a facile tool in the hands of the executive branch to browbeat and cow tow the innocent borrowers of the failed institutions into submission, and all the federal courts have had by way of guidance from the legislative branch, from you the lawmakers, is a 45 year old statute, which is at best outmoded,[43] and, in my case, simply does not apply for reasons previously stated.

On **November 29, 1994**, despite all of what you have heard

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[41] C.A. 93-1427 and 93-1613, RHETTA B. SWEENEY, ET AL., v. RESOLUTION TRUST CORPORATION, ET AL., U. S. Court of Appeals for the First Circuit.

[42] C.A. 93-1782, RHETTA B. SWEENEY, ET AL., v. RESOLUTION TRUST CORPORATION, ET AL., In The Supreme Court of the United States, October Term, 1993.

[43] Even the FIRREA amendment of 12 U.S.C. Section 1821(d)(9)(A), again greatly lacked in clarity as to the application of D'Oench. 12 U.S.C. Section 1821(d)(9)(A) provides: Except as provided in subparagraph (B), any agreement which does not meet the requirements set forth in section 1812(e) of this title shall not form the basis of, or substantially comprise, a claim against a receiver or the Corporation.

today, the RTC held an illegal auction on our property with court matters still pending in this case, and while we were on a respite with our family for Thanksgiving. They now have represented that they believe to hold legal title to our home and property.

On **January 31, 1995**, as I speak before you, the RTC has notified us -- if we are not out of our home by today, physical eviction will begin forthwith.[44]

CONCLUSION

The purpose of these hearings is to focus on the broad based abuse of the misapplication of the D'Oench, Duhme doctrine to borrowers of failed banks and S&Ls.

There is a need for Congress to rectify the RTC and FDIC abuse of the D'Oench, Duhme, and it ought to be retroactive to be effective and meaningful, in that the RTC is about to go out of business, leaving behind on the books a large body of bad precedent, injustice and wrongful acts, and the shards of the disrupted lives of many ordinary, innocent borrowers. This is manifestly unfair.

Federal courts, lacking guidance from Congress, have proceeded to continue to fashion their own devastating body of common law which has been harmful to the consumers who had done business with banks which failed.

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[44] See Appendix W, Eviction Notice.

Conflict arises when the RTC succeeds to a failed S&L and they blindly pursue their mission of removing cases with potential liability to the agency from state courts to federal courts, -- sometimes, as is the case here, **after the case was already tried in state court**, and the RTC goes after the little guy. Further tension arises when the borrower is unfairly attacked and the directors and officers of the failed S&L are protected by the RTC.

The RTC has misapplied the D'Oench, Duhme doctrine to commit and escalate government abuse, rather than correct it.

Furthermore, not all members of the Federal Court of Appeals are in unison with the U. S. Court of Appeals for the First Circuit. The fact alone that there is conflict over the application of the D'Oench, Duhme doctrine in the circuits provides all the more reason for Congress to set the record straight, setting forth specific guidelines as to what the courts must do and must not do in their application of the judge made D'Oench, Duhme doctrine.

The most terrible period of abuse suffered by me and my family has occurred at the hand of the RTC over the past four years. The RTC has known at all times of the terrible abuse we suffered at the hands of ComFed and their loan officers. Having borrowers pay for the misdeeds and mistakes in judgment made by the S&L's directors and officers should not be condoned and allowed to happen to us, or to anyone else in the future. An unrestrained exercise of

government power cannot be the intent of Congress, -- not now, not ever, -- and only you the law makers can now correct this abuse.[45]

Too often, D'Oench is being misapplied, as it has been here, to preclude such claims. Our claim for deceptive practices by the bank in violation of state statute does not turn on the enforceability of any written agreement or the validity of any unwritten representation. The U. S. Congress and this sub-committee are respectfully urged to use this occasion to dispel this confusion about D'Oench, Duhme by issuing retroactive legislation which properly limits it to effecting its intent.

Thank you.

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[45] D'Oench, Duhme was not intended to bar all claims against failed banks or their related entities. Nor was the related legislation intended to do so forty five years ago. Instead, the law advises customers of such banks that they cannot rely on oral agreements or representations, as the basis for a claim or a defense, in respect of determining their obligations to the bank or the bank's obligation to them. If, however, the bank is liable for violations of the law which do not depend on the existence of any unwritten agreement, the bank is not immune from otherwise viable claims.

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Reference

January 26, 1995

William S. Cohen, Chairman
United States Senate
Committee on Governmental Affairs
Washington, D.C. 20510

Re: Testimony of Attorney Michael C. McLaughlin
Subcommittee on Oversight of Government Management
Application of the D'Oench Duhme Doctrine
Tuesday, January 31, 1995

Dear Senator Cohen and Members of the Committee:

I would like to extend my appreciation to Senator Cohen of Maine for extending his invitation for me to speak before this Committee concerning the D'Oench Duhme Doctrine and the impact on not only my clients, but on thousands of innocent citizen borrowers around the country.

WHAT IS D'OENCH

The D'Oench Duhme Doctrine has the been the subject of considerable debate and litigation over the past five years. Generally, the D'Oench Doctrine has evolved from three separate sources: the case of D'Oench Duhme v. FDIC; the Federal Holder in Due Course Rule; and Congress' promulgation of 12 U.S.C. §1823(e) as amended by the Financial Institution Reform Recovery and Enforcement Act of 1989 ("FIRREA").

The D'Oench Doctrine initially resulted from the U.S. Supreme Court decision of D'Oench Duhme & Co. v. FDIC,[1] in which a borrower signed several notes and a secret agreement which relieved the borrower from the obligation of repayment of the notes. In short, the borrower and the bank entered into a scheme to mislead the Federal Deposit Insurance Corporation ("FDIC"). The

1. 315 U.S. 447 (1942)

Court held that the secret agreement was unenforceable against the FDIC and the borrower owed the full amount of the notes. Few today question the D'Oench decision result or the public policy logic which is its foundation. However, the expansion of the D'Oench Doctrine by judicial decision as well as by several acts of Congress into extraordinarily far reaching super-powers has produced an omni-powerful FDIC and has stripped the average citizen/borrower of nearly all rights (including, contractual rights and the right of judicial review of the FDIC's action), to such a level that the inequitability of such super-powers, strains credibility. The FDIC is now so over-protected that the citizen/borrower who has not participated in any form of fraud or deceit is left without any protection whatsoever.

There will be testimony from other witnesses before this Committee concerning the historic development of the D'Oench Duhme Doctrine. However, it is important to understand that the D'Oench decision was codified by Congress in 1950 in 12 U.S.C. §1823(e) which provided for a number of requirements to be met in order for any agreement outside the terms of the note to be enforceable against the FDIC. Generally, these requirements make any side agreement virtually impossible to enforce against the FDIC and as a result, 12 U.S.C. §1823(e) in and of itself provides extraordinarily broad protection to the FDIC. Notwithstanding that fact, the courts, at the urging of the FDIC, have expanded the application of the D'Oench Doctrine to bar defenses which include: (1) fraud on the part of the bank, (2) failure or lack of consideration, (3) oral agreements by bank officers to fill in the blanks in the loan document, (4) side agreements, including oral representations, (5) a breach of fiduciary duty, (6) accord and satisfaction, (7) deceptive trade practices by the bank, (8) tortious interference with contractual relationships, (9) material alteration of loan documents, (10)

undue influence of bank personnel over the borrower.[2] *It should be kept in mind that D'Oench and 12 U.S.C. §1823(e) provide these protections to the FDIC regardless of whether the borrower was acting in good faith and regardless of the bad faith of the bank predecessor to the FDIC.*

As if Congress has not granted enough super powers to the FDIC and RTC, the courts have provided an additional power under the Federal Holder in Due Course Rule. Under this provision, the FDIC is granted a status equivalent to a holder in due course with the additional provisions that the holder in due course status exists even if the FDIC had knowledge of the fraud or undisclosed agreements at the time it took control of the particular note. Under the standard Holder in Due Course status, the holder takes free and clear of the maker's claims and defenses subject to certain defenses including fraud in the factum and illegality provided that the holder had no knowledge of the existence of these defenses prior to taking possession of the note. Under the Federal Holder in Due Course Rule prior knowledge does not defeat the FDIC standing as a holder in due course. This is an extraordinary protection that is available to the FDIC as D'Oench is currently being interpreted by the courts. Again, this is a provision that has been initiated by the courts, rather than by Congress.

While these protections are extremely far reaching, I am not suggesting that Congress and the courts do not have a justifiable interest in protecting the viability and financial strength of the FDIC and the general banking industry. Rather, I believe that the current expansion of the D'Oench Doctrine goes beyond any expectation or understanding of the original drafters of 12 U.S.C. §1823(e) and so exposes innocent borrowers as to require this Committee to support the

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2 *See Note Baking Law: The D'Oench Doctrine and 12 U.S.C. §1823(e): Over-extended but Not Unconstitutional Oklahoma Law Review, Volume 53:315, 319.*

re-examination of and eventual dimunition of D'Oench's reach and application as will be suggested shortly in legislation offered by Senator Cohen and others so that a modicum of protection is available to innocent borrowers.

PUBLIC POLICY

Both Congress and the courts have established a balancing requirement in deciding that the interests of the innocent borrower, while substantial, especially in light of a fraudulent act by bank officers, are subordinate to the interests of the general public. This is based on the theory that the general public has taken no part in the operation of the failed bank nor in a particular loan in question. Essentially, the policy is that the public's interests outweighs the interests of the borrower, even if the borrower is being treated unfairly.

This theory of public policy belies the reality of the 1990's economy and the role of banks in citizens every day lives. Significant regional banking crises have dramatically affected nearly every aspect of the lives in the effected regions. Real estate, manufacturing, employment, and the stability of local economies are inextricably tied to the banks. The public policy differentiating between the "public" and the "borrower" of a particular failed bank, can no longer be realistically made. Virtually, every aspect of American life revolves around and participation in the banking industry, either as a depositor, borrower, credit card user, drafter of checks, user of money orders, etc. Today, the "public" and the "borrower" are by-in-large one and the same.

EXAMPLES OF "D'OENCH" ABUSE

My role today is not to provide a detailed history of the development of the D'Oench Doctrine, but rather, to provide you with several examples of how the super-powers embodied by D'Oench have resulted in extraordinary injustices to innocent borrowers (and banks) while at the same time diminishing the interests of the "public" which D'Oench was supposed to be protecting. The D'Oench

positions taken by the FDIC and the RTC as discussed below are actual positions taken in either litigation or in pre-litigation posturing. I cannot state whether all positions result from official FDIC or RTC policy or not. Rather, the D'Oench positions as described below are used regularly and have a very substantial intimidating impact, especially on the vast majority of borrowers who cannot begin to incur legal expenses in attempting to deal with such positions.

EXAMPLE ONE

DEFEAT OF FEDERAL CIVIL RIGHTS PROTECTION FOR WOMEN

My first example evidences the fact that the granting of the super-powers and the expansion of the judicial interpretation of those super-powers have given the FDIC essentially carte blanche to take whatever steps it believes necessary, regardless of the fairness, legality, public purpose or in fact Congressional intent. I mention Congressional intent because Congress has promulgated a number of laws which are extended as protection to American citizens, including civil rights protection under the Equal Credit Opportunity Act ("ECOA").[3] Under ECOA, Congress has provided that a spouse cannot be forced to execute bank documents in order to facilitate their husband's/wife's borrowing, unless said spouse's signature is actually required based upon the bank's creditworthy analysis. ECOA is regularly and nearly uniformly disregarded by banks. The vast majority of violations under ECOA are against women. Because of this disregard, women across the Country have been, and continue to be, illegally forced to execute loan documents in support of their husband's businesses. Naturally, hundreds of banks which regularly violated ECOA have been "taken over" by the FDIC and the Resolution Trust Company ("RTC"). Notwithstanding the illegality of loans which violate ECOA, the FDIC has taken the position that the protections

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[3] *15 U.S.C. §1691, et. seq.*

afforded women under ECOA are not available as a defense because these women, many of whom are unemployed housewives, are "D'Oenched". I have represented women in numerous cases where their signatures were illegally required despite their objections. Notwithstanding the fact that the wife's signature was illegally sought and obtained by the bank predecessor of the FDIC, the FDIC, or RTC has begun to foreclose on the homes of these women. The FDIC's position is that ECOA, a civil rights statute, does not and cannot be used as a defense since they are in fact a federal government agency with super-powers granted by Congress.

Clearly, one would question whether Congress ever intended that ECOA could be so disregarded by any Federal agency, much less the agency obligated to protect the public from illegal banking activities. This is especially true in light of the fact that Congress has recently passed a statute to enforce laws applicable to the general public, on its own members. It would appear that this would be an appropriate time for Congress to pass a law to require all government agencies to meet the requirements of all statutes applicable to general citizenry of the United States. If the FDIC were prevented from "D'Oenching" these innocent victims, literally thousands of women would be protected from illegal foreclosures on their home resulting from loan documents which violated Federal law. Then, and only then, would the protection afforded to women under the Equal Credit Opportunity Act be realized. Without a revision in D'Oench and particularly FIRREA, ECOA is nearly worthless to these women.

EXAMPLE TWO

NO OPPORTUNITY TO EXPLAIN

D'Oench and the requirements of §1823(e) and amendments to FIRRERA have also resulted in counter-intuitive decisions by courts and positions by the FDIC concerning contract law, fraud in the inducement and unfair and deceptive

trade practices by banks. One such example would be a case where a borrower signs a note extension as the "President of a corporation but not individually", the words "but not individually" were added beneath his name.

This was not a case where the individual signed as an individual, but intended to sign only as a president. Rather, it was a case where he signed as president and "not individually". The FDIC's position in this case was that the signature was intended to be something other than as it appeared. This ludicrous position could only be countered by the borrower with the evidence of the facts and circumstances surrounding the signing of the loan document itself. The borrower's testimony as to the facts and circumstances surrounding his signature, was opposed by the FDIC on the basis of D'Oench. Exclusion of that evidence based upon D'Oench strains any possible reading of D'Oench to the breaking point, either as it was first decided in 1942 or even under the expanded judicial decisions. In this case, D'Oench has no application whatsoever. However, the use of D'Oench in an effort to prevent the testimony is indicative of the FDIC's attempt to eliminate any possible defense no matter what the circumstances. Clearly, Congress never intended to have §1823(e) expanded to such extraordinary and bizarre lengths.

THIRD EXAMPLE

<u>FDIC AS ENFORCER OF AN USURIOUS NOTE</u>

This example revolves around the extraordinary level of protection granted to the FDIC and RTC even where the actions of its predecessor bank was so intertwined with fraud as to render the transaction otherwise void. In this particular case, a borrower enters into a loan agreement with a private lender, who in the process of making the loan, violates state usury laws by charging in excess OF thirty percent interest. This loan was a "usurious" loan. The individual lender then assigned the "usurious note" to the FDIC member bank as collateral

for loan taken by the individual lender from a FDIC member bank. Subsequently, the FDIC took over the bank. This left the FDIC in the position of holding the "usurious" note and subsequently attempting to enforce that note against the original borrower. All of the defenses that would have otherwise been available to the borrower for overpayments under the usury law if not the actual voiding of the usurious note, were "D'Oenched". Thus, FDIC was in the peculiar position of enforcing a usurious note and the defendant could not bring forward any defenses to it.

FOURTH EXAMPLE

FDIC DROPS THE BALL

My fourth example illustrates that D'Oench effects not only individual citizens, but also results in unfair shifting of burdens from the FDIC to its member banks. This case involves an FDIC member bank that was a member of a participation group funding a construction loan where all the participating banks, but for the member bank in question were eventually taken over by the FDIC. The FDIC has claimed protection under D'Oench for any causes of action by the borrower brought against the participation group now headed by the FDIC. The FDIC's claim of D'Oench protection caused the remaining solvent bank to face the claims on its own. In this case the member bank simply participated in the loan to a borrower. The member bank had no direct contact with the borrower nor any contractual relationship. All contact with the borrower was with the lead bank, which the FDIC closed and replaced with itself. The FDIC's protection through D'Oench even from potentially baseless claims of the borrower, unfairly shifted the burden of the defense away from the failed banks and the FDIC, to the one solvent bank. Clearly, this was not the intention of Congress when §1823(e) was drafted, nor do I believe it is the intention of Congress to continue this type of abuse.

FIFTH EXAMPLE

ENFORCEMENT OF FDIC PROMISES

A fifth example is one case from many thousands of cases where the FDIC refuses to honor its agreements, particularly verbal agreements. In this case, an individual borrower who has entered into negotiations with the FDIC and concluded those negotiations with a settlement only to have the FDIC withdraw from that settlement. It has been the FDIC's position that no claim under contract or any other cause of action can be brought against the FDIC since any such claim would have the effect of diminishing the FDIC's interests. It is important to understand that the claim by the borrower under a verbal agreement does not diminish the FDIC's interest in any asset of a failed bank. Rather, the action brought by the borrower is simply to enforce the settlement agreement. Notwithstanding that fact, the FDIC regularly and uniformly rests its decision to refuse to honor its own contracts on the D'Oench theory. Again, neither the D'Oench case nor the original drafting of §1823(e) could have ever anticipated such a result.

SIXTH EXAMPLE

FRAUD ON AN INNOCENT BORROWER

My final example illustrates how illogically D'Oench can be applied and can be seen in the case of FDIC v. McClanahan,[4] In this case a farmer hoped to obtain a bank loan to buy farm equipment and signed a blank promissory note. This note was given by the farmer, to an individual who fraudulently represented himself as the owner of the bank. This "owner" then informed the farmer that his application had been denied and the farmer financed his equipment through a different bank. The "bank owner" then filled in the blank note to reflect a $62,000

[4] *795 F.2d, 512 (5th Cir. 1986).*

loan and took the money for himself. Subsequent to this fraudulent loan, the FDIC was appointed receiver and sued the farmer to collect the money even though the farmer had not received any of the proceeds and was unaware of the note being filled in by the fraudulent owner of the bank. The farmer, naturally relied on his affirmative defenses of fraud and failure of consideration which were opposed by the FDIC under the D'Oench Doctrine because he was "part of a scheme". Even though the farmer was not part of any scheme to defraud the FDIC, he was held liable for the loan even though he never received any loan payments.

The McClanahan decision and dozens of others in a similar vein have been justified by a number of authorities based upon public policy.[5] The policy essentially results from the theory that the farmer was reckless in believing the fraud and therefore, must bear the risks of the transaction, rather than the depositors and the FDIC. While initially that public policy argument has some credibility, it is quickly overshadowed by the fact that the fraudulently induced borrower is indeed a greater victim than the insurer FDIC, since the system which defrauded him is FDIC controlled and regulated. This position results from the fact that the borrowers by necessity deal with banks both in their capacity as depositors and borrowers. It is the FDIC, that on a regular basis is informed about and makes judgments as to the financial health of each member bank. The borrower has little or no understanding of the relative strength or weakness of a bank with which the borrower is working. The "public policy" of shifting the burden to the borrower, is in fact shifting the burden not only of the loan itself but in large part, shifting the burden of mismanagement of the bank to the borrower and often times shifting the burden of failed regulatory policies and practices by

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5. ***See Oklahoma Law Review, Vol. 53:318.***

the FDIC onto the borrower himself. Thus, the FDIC's own failed policies and/or enforcement of its policies are paid for in part by the innocent, fraudulently induced borrower.

These examples are but a tiny portion of the cases I have encountered in my practice over the past several years. The nature of the changes that will be proposed to the existing statute are directed at preventing the continuance of this type of unfair and inequitable shifting of burdens to the induced innocent borrower. The extent of protection now available to the FDIC, RTC and others exceeds even the powers available to the Internal Revenue Service. At least Congress has provided judicial review of I.R.S. decisions. Further, Congress has provided remedies such as the Taxpayers Bill of Rights to protect citizens from I.R.S. abuses. Under D'Oench, both as codified and as interpreted by the FDIC, the innocent borrowers rights are obliterated without recourse by the borrower. FIRREA specifically denies the borrower the right to judicial injuctive relief from any court if the FDIC is acting in its capacity as the liquidator or receiver. That means that the innocent borrower cannot ask a court, even a federal court, to enjoin a foreclosure while the borrower has his or her day in court. FIRREA precludes the innocent borrower from seeking a declaratory action against the FDIC concerning an asset of the failed bank even if that asset is the innocent borrowers home.

These are indeed super-powers. It is inevitable that any agency given such powers will abuse them. The amendments necessary to bring D'Oench and FIRREA in line with a reasonable standard of fairness and equity need not render the FDIC unable to protect and regulate our banking system. Any hue and cry that any change or any return to earlier standards will incapacitate the FDIC, will of course, be greatly exaggerated. The system cannot and should not be allowed

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William S. Cohen, Chairman
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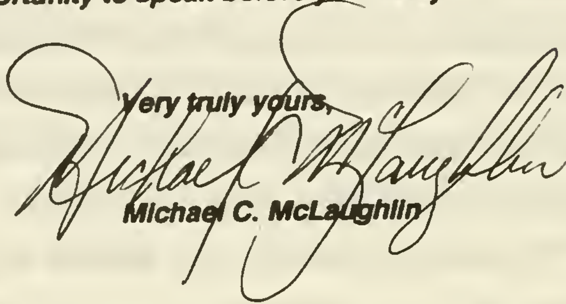
January 26, 1995

to reek such havoc on the live's of innocent borrowers under the guise of the betterment of the public good.

Thank you for the opportunity to speak before you today.



Very truly yours,

Michael C. McLaughlin

STATEMENT OF PROFESSOR J. MICHAEL ECHEVARRIA TO UNITED STATES SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS IN SUPPORT OF PROPOSED CHANGES TO 12 U.S.C. 1823(e)

By

PROFESSOR J. MICHAEL ECHEVARRIA

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I. PERSONAL BACKGROUND

I graduated from Harvard Law School in 1983. From 1983 to 1991 I was in private practice in Los Angeles. I have been an associate professor of law at Southwestern University School of Law (in Los Angeles) since 1991. I specialize in the areas of contracts, remedies and civil rights. I am intimately familiar with issues concerning 12 U.S.C. 1823(e) for two reasons. First, commencing in late 1986, I, along with other attorneys at my firm, represented the FSLIC (and later the FDIC) in a number of civil litigation matters. During the course of one of these matters, *Bartram v. FDIC*, 1 Cal.Rptr.2d 612 (1991), I raised as a successful defense to a fraud claim brought against the FDIC, the *D'Oench, Duhme* doctrine (which is codified, in part, in 12 U.S.C. 1823(e)) Second, within the past year I have published a 67-page article chronicling the evolution and policy implications of *D'Oench.* See, "A Precedent Embalms a Principle: The Expansion of the *D'Oench, Duhme* Doctrine, 43 Cath. U.L. Rev. 745 (1994). The conclusion I reach in my article is that *D'Oench* and its statutory codification are unnecessary and unfair and should be legislatively limited or repealed. The proposed changes by Senator Cohen's Office to 12 U.S.C. 1823(e) are consistent with changes I advocate in my article.

II. INTRODUCTION TO THE PROBLEM

In 1942 the United States Supreme Court in *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1947) established a precedent of federal common law that has now embalmed the principle for which it originally stood. In *D'Oench,* the Court, for the express purpose of maintaining the nation's confidence in the banking system, held that when the Federal Deposit Insurance Corporation (FDIC) takes over a failed bank, the commercial paper it acquires is not subject to certain common law defenses (such as lack of consideration) that are not apparent on the face

of the paper. *D'Oench* was based on state common law authority that held that a maker of an accommodation note could not assert lack of consideration as a defense to her obligations because of her participation in a scheme (i.e., the creation of the note) designed to misrepresent the assets of the institution. Through the course of subsequent case law. *D'Oench* (now codified at 12 U.S.C.§ 1823(e)) has been dramatically expanded in its application and now essentially precludes the assertion of fraud defenses or causes of action against successors to failed banks and savings and loan institutions (S&Ls). The expansion of *D'Oench* came at a time when savings and loan failures were widespread and, in no small measure, were caused by the fraud *D'Oench* removed from the realm of compensable actionable conduct. *D'Oench*, which was borne of the systemic bank failures of the Great Depression and based on a body of state common law creating a prophylactic rule to prevent fraud, can only be viewed now as ironic in its application, given the causes of the current crisis gripping the nation's financial institutions.

Because of the existing common law protections that historically and presently exist, *D'Oench* serves as a gap filler,catching within its net those bank customers against whom no historical common law defense would have been applicable. Those customers, by and large, are the passive victims of fraud.

III. *D'OENCH* AND ITS STATUTORY CODIFICATION

A. *D'Oench*, Duhme & Co. v. FDIC

In 1926, *D'Oench*, Duhme & Co., a securities dealer, sold certain bonds to Belleville Bank & Trust Co. and executed certain notes payable to the bank. The bonds later went into default, and in 1933, *D'Oench* executed renewal notes in favor of the bank to enable the bank

to carry the renewal notes and not show any past due bonds on its books and records. The notes on their face were non-negotiable. A receipt to the notes expressly provided that the notes would not be called due. Interest payments on the notes were thereafter made to keep them "as live paper." *D'Oench* was aware that the renewal notes were executed so that the past due bonds would not appear among the assets of the bank. In 1935, the bonds were charged off the banks' records. Three years later, the FDIC acquired the notes as part of the collateral securing a one million dollar loan made in connection with the assumption of the bank's deposit liabilities by another institution. The FDIC sued *D'Oench* to enforce the notes. *D'Oench* defended on the grounds of lack of consideration. The trial court held that, under state law, the FDIC was a holder in due course and acquired the notes free from all personal defenses. The United States Court of Appeals for the Eighth Circuit affirmed.

Writing for a unanimous court, Justice Douglas examined the Federal Reserve Act and found that it reflected a federal policy to protect the FDIC and the public funds which it administers, against misrepresentations as to the securities or other assets in the portfolios of the banks which [the FDIC] insures." Justice Douglas turned to older state common law cases as authority for a broad estoppel rule. He concluded that the root of the rule did not lie in injury, but rather in the "evil tendency" created by the acts. Justice Douglas reasoned that even if *D'Oench* actually did not know the note was used to deceive, its knowledge would be presumed since "[p]lainly one who gives such a note to a bank with a secret agreement that it will not be enforced must be presumed to know that it will conceal the truth from the vigilant eyes of the bank examiners."

The Court then fashioned the *D'Oench* rule:

> The test is whether the note was designed to deceive the creditors or the public authority, or would tend to have that effect. It would be sufficient in this type of case that the maker lent himself to a scheme or arrangement whereby the banking authority on which [the FDIC] relied in insuring the bank was or was likely to be mislead.

B. 12 U.S.C. § 1823(e)

In 1950, eight years after the Supreme Court decided *D'Oench*, Congress amended the Federal Deposit Insurance Act to allow the FDIC to rely exclusively on the facial validity of a closed bank's books and records. Section 1823(e) of Title 12 provides that any agreement infringing upon the interests of the FDIC in an asset, acquired under its corporate capacity, is invalid unless certain conditions are met. Congress' enactment of section 1823(e) raises the question whether it represents a statutory codification of the *D'Oench* rule. The sparse legislative history behind section 1823(e) reveals that, in enacting the statute, Congress was not interested in expanding the FDIC's existing powers, but sought instead to define them more rigidly.

Similar to *D'Oench*, section 1823(e) invalidates claims or defenses against the FDIC based on secret side agreements. For example, the accommodation note maker's oral agreement with the bank not to enforce the note is invalid under both *D'Oench* and the statute. Section 1823(e)'s technical requirements, however, are narrower in the senses that so long as the nonenforcement agreement becomes an official bank record it is enforceable. Of course, in the context of an accommodation note, officially recording its unenforceability utterly defeats the purpose of artificially inflating an institution's asset value.

At the same time, however, the statue is broader than *D'Oench* in that it lacks a scienter requirement. While *D'Oench* involved a situation where the note maker's culpability was at least presumed, section 1823(e), by not limiting its application to specified arrangements (e.g. accommodation notes), invalidates all arrangements falling outside of its strictures regardless of the culpability of the bank customer. Moreover, the statute says nothing about the existence of a "deceptive scheme" or the ignorance of the FDIC with respect to the scheme.

IV. THE EXPANSION OF *D'OENCH* THROUGH THE CASE LAW

For the first thirty years of its resilient life, courts often cited *D'Oench* as an example of federal common law, but rarely relied upon the holding for any substantive proposition. The Supreme Court did not revisit the issues raised in *D'Oench* until 1987, and expansion of its holding did not begin until the late 1970s and early 1980s. Since that time, *D'Oench* has been substantially expanded.

More specifically, *D'Oench* has become a "super" holder-in-due-course statute for the federal government and now effectively precludes the assertion not only of claims or defenses based on lack of consideration, but also claims or defenses based on traditional defenses such as waiver, estoppel, laches, fraud in the inducement, usury, accord and satisfaction, and the like. Beginning in the early 1970s and culminating with the Supreme Court's 1987 decision in *Langley v. FDIC*, 484 U.S. 86 (1987) the case law traced three often indistinct paths: (1) cases based solely on *D'Oench*; (2) cases based on section 1823(e); and (3) cases based on broad notions of federal common law.

Cases involving the FSLIC or the FDIC in its receivership capacity were decided under *D'Oench*. In early cases, courts construed the application of *D'Oench* as narrow and equitable,

often turning on the culpability of the defendant. See eg. *FDIC v. Meo*, 505 F.2d 790 (9th Cir. 1970). Courts in the mid-1970s and early 1980s applied *D'Oench* as part of the nebulous body of "federal common law" and limited its application to cases where the borrower could validly have been said to have participated in a fraudulent scheme. Subsequent courts, however, deciding cases under the statutory codification of *D'Oench*, section 1823(e) interpreted it as a strict liability statute that applied not only to independent side agreements (for example, an agreement not to call note due), but also to oral terms not contained in written agreement.

By the early 1980s, the scope and breadth of *D'Oench* and section 1823(e) was somewhat muddled. The cases interpreting section 1823(e) seemingly loosened *D'Oench* from its equitable moorings by premising liability on a mechanistic view of the statute. Moreover, the section 1823(e) cases, or at least the trend of those cases, created a super holder-in-due-course status in the FDIC in the absence of statutory authority or legislative history. In 1982, these two lines of case law spawned a third, with the United States Court of Appeals for the Eleventh Circuit's opinion in *Gunter v. Hutcheson*, 674 F.2d 862 (11th Cir. 1982).

In December 1974, the Gunters purchased the majority of the outstanding common stock of a bank for $5.5 million, securing their obligation by signing two promissory notes. The Bank induced them to purchase the stock by fraudulent representations of the bank's officers concerning future actions of the bank and the bank's financial condition. Two months later, the FDIC declared the bank insolvent and was appointed receiver. The Gunter sued the bank's former officers and directors for fraud, seeking to rescind the promissory notes now held by the FDIC. The FDIC, in turn, counter-claimed for payment under the notes.

The FDIC moved for summary judgment, arguing that the Gunter's claims were barred by both section 1823(e) and federal common law. The Eleventh Circuit affirmed the district court and granted the summary judgment motion. However, the court of appeals did not find that the FDIC was protected by either section 1823 or the federal common law of *D'Oench*.

The court first considered the Gunters' claims in light of section 1823(e). Although certain alleged misrepresentations such as promise by the bank to defer interest payments on the notes were based upon agreements between the parties, other alleged misrepresentations such as representations concerning the financial condition of the bank could not arguably have been claimed to be "agreements." The court implicitly distinguished between promissory representations and non-promissory representations, with the latter falling outside the scope of section 1823(e). The court adopted a rather strict interpretation of the word "agreement" under the statute, and contrasted it with a claim of fraudulent inducement, which negates the existence of an agreement. For this reason, the court concluded that section 1823(e) did not apply.

Instead of relying on section 1823(e) or *D'Oench*, the *Gunter* court relied on broad principles of federal common law to fashion a rule that protected the FDIC from ordinary fraud claims. The *Gunter* court concluded by fashioning the following rule:

> Accordingly, we hold that as a matter of federal common law, the FDIC has a complete defense to state and common law fraud claims on a note acquired by the FDIC in the execution of a purchase and assumption transaction, for value, in good faith, and without actual knowledge of the fraud at the time the FDIC entered into the purchase and assumption agreement.

In 1987 the United States Supreme Court revisited the issue of *D'Oench*, in *Langley v. FDIC*. The Langleys borrowed money from the bank in order to purchase certain real property

owned by the bank. The Langleys' purchase was secured by a note, collateral mortgage, and personal guarantees. The bank made material misrepresentations to the Langleys concerning the acreage, mineral deposits, and encumbrances on the land. No reference to the alleged misrepresentations, however, appeared on any of the transaction documents. When the Langleys defaulted on their note and the bank sued, the Langleys defended on the grounds of fraud in the inducement. Unfortunately, while the suit was still pending, the bank became insolvent, and the FDIC was appointed receiver and became plaintiff in the suit. The district court granted summary judgment in favor of the FDIC, and the United States Court of Appeals for the Fifth Circuit affirmed the lower court's judgement.

Before the Supreme Court, the Langleys argued that the lower court erred in concluding that their defense was barred under section 1823(e). They argued that since no "agreement" existed, section 1823(e) did not apply. The Court confronted the narrow issue of the interpretation of the word "agreement" contained in section 1823(e). Justice Scalia, writing for a unanimous Court, chose the most narrow fashion to decide the issue. The Court's opinion did not enunciate any rule of federal common law, nor did it examine the legislative history to interpret the statute. Instead, the Court's opinion concentrated exclusively on the plain meaning of the words in section 1823(e) to resolve the issue. Citing contract treatises, Justice Scalia noted that the word "agreement," in the normal contract sense, encompasses not only promises but conditions, and warranties regarding land are considered conditions to performance. Thus, "agreement" as used in section 1823(e) encompasses not only unrecorded promises but also unrecorded representations and warranties. Section 1823(e) therefore barred the Langleys' fraud in the inducement defense.

The case law since *Langley* continues the expansion of *D'Oench*. The FDIC and the FSLIC are now clothed in impenetrable armor shielding it from defenses not only based on lack of consideration and fraud in the inducement (promissory and non-promissory), but also estoppel, waiver, usury, and the like. The penumbra of *D'Oench* and its progeny encompasses negotiable and non-negotiable instruments. *D'Oench* applies in a context where there is no arguable agreement: in the context of an intentional misrepresentation. *D'Oench* bars not only defenses to obligations, but also affirmative claims: "The *[D'Oench]* doctrine has been expanded to encompass any claim against an insolvent institution that would either diminish the value of the assets held by the FSLIC [or FDIC] or increase the liabilities of the insolvent institution." *Castleglen, Inc. v. Commonwealth Sav. Ass's, 728 F.Supp 656, 671 (D. Utah 1989). D'Oench* applies even where the FDIC inherits no outstanding asset.

Courts routinely cite *D'Oench* and section 1832(e) in affirming judgments in favor of the FDIC, and have done so literally hundreds of times within the past several years. *D'Oench* has been described in the *National Law Journal* as a "once-little-used doctrine. . . applied to nearly every major S&L failure as myriad borrowers try to get out from under their debts." Mechanically, the further expansion of *D'Oench* has been accomplished by the merger of the *D'Oench* doctrine with section 1823(e) jurisprudence, including *Langley* and *Gunter*. Whereas before three connected but independent lines of authority existed, courts today treat analytically distinct factual scenarios in an identical manner. Even if a court differentiates a case based on its facts, the three lines of authority have broadened so significantly that the distinctions are meaningless as courts will employ one doctrine/rule as an alternative to another. If section

1823(e) does not apply, *D'Oench* will, and if *D'Oench* does not, *Gunter* will. *D'Oench* and its progeny have become a seamless web.

The merger of *D'Oench*, section 1823(e) and *Gunter* is reflected in numerous judicial decisions. In *FSLIC v. Gordy, 928 F.2d 1558 (11th Cir. 1991),* the United States Court of Appeals for the Eleventh Circuit affirmed a district court's judgment in favor of the FSLIC based on *D'Oench*. S&L officers made statements misrepresenting the S&L's financial condition to the borrowers, and because the FSLIC was a party, section 1823(e) did not expressly apply and *Langley* was therefore seemingly inapposite. Moreover, because the representations were nonpromissory, it would have been difficult to see where there existed any "secret agreement." The court nonetheless held that *Langley* compelled the result that the defendant guarantee makers were estopped from asserting a fraud in the inducement defense.

The importance of cases such as *Gordy* lies in the broadening of *D'Oench* so that the "secret agreement" element is no longer required for the application of the doctrine. Anything falling short of fraud in the factum is now barred under *D'Oench*. *D'Oench* applies as long as the borrower's defense or claim is based on something outside of the bank's records. Even where courts hold that section 1823(e) does not expressly apply, *D'Oench* and *Gunter* exist as fallback positions. The expansion of *D'Oench* has led to a number of egregiously inequitable results. For example:

In *FDIC v. Kasal*, 913 F.2d 487 (9th Cir.), a borrower was estopped from asserting payment as a defense to a note obligation where the payment was made to a bank employee who misappropriated the funds. The court conceded that the result was "harsh," but felt it had no choice given the evolution of case law under *D'Oench*.

In *Kilpatric v. Riddle*, 907 F.2d 1523 (5th Cir. 1990), borrower was estopped from asserting against the FDIC's purchaser of assets a claim under the federal securities laws of which the FDIC was aware at the time of acquisition. Judge Brown in dissent posed the following semi-rhetorical question:

> The question is whether the *D'Oench, Duhme* doctrine and its [sic] so-called codified counterpart, 12 U.S.C. § 1823(e), estop all defenses to the repayment of loans of failed banks which the FDIC has assumed in receivership. Is the doctrine so powerful and all encompassing that nothing can stand in its way, including federal statues protecting investors?

In *FDIC v. Texarkana* Nat'l Bank, 874 F.2d 264(5th Cir. 1989) a bank that innocently participated in a document loan participation, but not the underlying deceptive transaction, could not claim a set-off based on *D'Oench* and *Langley*. In essence, the court held that a completely innocent bank is responsible for the concealed fraud of another.

In *FSLIC v. T.F.* Stone-Liberty Land Assocs., 787 S.W.2d 475 (Tex. Ct. App. 1990), a judgment creditor's claim was defeated because *D'Oench* applies to claims already adjudicated, even where the FSLIC is aware of the judgment and merely is appointed receiver after the trial.

In *McCullough v. FDIC*, 987 F.2d 870 (1st Cir. 1993), borrowers who brought an action based on a bank's failure to disclose material facts, in violation of a statutory requirement, were estopped from asserting the claims against the FDIC based on *Langley*. This holding represents *Langley* at its most illogical and absurd, as the McCullough court essentially held that a non-disclosure constituted an "agreement."

V. CRITIQUE OF *D'OENCH*

A. *The Anti-Safety Net*

The Supreme Court designed the *D'Oench* rule to restore public confidence in the financial institution system by allowing the public's representative, the government, to rely on the stated asset valuation of the institution. *D'Oench* was designed to deter and, in some respects punish those who lent themselves to an arrangement whereby the public guardian could be misled. The *D'Oench* decision arose in the wake of the Great Depression at a time when the public's confidence was at an all-time low because of the systemic failure of savings institutions.

In the late 1970s and early 1980s, as S&L failures began to rise, the *D'Oench* doctrine, not coincidentally , began to expand. Prior to this expansion, bank S&L borrowers confronted a number of legal hurdles in avoiding liability. To the extent the borrower alleged that a written obligation was subject to unrecorded oral terms, the parol evidence rule stood as a potential bar to the enforcement of those terms. To the extent the borrower executed a document she never intended to be enforced, the borrower's lack of consideration defense was subject to an equitable estoppel rule. To the extent the borrower entered into a transaction designed to deceive a regulator, she faced common law rules of illegality and conspiracy to breach fiduciary duty.

The expansion of *D'Oench*, largely through the expansive interpretation of section 1823(e) and the intermingling of *D'Oench* and section 1823(e) jurisprudence, caught these borrowers in a net. Those individuals unlucky enough to have been defrauded by an oral representation now found themselves incapacitated in the ability to raise traditional contract defenses. Their ability to defend against liability on an obligation was severely limited because to the extent a defense

was not subject to common law restriction, it was now subject to a *D'Oench or* section 1823(e) restriction.

B. *Why D'Oench Is Too Broad*

In *Langley v. FDIC*, the borrowers argued as a fallback position that an equitable exception for fraud in the inducement should be read into section 1823(e), at least where the FDIC has knowledge of the asserted defense at the time it acquires the asset. Justice Scalia rejected any argument based on the equities, finding that the equities favored the government. Justice Scalia made several points. First, he seemed to imply that the borrower is in a better position to protect herself because she can insist that the representations be recorded. Second, even if the borrower is defrauded, so too is the public because the borrower's obligation is subject to an unrecorded ("secret") liability. Third, section 1823(e) is not meant only to allow the FDIC to rely on official bank records, but also insures that when a bank makes a loan, it is done in a deliberative and prudent manner. None of these arguments is terribly compelling.

First, it is axiomatic that one who participates in a transaction is in a better position to guard against its hazards than one outside the transaction. But it is normally the justification where both parties are at least partially at fault, such as in cases involving negligence or assumption of the risk. Where both parties are blameless, the core inquiry is determining which party can better afford the loss. Where a bank official makes a non-promissory misrepresentation, such as a misstatement about value, it is difficult to perceive the defrauded person as the party at fault. The expansive *D'Oench* doctrine shifts the burden of loss from the public insurance fund to the individual. But what was the justification for the creation of the FDIC and the FSLIC initially if not to assume the risk of institutional failure, thereby displacing

the risk from the shoulders of individuals? Moreover, the borrower has little or no control over satisfying the rigorous requirements of section 1823(e). Specifically, the borrower has no control over the content and maintenance of bank records and must, as an act of faith, assume that the bank official with whom she is dealing has authority and has received formal approval for the transaction. The borrower's reliance is especially misplaced where the bank official engages in intentional deception.

The second point made by Justice Scalia is that two parties have been defrauded -- the individual and the public -- and that implicitly the public's interest outweighs the interest of the individual. The whole justification for the creation of a governmental oversight and insurance system, however, was that individual losses in the aggregate had a tremendous demoralizing effect on the public. It appears difficult, therefore, to separate the public's interest from the individual's interest. Is it not the case that the public's confidence is eroded each time an individual is defrauded and can find no shelter from her appointed protectorate?

Finally, when Justice Scalia opined that section 1823(e) was created at least in part to assure deliberative and thoughtful decision making as a part of the loan making process, he does so based on sheer speculation and inference. If that had been Congress' intent, why then restrict the enforceability of unrecorded agreements only in the context of a takeover by the FDIC? The more likely congressional intent was to codify more expressly and rigidly *D'Oench* by establishing a bright line rule. Prudence in the decision making process is already legally assured, at least to some extent, by virtue of the existence of traditional common law rules, including the parol evidence rule and the statute of frauds.

The inclusion of a fraud in the inducement defense within the parameters of *D'Oench* is particularly inequitable due to the peculiar context in which *D'Oench* is applicable. *D'Oench* applies only to those situations where a bank has failed, and a statutory successor in interest (the FDIC) has been appointed. By definition the defrauded party can no longer look to the original miscreant (i.e., the bank) for recourse because it no longer exists. A public policy justification may exist for not permitting the defrauded party affirmative recovery against the successor. However, where the victim merely seeks to avoid her own liability, little justification exists for denying a shift in responsibility where the culpable party is judgment-proof.

Moreover, the expansion of *D'Oench* goes far beyond the mere conversion of the FDIC into a holder-in-due-course. While a normal holder-in-due-course is immune to a myriad of defenses to obligations owed to a payee under a negotiable instrument, *D'Oench* has been expanded to encompass non-negotiable instruments. It has been estimated, however,that in the typical FDIC takeover, eighty percent of the assets acquired are non-negotiable. Thus, *D'Oench* has exponentially changed the substantive commercial law by making holder-in-due-course status applicable in the majority of cases to situations where it previously hand no relevance. *D'Oench* makes the exception the rule.

The case law beginning before *Gunter* and continuing through *Langley* is based not so much on an equities concern, but instead on an efficiency concern. Courts view the grant of "super" powers to the FDIC as an efficient way of allowing the FDIC to sell failed institutions without shutting them down. The *D'Oench* rule facilitates purchase and assumption transactions. However, the government can already accomplish this objective without sacrificing the equities of the individual. In a typical purchase and assumption transaction, the FDIC has the ability to

indemnify the purchasing institution from losses. Allowing a defrauded borrower to assert fraud as a defense to an obligation on a note would simply present an indemnity claim by the purchasing institution against the FDIC. The loss would again be shifted to the party best able to bear it, the government.

C. *We Do Not Need D'Oench*

D'Oench is troublesome because it is too broad: it captures within its net persons whose equitable claims would ordinarily not be barred. If *D'Oench* did not exist, however, a number of the common law doctrines would already provide adequate security for the FDIC.

A number of concerns are identifiable from the case law: (1) the desire to maintain the integrity of bank/S&L record keeping, (2) the desire to prevent collusive arrangements between bank officers and customers, (3) the desire to insure that agreements are not subject to secret conditions or terms; and (4) the need to restore and maintain public confidence in the nation's financial institutions. Most of these goals can be met in the absence of *D'Oench* because of current common law protections.

The first such protection is the parol evidence rule. The common law parol evidence rule specifies that if a written contract constitutes a total integration, meaning that it is the final and exclusive expression of the contracting parties' agreement, it may not be supplemented by prior contradictory or additional terms. Additionally, if the written contract constitutes a partial integration, that is, it is not meant to be an exclusive expression, it may be supplemented by consistent additional terms. In the context of concerns under *D'Oench*, the parol evidence rule has the following effect. For large real estate transactions where the bank takes back paper (i.e., promissory notes), the paper itself is part of the larger transaction that, if the paperwork is

adequate, in the aggregate probably constitutes a total integration. Thus, to the extent at the time the documents are executed the notes are subject to undisclosed terms concerning, for example, loan funding requirements, bank obligations, and the like, these undisclosed terms or agreements are unenforceable under the parol evidence rule.

To the extent that the documents for such transactions only constitute a partial integration, the terms of the agreement may be supplemented by consistent additional terms. In the case of an accommodation note, the terms sought to be introduced (i.e., the agreement not to enforce the note) is normally contradictory and thus unenforceable even if the transaction is only partially integrated. One thing the parol evidence rule will not exclude, however, is evidence that goes toward establishing that an agreement is voidable because consent was induced by a misrepresentation. To the extent a borrower seeks to deny liability based on a material misrepresentation, at least of a non-promissory nature, she is able to do so under the parol evidence rule.

A second protection available to the FDIC under the common law is the doctrine of equitable estoppel. For over fifty years before the Supreme Court decided *D'Oench*, numerous states had developed a common law estoppel rule for collusive borrower/bank official transactions. Specifically, these cases consistently held that where a borrower executes a document she knows to be fallacious, she is estopped from denying its unenforceability on the basis of, for example, lack of consideration. The same result would hold where a bank fraudulently represents that it will not call a note due. The borrower, regardless of the bank's intentions, has knowingly executed what she believes to be a false document and should thereby be equitably estopped.

The common law estoppel rule, which could also be viewed simply as a narrow interpretation of *D'Oench*, has the effect of making accommodation (i.e., non-liability) agreements unenforceable. An estoppel rule, which is grounded in equitable considerations, however, would have no application where a party did not knowingly participate in any deceptive conduct. Therefore, most fraud in the inducement defenses, with the exception of the accommodation note context, will be preserved.

Finally, to the extent that *D'Oench* originally concerned a situation in which a borrower was validly a party to a fraud, the doctrines of illegality and conspiracy to breach a fiduciary duty arguably prevent the borrower from at least affirmative recovery, and probably prevent her from protective defensive shelter.

VI. CONCLUSIONS

The principle upon which the *D'Oench* doctrine was originally based concerned confidence: the public's confidence in the banking system as guaranteed by their appointed guardian's confidence in the records of banks. *D'Oench* was originally meant to deter and preclude misleading financial arrangements between bank officials and bank customers. The *D'Oench* precedent, however, has embalmed this principle by expanding to apply to situations where public confidence is not served. Its application is ironic. In an era of widespread fraud, the victims of fraud are punished. Perhaps the only way to solve the inequities of *D'Oench* is for Congress to repeal, or at least amend, section 1823(e). Until such time, however, the doctrine of *caveat emptor* still endures. The proposed changes by Senator Cohen's office, which would, among other things, remove holder-in-due-course status from the FDIC and exempt fraud claims from the strictures of the statutory codification of *D'Oench*, go a long way in that regard.

WRITTEN STATEMENT OF VIEWS ON D'Oench, Duhme

submitted to the

Subcommittee on Oversight of Government Management

of the

Senate Committee on Governmental Affairs

by

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I thank Senator Cohen, Senator Levin, and the members of the Subcommittee for this opportunity to present my views on D'Oench, Duhme & Co., Inc. v. FDIC 1/ and its statutory heir, 12 U.S.C. § 1823(e).

At no other time since the banking crisis of the 1930s2/ has the federal government focused so intensely on the problem of resolving failed depository institutions.3/ As the Federal Deposit Insurance Corporation

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1/ 315 U.S. 447 (1942).

2/ For background on the 1930s banking crisis, see 2 Michael P. Malloy, Banking Law and Regulation 7.7 - 7.16 (1994), and sources cited therein.

3/ See 1 Malloy, supra note 2, at §§ 1.4.3, 1.4.5-1.4.6 (discussing 1989, 1991 and 1994 legislation). See also Bruce A. Green, After the Fall: The Criminal Law Enforcement Response to the S&L Crisis, 59 Fordham L. Rev. S155 (1991) (discussing 1989 legislative response adding new criminal sanctions); Michael P. Malloy, Double, double toil and trouble: Bank Regulatory Policy at Mid-Decade, 63 Fordham L. Rev. --- (forthcoming May 1995) (discussing 1989-1994 legislation and offering mid-decade assessment); Note, Causes of the Savings and Loan Debacle, 59 Fordham L. Rev. S263

(FDIC)4/ has become extensively involved in litigation related to resolutions, unusual, and often unanticipated, factual situations have arisen calling into question5/ the appropriate application of the provisions of federal statutory law to specific cases.6/

One aspect of this statutory law that raises significant concern in this regard is section 13(e) of the Federal Deposit Insurance Act (FDIA).7/ This provision codifies, in a more elaborate and formal way, the holding of the Supreme Court's 1942 decision in the D'Oench, Duhme case.8/ The case and the statutory provision elaborating upon it (and the subsequent cases applying the statute) are now often referred to collectively as the "D'Oench, Duhme doctrine."9/

(1991) (analyzing the 1980s crisis); Note, Playing with FIRREA, Not Getting Burned: Statutory Overview of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, 59 Fordham L. Rev. S323 (1991) (discussing 1989 legislation).

4/ For simplicity of presentation, these remarks refer only to the FDIC. For a limited time, the Resolution Trust Corporation is also involved in depository institution resolutions. See 1 Malloy, supra note 2, at 1.83 - 1.84. For discussion of the roles of the FDIC and the RTC in such resolutions, see Note, The Resolution Trust Corporation: Waste Management and the S&L Crisis, 59 Fordham L. Rev. S339 (1991).

5/ For a review and critique of such litigation, specifically with respect to the application of 12 U.S.C. § 1823(e), see J. Michael Echevarria, A Precedent Embalms a Principle: The Expansion of the D'Oench, Duhme Doctrine, 43 Cath. U. L. Rev. 745 (1994).

6/ For a discussion of the statutory authorities available to the FDIC in resolving problems of failing depository institutions, see 3 Malloy, supra note 2, at 11.27 - 11.45.

7/ 12 U.S.C. § 1823(e) (1988 & Supp. II 1990).

8/ Supra note 1.

9/ See, e.g., Echevarria, supra note 5, at 747 & n.5. Despite this generic identification, there are

The remarks that follow will first provide background analysis of the D'Oench, Duhme decision,10/ showing that it represents an intuitive, federal common law response to a very common sort of bank accounting fraud. Second, the remarks will review the current statutory authority of the FDIC under the doctrine,11/ suggesting that the statute and the subsequent case law have drifted away from the intuitive response of D'Oench, Duhme. Third, in light of this background and review, the remarks will then offer specific answers12/ to questions posed by Senator Cohen's letter of invitation.13/

1. D'Oench, Duhme on its own Terms

D'Oench, Duhme needs to be understood on its own terms. The case came before the Supreme Court on what we may view as, essentially, a federalism issue. When a federal instrumentality (the FDIC) sues a private party (D'Oench, Duhme & Co.) in the federal district court in the party's home state (Missouri), under the authority of a federal statute (the FDIA), in a controversy involving a contract between that party and a now defunct bank from a second state (Illinois), the "controversy revolves around the question as to what law is

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some significant distinctions to be drawn between the state of the law under the holding of D'Oench, Duhme itself and the formal requirements of the statutory provision. See infra, notes 65-76 and accompanying text (discussing the differences between D'Oench, Duhme and § 1823(e)). As a technical matter, the requirements of the statutory provision appear to have superseded the holding of the case. See Gunter v. Hutcheson, 674 F.2d 862, 869, 872 n.14 (11th Cir.), cert. denied, 459 U.S. 826 (1982) (FDIC operates under "specific statutory scheme").

10/ See infra notes 14-60 and accompanying text.

11/ See infra notes 61-89 and accompanying text.

12/ See infra notes 90-102 and accompanying text.

13/ Letter from Senator William S. Cohen to Professor Michael P. Malloy, Jan. 24, 1995, at 1. A copy of the letter is appended to these remarks.

applicable."14/ A court might apply directly the law of the state where the bank had been located when the transaction was entered into.15/ Alternatively, a court might choose a body of state law to apply based on some generalized principle of conflict of laws, such as choosing the law of the state where the contract was made.16/ However, a federal court might decide the conflict of laws issue by reference to the law of the state in which it sits.17/ Finally, if a court focused on the federal statute that empowered the federal instrumentality to initiate the suit, it might view the case as "involv[ing] decision of a federal, not a state, question,"18/ and thus decide the case on the basis of federal law. It was this last approach that ultimately served as the basis for Justice Douglas' majority opinion in D'Oench, Duhme.19/

In this sense, then, D'Oench, Duhme may be viewed primarily as a case working out some of the implications of Erie R. Co. v. Tompkins.20/ Decided four years before D'Oench, Duhme, Erie held that in diversity cases21/ a federal court is compelled to apply state law, and it declared that "[t]here is no federal

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14/ D'Oench, Duhme, 315 U.S. at 455.

15/ This was the option chosen by the district court in D'Oench, Duhme. See id.

16/ This was the option chosen by the the court of appeals. D'Oench, Duhme & Co. v. FDIC, 117 F.2d 491 (8th Cir. 1941), affirmed on other grounds, 315 U.S. 447 (1942).

17/ This was the option urged by the private party. See D'Oench, Duhme, 315 U.S. at 455.

18/ Id. at 456.

19/ See id. at 455-56 (distinguishing the approach taken in diversity cases and arguing for a federal rule of decision).

20/ 304 U.S. 64 (1938).

21/ See 28 U.S.C. § 1332 (1988) (jurisdiction of federal courts based on diversity of citizenship of parties).

general common law"22/ to be applied in such cases.23/ While recognizing that, in diversity cases, the federal courts must follow the local forum's conflict of laws rule in deciding what state law principles to apply,24/ the Court in D'Oench, Duhme took the position that FDIC resolutions under the FDIA involved "a federal, not a state, question" outside the ambit of the Erie doctrine.25/

What, then, is the federal rule of decision fashioned in D'Oench, Duhme itself? The rule responded directly to the specific facts before the Court, facts which may serve as the basic scenario that gives sense to the so-called D'Oench, Duhme doctrine in subsequent litigation. Briefly, the scenario may be understood in the following terms.26/

A Corp., located in state X, sells bonds to B Bank, located in state Y, in 1926. The bonds are later defaulted. In order to assist B in avoiding a realized loss of the bonds on its books, A executes demand notes

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22/ Erie, 304 U.S. at 78.

23/ For an interesting analysis of the implications of Erie for decisions involving federal question jurisdiction, see D'Oench, Duhme, 315 U.S. at 465-75 (Jackson, concurring) (offering "a more explicit answer to the question whether federal or state law governs our decision").

24/ See D'Oench, Duhme, 315 U.S. at 455 (citing Klaxon Co. v. Stentor Electric Mfg. Co., 313 U.S. 487, 496 (1941)). The D'Oench, Duhme Court explictly declined to decide whether the rule in Klaxon, a diversity jurisdiction case, would require application of local forum state conflict of laws principles with respect to state law aspects of a case arising under federal question jurisdiction. D'Oench, Duhme, 315 U.S. at 456.

25/ D'Oench, Duhme, 315 U.S. at 456, citing Deitrick v. Greaney, 309 U.S. 190 (1940) (involving National Bank Act).

26/ The facts contained in the scenario that follows are drawn from the Court's factual statement of the case. Id. at 453-454.

in B's favor in 1933. (A's president signed the notes and was aware of their intended purpose.) Any proceeds from the bonds are to be applied to the notes. The receipt for each note contains the statement, "This note is given with the understanding it will not be called for payment. All interest payments to be repaid."27/ A makes interest payments on the notes, to give the appearance that they are performing assets on B's books. In 1933, A executes a new note in renewal of the original notes, presumably subject to the same restriction contained in the original receipts. In 1934, the FDIC insures the deposits of B.28/ B fails some time thereafter, and in 1938 the FDIC arranges for the assumption of B's deposits by another bank, lending B over $1,000,000 to facilitate the assumption transaction.29/ As collateral for the loan, the FDIC acquires, among other assets of B, the renewal note. When the FDIC sues A on this demand note, A raises as a defense its agreement with B (evidenced by the receipts for the original notes) that the note will not be called.

In responding to this defense, a number of approaches may be available to the FDIC, depending upon the specifics of the varied bodies of state law that might be applicable to the merits of the suit on the

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27/ Echevarria characterizes these notes as "on their face . . . nonnegotiable," citing D'Oench, Duhme, 315 U.S. at 454. Echevarria, supra note 5, at 764 & n. 134. However, the opinion does not explicitly characterize the notes as nonnegotiable; it merely describes the transactions between the bank and the firm and quotes the language of the receipts given for the note. D'Oench, Duhme, 315 U.S. at 454. Cf. UCC § 3-104(a)(3), (d) (to render ostensibly negotiable instrument nonnegotiable, restrictions on its negotiability must be conspicuous on the face of the instrument).

28/ Echevarria states that the FDIC did not insure deposit accounts until 1950. Echevarria, supra note 5, at 754-755. But cf. id. at 764 n.139 (acknowledging that the FDIC was insuring deposit accounts in 1934).

29/ For a discussion of assumption transactions in this context, see 3 Malloy, supra note 2, at 11.23-11.25.

note.30/ Perhaps state Y's law would apply estoppel to bar the defense.31/ Perhaps state Y would consider the FDIC to be a holder in due course, entitled to cut off such defenses by the maker of the note.32/ However, to the extent that the status of the defense is essentially a matter of applicable state law (however the court may be required to choose the applicable state law), results in FDIC suits initiated pursuant to its authority under the FDIA will potentially vary from state to state.33/

In his opinion for the Court, Justice Douglas essentially cut across these considerations by asserting that the issue was a question of federal law.34/

30/ Cf. supra notes 15-18 and accompanying text (discussing alternative bodies of state law that might provide the rule of decision in the case).

31/ The FDIC made such an estoppel argument before the Court. D'Oench, Duhme, 315 U.S. at 456. For a very useful discussion of judicial use of the estoppel doctrine to bar a defense, see Echevarria, supra note 5, at 756-764 (arguing that the "estoppel" rule invoked in such cases was really grounded on a concern over the "illegality" of the transaction undermining the stability of the banking system).

32/ This appeared to be the approach taken by the lower courts in D'Oench, Duhme, applying Illinois law. See D'Oench, Duhme, 315 U.S. at 455. D'Oench, Duhme disputed the FDIC's status as a holder in due course. Id. at 456. Cf. UCC § 3-305 (1990) (holder in due course rule).

33/ For example, counsel for D'Oench, Duhme argued that under Missouri law a court would presume that Illinois law was the same as Missouri Law, D'Oench, Duhme, 315 U.S. at 455, and that under Missouri law all defenses to the note would be available. See id. at 452 (statement of Argument for Petitioner, citing Missouri cases). Counsel also argued that the note failed for lack of consideration. Id. at 456. But cf. id. at 462-463 (Frankfurter, concurring in the result) (disputing the conclusions to be drawn from Missouri case law).

34/ Id. at 456.

Reviewing the relevant provisions of the predecessor to the FDIA, the Court identified "a federal policy to protect [the FDIC], and the public funds which it administers, against misrepresentations as to the securities or other assets in the portfolios of the banks which [the FDIC] insures or to which it makes loans."35/ Furthermore, the Court read its earlier decision in Deitrick v. Greaney 36/ as involving a similar federal policy with respect to concealment of a transaction that violated express prohibitions under the National Bank Act (NNA).37/ However, Deitrick did not squarely resolve the issue in D'Oench, Duhme. In the former case, the scheme was contemporaneously intended to conceal a violation of the NBA, whereas in the latter case, the concealment occurred before the FDIC existed. Hence, one could not say that the concealment was intended to deceive the FDIC.38/

Nevertheless, the Court found guidance in a general principle that it derived from Deitrick. In doing so, however, it eliminated the violation of a specific statutory provision -- a factor present in Deitrick itself -- as a material element of the general principle that it identified. The Court stated:

> the reach of the rule which prevents an accommodation maker of a note[39/] from setting up the defense of no consideration against a bank or its receiver or creditors is not delimited to those instances where he has committed a statutory offense. As indicated by the cases cited in the Deitrick case, an accommodation maker is not allowed that defense as against the receiver of the

35/ Id. at 457.

36/ 309 U.S. 190 (1940).

37/ Id. at 198.

38/ D'Oench, Duhme, 315 U.S. at 457.

39/ An "accommodation maker" of a note may be understood as a person who signs a note, without consideration, intending to lend his credit as an accommodation to another party. See, e.g., Bank of Crockett v. Cullipher, 752 S.W.2d 84, 89 (Tenn. App. 1988) (discussing the concept).

> bank and its creditors, or at times even against the bank itself, where his act contravenes a general policy to protect the institution of banking from such secret agreements. In some of those cases, the accommodation maker was party to the scheme of deception, in the sense that he had full knowledge of the intended use of the paper. . . . In others he had "no positive idea of committing any fraud upon anyone." . . . Yet, he has not been allowed to escape liability on the note as against the receiver even though he was "very ignorant and ill-informed of the character of the transaction."40/

Having generalized the policy underlying Deitrick and the cases that it cited in fashioning a guiding principle, the Court then implictly addressed the problem created by the sequence of the events in its basic scenario, namely, the fact that the FDIC did not exist at the time of the contravention of this general policy. Just as it jettisoned the element of violation of a specific statutory provision, so also the Court eliminated any element of direct contemporaneous injury as a requirement for finding liability. In this regard, the Court asserted that "the fact that creditors may not have been deceived or specifically injured is irrelevant."41/ What is intended under the Court's construction of this federal rule of decision in D'Oench, Duhme is not the redress of some specific injury to parties dealing with the bank, but rather, the vindication of a systemic, regulatory value or objective. As the Court explicitly indicates, "it is the 'evil tendency' of the acts to contravene the policy governing banking transactions which lies at the root of the rule."42/

The Court then reintegrated this generalized policy into a specific analysis of the factual scenario presented by the case. D'Oench, Duhme did not know (indeed, under the circumstances could not know) that the note would be used to deceive the as yet nonexist-

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40/ D'Oench, Duhme, 315 U.S. at 458-459 (omitting citations).

41/ Id. at 459.

42/ Id. at 459, quoting Deitrick, 309 U.S. at 198.

ent FDIC.43/ However, since direct contemporaneous injury is not an element under the rule fashioned by the Court,44/ and since in any event "no positive idea of committing any fraud upon anyone"45/ is required under the Court's rule, the firm's actual knowledge of any possible deception of the FDIC would seem to be irrelevant.46/ Nevetheless, the opinion can be read to suggest that such knowledge could be inferred from subsequent facts.47/

43/ D'Oench, Duhme, 315 U.S. at 459.

44/ See supra text at note 41. See also D'Oench, Duhme, 315 U.S. at 461: "The federal policy expressed in the Act, like its counterpart in state law, is not dependent on proof of loss or damage caused by the fraudulent practice."

45/ D'Oench, Duhme, 315 U.S. at 458, quoting Denny v. Fishter, 36 S.W.2d 864, 865 (Ky. 1931).

46/ See, e.g., D'Oench, Duhme, 315 U.S. at 460:

> [O]ne who gives such a note to a bank with a secret agreement that it will not be enforced must be presumed to know that it will conceal the truth from the vigilant eyes of the bank examiners. . . . The test is whether the note was designed to deceive the creditors or the public authority, or would tend to have that effect. It would be sufficient in this type of case that the maker lent himself to a scheme or arrangement whereby the banking authority on which [the FDIC] relied in insuring the bank was or was likely to be misled.

(Emphasis added.)

47/ See id. at 459-460, where the Court observed:

> [T]he permission which [D'Oench, Duhme] gave the bank to carry the note as a real asset was a continuing one and not revoked. That permission must be presumed to have included authority to the bank to treat the note as genuine for purposes of examination at the hands of the public authorities as well as for its general banking activities.

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The firm did not participate in or even know of the eventual use by the bank of the note as part of its collateral for the FDIC loan.48/ Still, on the facts of the case, it was literally the case that "it was responsible for the creation of the false status of the note in the hands of the bank."49/ As a result, its actions implicate "the federal policy to protect [the FDIC] against such fraudulent practices,"50/ and vindication of that policy directly leads, in the Court's view, to the barring of the firm's defense to the note.51/

It may be useful to emphasize that what the Court was doing in this case was to construct, independent of corresponding state law doctrines to which it referred, a justification for barring the defense derived from the Court's perception of the public policy underlying the FDIA. While it may appear that the guiding principle of decision in the case is related to traditional state law concepts such as estoppel,52/ the Court it-

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> . . . Clearly [the FDIC] is a member of the creditor class which the banking authorities were intended to protect.

48/ Id. at 461.

49/ Id.

50/ Id.

51/ Barring the defense is necessary to vindicate the policy because,

> [i]f the secret agreement were allowed as a defense in this case the maker of the note would be enabled to defeat the purpose of the statute by taking advantage of an undisclosed and fraudulent arrangement which the statute condemns and which the maker of the note made possible.

Id.

52/ See id. ("federal policy expressed in the Act, like its counterpart in state law"). See also id. at 465 (Jackson, concurring) ("apply[ing] a doctrine of estoppel actually -- but not avowedly -- drawn from

self repeatedly and explicitly grounds its approach on the broader, less technical basis of the vindication of a public policy derived from its reading of the federal statutory scheme.53/ In other words, the decision represents an exercise in federal common law.

That the decision results in the construction of an independent federal common law principle, distinct from traditional state law concepts, is evident from the two concurring opinions in the case. Justice Frankfurter concurred in the result based on "whatever law be deemed controlling."54/ However, he concluded by insisting that "it seems unnecessary to force such a result [i.e., that the FDIA affirmatively applies to the facts of the case] when a solution according to settled doctrines is available."55/

Justice Jackson wrote in concurrence, but suggested that the Court should have been more explicit on "the question whether federal or state law governs our decision in this sort of case."56/ He viewed the issue raised by the case as involving "the question whether . . . we are bound to apply the law of some particular state or whether, to put it bluntly, we make

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common law sources"). Echevarria criticizes the decision in part on this basis. See Echevarria, supra note 5, at 768 (decision "based on the state common law estoppel precedents" and "framed in terms of a rule of estoppel").

53/ See, e.g., D'Oench, Duhme, 315 U.S. at 457 (provisions of the act "reveal a federal policy to protect [the FDIC]"); id. at 459 (acts tending "to contravene the policy governing banking transactions"); id. (principles applicable "because of the federal policy evidenced in this Act to protect [the FDIC]"); id. at 461 ("federal policy expressed in the Act"); id. ("federal policy to protect [the FDIC]"). Cf. id. at 457-458 (comparison with "policy of the National Bank Act"); id. at 461-462 (same).

54/ Id. at 462 (Frankfurter, concurring in the result).

55/ Id. at 465.

56/ Id. (Jackson, concurring).

our own law from materials found in common-law sources."57/ Unlike Justice Frankfurter,58/ Justice Jackson expressed a willingness to fashion an answer to a question not directly addressed by federal statute that would be "a part of the federal non-statutory or common law."59/ It is precisely the federal common law basis and effect of the Court's opinion that appears to distinguish Justice Frankfurter's concurrence in the result and Justice Jackson's decision to "concur in the Court's holding because [he thought] that the defense asserted [was] nowhere admissible against the [FDIC] and that we need not go to the law of any particular state as our authority for so holding."60/

2. Current FDIC Statutory Authority under the Doctrine

Justice Frankfurter's concern that there was "no federal statute to override" applicable principles of local state law61/ in a D'Oench Duhme situation was essentially met in 1950, when the Congress introduced

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57/ Id. at 468.

58/ See id. at 465 (Frankfurter, concurring in the result): "[W]e have put to one side as unnecessary to the disposition of this case, the duty of this Court to make law 'interstitially' . . . in controversies arising in the federal courts outside their diversity jurisdiction."

59/ Id. at 469 (Jackson, concurring).

60/ Id. at 473. However, Jackson did not go so far as to deny any role to a specific state's laws in determining the rights and obligations of the FDIC. In this regard, he observed:

> No doubt many questions as to liability of parties to commercial paper which comes into the hands of the [FDIC] will best be solved by applying the local law with reference to which the makers and the insured bank presumably contracted. . . . But [D'Oench, Duhme's] conduct here was not intended to confer any right on the bank. . . .

61/ Id. at 463 (Frankfurter, concurring in the result).

section 13(e) into the FDIA.62/ It was amended in 1989,63/ to expand the scope of the provision.64/

The amended FDIA continues65/ in a more formal and

62/ 12 U.S.C. § 1823(e) (1988 & Supp. II 1990). For a useful analysis of the legislative history of the provision, see Echevarria, supra note 5, at 768-770, 799.

63/ See Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, § 217(4), 103 Stat. 183, 256 (1989) (codified at 12 U.S.C. § 1823(e)) (applying the provision to FDIC in corporate capacity and to the RTC; and to direct claims against FDIC and RTC). For a general discussion of the FIRREA, see Gail & Norton, A Decade's Journey from "Deregulation" to "Supervisory Regulation": The Financial Institutions Reform, Recovery, and Enforcement Act of 1989, 45 Bus. Law. 1229 (1990); Malloy, Nothing to Fear but FIRREA Itself: Revising and Reshaping the Enforcement Process of Federal Bank Regulation, 50 Ohio St. L.J. 1117 (1989).

64/ Among other things, the provision now applies to affirmative claims as well as to defenses. Jackson v. FDIC, 981 F.2d 730 (5th Cir. 1992). Accord Bruneau v. FDIC, 981 F.2d 175 (5th Cir. 1992); FDIC v. Byrne, 736 F. Supp. 727 (N.D.Tex. 1990) (rule precludes affirmative claims as well as defenses).

65/ Some courts appear to take the position that section 1823(e) codifies but does not preempt the D'Oench, Duhme decision. See, e.g., FSLIC v. Griffin, 935 F.2d 691, 698 (5th Cir. 1991), cert. denied sub nom. Griffin v. First Gibraltar Bank, FSB, 112 S.Ct. 1163 (1992); Adams v. Madison Realty & Development, Inc., 746 F. Supp. 419 (D.N.J. 1990), affirmed, 937 F.2d 845 (3d Cir. 1991). See also FDIC v. Wainer, 124 N.E.2d 29 (Ill. App. 1955) (interpreting § 1823(e)); Central W. Rental Co. v. Horizon Leasing, 967 F.2d 832, 840 (3d Cir. 1992) (doctrine prevents use of "oral undocumented agreements" as defense against enforcement of FDIC judgment); FDIC v. Kasal, 913 F.2d 487 (8th Cir. 1990), cert. denied, 498 U.S. 1119 (1991) (applying § 1823(e)); Oliver v. RTC, 747 F. Supp. 1351 (E.D. Mo. 1990), affirmed, 955 F.2d 583 (8th Cir. 1992) (applying 1823(e)); Morgan v. Heights Sav. Ass'n, 741 F.

codified form the basic rule of D'Oench, Duhme barring the effect of secret agreements against the interests of the FDIC.66/ Under this rule, any agreement between a depository institution and a third party that would tend to diminish or defeat the interest of the FDIC in any asset acquired by it under the financial assistance provisions of the FDIA67/ or the conservatorship and receivership provisions of the FDIA,68/ either as security for a loan, by purchase, or as receiver, is invalid unless it meets certain specified condi-

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Supp. 620 (E.D.Tex. 1990) (applying doctrine to alleged pre-insolvency settlement of action on mortgage); Mery v. Universal Savings Ass'n, 737 F. Supp. 1000 (S.D.Tex. 1990) (applying § 1823(e) to partner's liability for partnership notes to failed institution); Carico v. First National Bank of Bogata, 734 F. Supp. 768 (E.D. Tex. 1990) (applying § 1823(e)). See generally FDIC v. Kucera Builders, Inc., 503 F. Supp. 967, 970 (N.D.Ga. 1980) (collecting cases); Skillern, Federal Deposit Insurance Corporation and the Failed Bank: The Past Decade 99 Banking L.J. 292, 295-305 (1982) (discussing cases interpreting § 1823(e)). But cf. Gunter, supra note 9 (suggesting that § 1823(e) supersedes D'Oench, Duhme).

66/ 12 U.S.C. § 1823(e). See Timberland Design v. FDIC, 745 F. Supp. 784 (D.Mass. 1990), affirmed, 932 F.2d 46 (1st Cir. 1991) (applying amended § 1823(e) retroactively to the benefit of FDIC as receiver); FDIC v. Sullivan, 744 F. Supp. 239 (D.Colo. 1990) (applying amended § 1823(e) retroactively); RTC v. Camp, 965 F.2d 25, 31 (5th Cir. 1992) (avoiding question of retroactivity). Cf. RTC v. Murray, 935 F.2d 89, 94 (5th Cir. 1991) (extension of doctrine to RTC claims); Olney S&L Ass'n v. Trinity Banc Savings Ass'n, 885 F.2d 266 274 (5th Cir. 1989), rehearing denied, 892 F.2d 78 (extension of doctrine to FSLIC claims).

67/ 12 U.S.C. § 1823(c). On financial assistance provisions of the FDIA, see 3 Malloy, supra note 2, at 11.26, 11.30 - 11.31.

68/ 12 U.S.C. § 1821. On conservatorship and receivership powers, see 3 Malloy, supra note 2, at 11.31 - 11.35.

tions.69/ These statutory conditions, nowhere to be found explicitly in D'Oench, Duhme itself, are as follows:

(i) The agreement must be in writing.70/

(ii) The agreement must have been executed by the depository institution and the third party contemporaneously with the acquisition by the institution of the asset in question.71/

(iii) The agreement must have been approved by the institution's board of directors or its loan committee.72/

(iv) The agreement must have been, continuously from the time of its execution, an official record of the institution.73/

Thus, if these statutory conditions are not met,74/ if the depository institution A had among its

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69/ 12 U.S.C. § 1823(e). The doctrine may even be raised in the first instance on appeal in exceptioanl circumstances. In re 604 Columbus Avenue Realty Trust, 968 F.2d 1332, 1343-1344 (1st Cir. 1992) (discussing circumstances).

70/ 12 U.S.C. § 1823(e)(1).

71/ Id. § 1823(e)(2).

72/ Id. § 1823(e)(3). This approval must be reflected in the minutes of the board or committee. Id.

73/ Id. § 1823(e)(4).

74/ A depository institution's alleged negligence in failing to meet these conditions is not imputable to the FDIC. FDIC v. Alker, 164 F.2d 469 (3d Cir. 1947). See also Timberland Design, Inc. v. First Service Bank for Savings, 932 F.2d 46, 50 (1st Cir. 1991) (actual knowledge of agreement by FDIC not a bar to application of the doctrine). The doctrine bars defenses and affirmative claims whether characterized as contract or tort. Id. But see FDIC v. Meo, 505 F.2d 970 (9th Cir. 1974) (third party's defenses valid under § 1823(e) if misrepresentation of bank's records not the result of

assets at the time of its default a note from Ms. S, but S claims that the note was only given to A to help it conceal its owenership of past due defaulted bonds, and that there was an understanding between A and S that the note would not be called for payment, the FDIC as receiver would be able to call the note, the "secret agreement" between A and S being invalid. This result would, of course, be the same if one were solely applying D'Oench, Duhme itself, rather than the statute.75/ However, the array of technical requirements enunciated in § 1823(e), and the broad application given to it by the courts, reaches out to bar a significantly wider range of claims.76/

These increasingly expansive applications of the D'Oench Duhme rule at the core of § 1823(e) have moved it progressively further from the common law underpinnings of the decision. Justice Frankfurter could reasonably view the result under the majority opinion as functionally indistinguishable from the results one might obtain under a state law equitable estoppel theory 77/ or under a state law application of the

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action or inaction of the third party). Prior to Gunter, supra note 9, there had been decisions suggesting that a defense of fraud in the inducement on the part of the depository institution may constitute a good defense despite § 1823(e). See Black v. FDIC, 640 F.2d 699 (5th Cir. 1981); FDIC v. Hoover-Morris, 642 F.2d 785 (5th Cir. 1981). Cf. FDIC v. Selaiden Builders, 973 F.2d 1249, 1254-1255 (challenging ownership by FDIC of notes in question); RTC v. Oaks Apartments Joint Venture, 966 F.2d 995, 999-1001 (5th Cir. 1992), rehearing denied, 974 F.2d 1337) (defenses based on obligations contained in integral loan agreement documents); FSLIC v. Mackie, 962 F.2d 1144, 1150-1151 (5th Cir. 1992) (same); Garrett v. Commonwealth Mortgage Co. of America, 938 F.2d 591, 594-595 (5th Cir. 1991) (defenses involving breach of fiduciary duty or negligence not necessarily dependent on "secret agreement")

75/ See D'Oench, Duhme, supra note 1 (so holding).

76/ For a thorough discussion of the progressively expansive application of § 1823(e) by the courts, see Echevarria, supra note 5, at 771-796.

77/ See D'Oench, Duhme, 315 U.S. at 462-463

concept of the rights of a holder in due course to sue on a note without regard to most defenses of the maker.78/ Likewise, Justice Jackson could safely assume in light of his reading of the case that the FDIC could "succeed only to the rights which the bank itself acquired where ordinary and good-faith commercial transactions are involved."79/ However, no such assumptions can be safely entertained under the statutory version of the D'Oench, Duhme doctrine, for several reasons.

First, the equities of the parties no longer count. Any distinction between the good faith of an innocent third party dealing with a bank and, for example, the bad faith of a participant in a bank's scheme to conceal its losses is essentially irrelevant to the harsh application of the statutory provision.80/ Indeed, a whole spectrum of equitable defenses, arguably not even "agreement-based" are barred by current judicial interpretations of § 1823(e).81/

Second, the FDIC occupies a favored status as a holder in due course. Under generally applicable law, a holder in due course is still subject to a defense by the maker of the note that it was based upon a misrepresentation inducing the maker to sign the instrument.82/ However, under the current judicial interpre-

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(Frankfurter, concurring in the result) (discussing likely result under Missouri estoppel principles).

78/ See id. at 463 (referring to Illinois law, treating FDIC as holder in due course).

79/ Id. at 474 (Jackson, concurring).

80/ See, e.g., Langley v. FDIC, 484 U.S. 86 (1987) (oral misrepresentations by bank concerning subject property and materially misleading borrowers treated as "agreement" subject to the formal requirements of § 1823(e); barring borrowers' claim).

81/ See, e.g., Echevarria, supra note 5, at 774 n. 193 (collecting cases). But see Gunter, 674 F.2d at 867 (certain misrepresentations not "agreements" for purposes of § 1823(e)).

82/ UCC § 3-305 (1987). The revised version of

tations of § 1823(e), such fraud defenses are barred where the pertinent "agreement" does not comply with the technical requirements of the section.83/

Third, the fact that a third party dealing with a bank is acting consistent with ordinary good faith is irrelevant to the question whether the technical requirements of the provision are satisfied.84/ Some relief from this exclusively statutory approach might seem promised by the 1982 decision of the Eleventh Circuit in Gunter v. Hutcheson,85/ which used an independent federal common law analysis outside the scope of the statutory requirements of § 1823(e).86/ Although the specific federal common law rule adopted by Gunter itself barred the fraud claim in that case,87/ in principle the approach of the case might leave open the possibility of applying other federal common law rules, outside the ambit of § 1823(e). Unfortunately, Gunter may be of questionable authority, in light of the Supreme Court's recent decision in O'Melveny &

Article 3 of the UCC continues this rule. See UCC § 3-305(a)(1)(iii) (1990).

83/ See, e.g., Echevarria, supra note 5, at 778-789 (discussing cases). Even if a misrepresentation were not considered an "agreement" for these purposes, see Gunter, 674 F.2d at 867, they might still be barred under the broad scope of a federal common law holder in due course rule that bars ordinary fraud claims. See id. at 873. However, the validity of Gunter's federal comon law approach may now be questionable, in light of the Supreme Court's 1994 decision in O'Melveny & Myers v. FDIC, 62 U.S.L.W. 4487 (1994). See infra notes 97-102 and accompanying text (discussing possible effect of O'Melveny & Myers).

84/ See, e.g., Echevarria, supra note 5, at 748-751, 801-802 (discussing unreported case of Bartram v. FDIC; claims of good faith parties, allegedly defrauded by savings and loan association, barred by § 1823(e)).

85/ Supra note 9.

86/ Gunter, 674 F.2d at 871-873.

87/ Id. at 873.

Myers v. FDIC,88/ refusing to fashion a uniform federal common law rule for imputation of bank officer's knowledge to the bank under the FDIA.89/

3. Responses to Questions posed by the Subcommittee

In light of the preceding discussion, I offer the following responses to the questions posed by Senator Cohen's letter.

a. Doctrinal expansion under statute and cases

I have no doubt that, in the five decades since D'Oench, Duhme was decided, federal bank regulatory law has experienced a significant expansion of the terms and scope of the legal principal enunciated in the case. First, the provisions of § 1823(e) on their own terms, even if construed narrowly, would represent a significant broadening of the original D'Oench, Duhme rule. The technical requirements of the provision90/ reach far beyond the basic scenario condemned by the D'Oench, Duhme Court,91 threatening even "ordinary and good-faith commercial transactions"92/ that fail to comply with those requirements.

The case law, especially within the past twenty years, has greatly expanded the scope of the original rule. Particular attention should be paid to the effect of those decisions reading such statutory terms as "agreement" so broadly as to draw within the scope of the technical requirements an array of oral communications, discussions and other circumstances which in no

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88/ Supra note 83.

89/ See infra, notes 97-102 and accompanying text (discussing possible effect of O'Melveny & Myers).

90/ See supra notes 70-73 and accompanyng text.

91/ See supra text at notes 27-29 (outlined the factual circumstances to which the original D'Oench Duhme rule responding).

92/ D'Oench, Duhme, 315 U.S. at 474 (Jackson, concurring).

practical sense could be considered agreements at all, "secret" or otherwise. Furthermore, the assimilation by the cases of even traditional equitable defenses (such as laches, waiver, and fraud) into the scope of the statute93/ creates a radically unbalanced approach to the basic policy objective identified by the case: protecting the FDIC from "fraudulent practices" by parties acting in concert with an insured institution.94/ The extension of § 1823(e) into such areas creates an inherently illogical result. For example, how is laches (an unfair and inequitable delay in pursuing a legal right or claim) supposed to be reduced to a writing contemporaneous with the original written agreement with the bank. By definition, at the time the agreement is signed no laches yet exists.

b. Holder in due course status

Cases like Gunter, according the FDIC a federal common law version of "holder in due course" that insulates the FDIC from defenses like fraud are to a significant extent a distortion of the concept as it operates under traditional common law and under the Uniform Commercial Code. Fraud, and specifically misrepresentations inducing the party to participate in the transaction, are normally valid against the holder in due course.

c. Impact on innocent parties

The impact of the D'Oench, Duhme doctrine, as modified by the statute and interpreted by the courts, places innocent third parties who have dealt with a now insolvent depository institution in an intolerably unfair position. This effect is well illustrated by reference to the holder in due course concept. One justification for excluding most defenses as against a holder in due course is that the maker of the note presumably retains a possible cause of action against the original party who took the note, and who has since negotiated it to the holder. As a practical

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93/ See Echevarria, supra note 5, at 774, 792 (discussing cases).

94/ D'Oench, Duhme, 315 U.S. at 461.

matter, this cannot be the result in § 1823(e) litigation, since the FDIC steps into this role precisely when the institution that took the note is insolvent and therefore judgment proof.

d. Continued application of the expanded doctrine

There is some merit in continuing to apply the doctrine in a relatively expanded form, that is, in a form more expansive than that which would exist under the holding in D'Oench, Duhme strictly construed. The case, emerging from a very fact-specific context, leaves much unresolved beyond its particular facts. How can a third party seeking to obtain a concession from a bank in negotiations or a modification of an ongoing contractual relationship ensure, as a practical matter, that the new arrangement will not be viewed after the fact as a "secret agreement," running afoul of the holding in the case? What should be the treatment of a third party who is not as egregiously culpable as D'Oench, Duhme itself, but still perhaps negligent or grossly negligent in its dealings with a bank? on the other side of the equation, how is the FDIC to assess the relative safety and soundness of institutions subject to its jurisdiction, either before any insolvency situation is apparent or at the initial stages of its response to a failure?

One benefit of the statute is that it provides more concrete guidance to all concerned parties. In a sense, of course, it may operate -- to the FDIC's advantage -- as a rather harsh federal statutory version of traditional state law statutes of fraud, mandating certain formalities (typically, a writing) for agreements to be enforceable. On the other hand, to the extent the statute's formal requirements are complied with, the third party in effect obtains the benefits of a safe harbor, sheltered from any unforeseen application of the general statement of the rule in the case itself.

The problem, however, is that the administrative and judicial practice that has grown up around D'Oench, Duhme and § 1823(e) has somehow detached the rule from its underlying rationale, the policy of protecting the FDIC from questionable or fraudulent schemes and practices. Hence, if the statute is retained, it needs to be drawn closer to the original factual scenario.

Of course, it may be argued that administrative and judicial practice in this area has drifted so far from the basic, intuitive objective of the rule and has become so ungovernable that it would better be to dispense with it, and allow these issues to be decided as a matter of federal or state common law, or some combination of both. There are two problems with this approach. First, resigning these issues to the common law may create, particularly in the short term, precisely the kind of indeterminacy and uncertainty of result that would benefit neither third parties nor the FDIC.

Second, the comforting assumption that traditional common law is fully capable of handling these issues, through such devices as the parol evidence rule, principles of equitable estoppel, illegality and related notions of public policy barring certain types of claims, may be overly optimistic. Speaking as a Contract Law professor, I would venture to say that nothing is quite so fact-specific and open to myriad variation as trying to develop -- across fifty jurisdictions and a range of different common law concepts -- a consistent national policy on this issue. A statutory approach gives a degree of certainty to third parties and genuinely protects the legitimate interests of the FDIC in resolving failing institutions.

Third, it is not clear that revoking § 1823(e) would simply return the situation to the intuitively sensible federal common law rule adopted in D'Oench, Duhme itself. The 1982 Gunter case opened up an area of federal common law, independent of both § 1823(e) and individual state common law, on the question of the rights of FDIC as a holder in due course. It did so, in reliance on the test of United States v. Kimbell Foods, Inc.,95/ finding that there was a need for a uniform federal rule with respect to FDIC resolution of failed institutions.96/ Can we safely assume, based on such precedents, that the uprooting of § 1823(e) would return us to a uniform and manageable federal common law rule?

95/ 440 U.S. 715 (1979).

96/ Gunter, 674 F.2d at 873.

The authoritative source of common law principles invoked in the context of federal bank regulatory law is far from certain, though often assumed to exist.97/ The validity of the approach suggested by Gunter has, in any event, been thrown into serious doubt by the Supreme Court's recent decision in O'Melveny & Myers.98/ There the Court considered the FDIC's argument that, in light of the Kimbell Foods test, it was necessary to fashion a uniform federal common law rule governing the imputation of the knowledge of the officers of a savings bank to the savings bank itself, to determine if the bank "knew" that its outside counsel had breached a fiduciary duty to it.99/ In the FDIC's view, a uniform federal common law barring such imputation to the bank, and hence to the FDIC standing in the bank's place as receiver, would vindicate the federal policy reflected in the "comprehensive legislation" amending the FDIA and giving the FDIC expanded powers as receiver.100/

Writing for a unanimous Court, Justice Scalia rejected each of the FDIC's arguments in this regard. Harking back to Erie, the opinion rejected the contention that a federal common law could exist to displace applicable local law. "The first of these contentions . . . is . . . plainly wrong. 'There is no federal general common law,'"101/ the Court declared, quoting Erie and ignoring D'Oench, Duhme. Furthermore, nothing in the comprehensive regulatory scheme of the FDIA was deemed to require even a more narrow federal common law rule barring the application of the state imputation rule against the interests of the FDIC.102/ Hence, it must be acknowledged that revocation of the statutory rule provided by § 1823(e) might well leave us, by

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97/ See, e.g., 1 Malloy, supra note 2, at 3.3 - 3.4 (discussing the problem of determining the source of common law rules in this context).

98/ Supra note 83.

99/ O'Melveny & Myers, 62 U.S.L.W. at 4488.

100/ Id. at 4489.

101/ Id. at 4488, quoting Erie, 304 U.S. at 78.

102/ Id. at 4489.

default, with a potential diversity of applicable state law rules on the subject, which would hardly facilitate the protection of the FDIC's legitimate interests.

e. Reforming the doctrine

This is not to say that § 1823(e) should simply be left alone, with all of its current interpretive gloss. Serious inequities do exist under current practice, and a legislative solution needs to be crafted that would protect the legitimate interests of innocent third parties in pursuing good faith claims and raising good faith defenses, without compromising the extremely important interests of the FDIA in swiftly and efficiently resolving situations of failing institutions. I would recommend an amendment of § 1823(e) that included the following features:

1. An explicit, statutory expression of legislative purpose to the effect that the claim/defense preclusion rule of § 1823(e) is intended to apply to any concealed agreement with respect to any asset acquired by, or defense of a liability assumed by, the FDIC that would tend to mislead supervisory authorities as to the financial condition of an insured depository institution in any material way.

2. A provision stating that the preclusion rule was not to be construed as conferring holder in due course status on the FDIC, nor to affect such status under applicable state law.

3. A provision stating that a claim or defense against the FDIC or a depository institution in conservatorship or receivership, based upon fraud, intentional misrepresentation, or other similar state common law cause of action by the institution or its "institution-affiliated parties" is not required to be based upon any written agreement.

Once again, I thank you for this opportunity to present my views to the Subcommittee, and I commend you for your attention to these important issues.

TESTIMONY OF

JOHN F. BOVENZI, DIRECTOR
DIVISION OF DEPOSITOR & ASSET SERVICES
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

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

BEFORE THE

COMMITTEE ON GOVERNMENTAL AFFAIRS
SUBCOMMITTEE ON OVERSIGHT OF GOVERNMENT MANAGEMENT
AND THE DISTRICT OF COLUMBIA
UNITED STATES SENATE

2:00 P.M.
TUESDAY, JANUARY 31, 1995
ROOM 342, DIRKSEN SENATE OFFICE BUILDING

Mr. Chairman, and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation about our policies for application of the D'Oench doctrine and 12 U.S.C. 1823(e). I welcome the opportunity to discuss these important public policy issues with you.

My testimony will briefly describe the D'Oench doctrine and the requirements of section 1823(e); the steps that the FDIC is taking to balance the interests of the regulators, the deposit insurance funds, creditors of failed banks and private parties; the important public policies served by D'Oench and section 1823(e); and the potential impact of amendments to limit the application of D'Oench and section 1823(e).

THE D'OENCH DOCTRINE

What is commonly referred to as the "D'Oench doctrine" is a principle of law applied by the courts to bar enforcement of secret agreements against the receiver of a failed bank. This legal principle states that an agreement with the bank is not binding after the bank fails unless it is in writing and recorded in the bank's files. The D'Oench doctrine arises from a 1942 United States Supreme Court decision whose full name is D'Oench Duhme & Co. v. FDIC. The related statute, section 1823(e), was enacted as part of the Federal Deposit Insurance Act (FDI Act) in

1950 and it codifies specific requirements for agreements to be binding if the bank subsequently fails.

The legal principles behind the D'Oench doctrine and section 1823(e) are important to the FDIC for a number of sound public policy reasons. The public policies achieved by these principles lie at the core of the ability of the FDIC and other bank regulators effectively to supervise open banks and to resolve the failures of failing banks. The ability to rely upon the records of a failed bank in order to evaluate its assets and liabilities is essential to protect the deposit insurance funds and the public interest in a sound banking system.

The public policies achieved by D'Oench and section 1823(e) include insuring the ability of bank regulators to accurately evaluate the books and records of open or failed institutions, the validity of the asset information provided on Call Reports submitted by banks to regulators, fairness to the creditors and depositors of a failed bank, and protection of the deposit insurance funds.

FDIC INITIATIVES REGARDING D'OENCH AND SECTION 1823(e)

While we believe that the FDIC's application of these legal principles over the past 40 years has been appropriate in the great majority of cases, we recognize D'Oench and section 1823(e)

involve a balancing of the public interest against private interests. Questions about the application of D'Oench or section 1823(e) were raised during Chairman Helfer's confirmation process and during testimony by Vice Chairman Hove last year. Chairman Helfer committed during her confirmation process to reexamine the FDIC's policies for the use of D'Oench and section 1823(e).

Chairman Helfer and the FDIC have followed through on this commitment by reviewing existing policies and preparing new guidelines to govern when and under which circumstances the use of D'Oench and Section 1823(e) will be appropriate. In addition, we are including recommendations for statutory changes as an attachment to our testimony today. We believe that these changes strike an appropriate balance by preserving the important public policy goals accomplished by D'Oench and section 1823(e), while addressing concerns about fairness.

GUIDELINES FOR APPLICATION OF D'OENCH AND SECTION 1823(e)

The FDIC has adopted Guidelines to govern the use of D'Oench and Section 1823(e). These Guidelines will insure that the FDIC, its outside attorneys, and its contractors apply these legal powers appropriately and consistently.

Adoption of the Guidelines goes back to the concerns raised in recent years by you, Mr. Chairman, and some of your colleagues

about the use of _D'Oench_ and Section 1823(e). The issue was also raised during Chairman Helfer's confirmation hearings. During March 1994, the FDIC established an inter-divisional working group to discuss an appropriate response to those concerns and to prepare recommendations to present to the new Chairman. The working group was made up of representatives of all affected groups within the FDIC, including those parts of the FDIC responsible for supervision of open banks, resolution of failing banks, and disposition of the assets and payment of claims against failed banks. In addition, the working group consulted extensively with representatives of the Resolution Trust Corporation.

As a result of the working group's efforts, and Chairman Helfer's leadership, the Guidelines were implemented during November 1994. All FDIC staff, outside law firms, and contractors are now subject to the Guidelines in all cases. The FDIC has been conducting training for its staff across the country regarding the Guidelines and has recently completed training of all staff in our New England offices.

The Guidelines provide a structure for the FDIC to promote the exercise of sound discretion and consistency in the application of _D'Oench_ and section 1823(e) by requiring prior Washington approval in seven specific categories of factual circumstances. Critical to the Guidelines is a recognition that

"case by case" review is necessary in appropriate cases to protect against unfairness while insuring that secret agreements remain barred. As a result, the Guidelines require FDIC attorneys, outside attorneys, asset servicing contractors, and other staff to obtain approval from FDIC Headquarters in Washington before asserting D'Oench or Section 1823(e) in any case within the seven categories.

The seven categories include claims by pre-closing vendors, claims or defenses asserted where an authorized bank officer signed the agreement but it was not included in the bank records, claims or defenses based on the bank's violation of some part of a written agreement, and claims where there is no loan transaction involved in the dispute. In these and the other categories of cases, D'Oench or section 1823(e) cannot be asserted without specific prior approval. Thus, the Guidelines will permit the FDIC to avoid inappropriate and inconsistent application of D'Oench and section 1823(e) while continuing the important public policy underlying them of barring secret agreements.

One of the few clear-cut examples where application of D'Oench and section 1823(e) generally is prohibited by the Guidelines involves claims by pre-receivership sellers or providers of goods and services to the failed bank. As Chairman Helfer and Vice Chairman Hove confirmed to Congress, D'Oench and

section 1823(e) will not be asserted to bar those claims where the goods or services were actually received by the bank, regardless of the existence of a written agreement.

We believe that the requirement of prior review and approval through current Legal Division procedures, in consultation with the FDIC's Division of Depositor and Asset Services (DAS), will promote a consistent approach to application of these powers. In addition, the flexibility contained in the proposed Guidelines permits a careful examination of the unique facts of a proposed case and avoids discouraging use of these powers to prevent secret agreements.

The Guidelines do not apply directly to purchasers of FDIC receivership assets because those assets, by definition, are neither owned nor controlled by the FDIC. The courts have, however, interpreted <u>D'Oench</u> as extending to asset purchasers. The FDIC is continuing to examine whether any more flexibility can be encouraged in those cases as well.

In summary, the Guidelines preserve the FDIC's flexibility in addressing the specific facts of individual cases, but provide additional safeguards against any overly aggressive application of <u>D'Oench</u> and section 1823(e). At the same time, the Guidelines will assist the FDIC in preserving the important public policy underlying these powers — that banking regulators must be able to

rely on the bank's records in evaluating open banks and in resolving failed banks.

PROPOSED STATUTORY AMENDMENTS

Although the FDIC believes that the new Guidelines will address many of the concerns about the application of D'Oench and section 1823(e), we have also attempted to develop legislative language consistent with the Guidelines. We have attached a copy of our proposed legislative changes to this testimony for the Committee's consideration. First, the amendment would bar the use of Section 1823(e) against any contractor, merchant, or other provider of a product or service to the failed bank worth $20,000 or less if the bank actually received the product or services. We have drawn this provision directly from your proposed legislation, Mr. Chairman. As a result, Section 1823(e) could not be used if the bank had hired a local nursery to plant flowers around a bank without a written contract. This is consistent with current FDIC policy that requires that D'Oench will not be asserted against vendors where the goods or services were actually received by the bank, regardless of the existence of a written agreement.

Second, the amendment would insure that agreements by the bank to settle or restructure a loan could not be challenged under Section 1823(e) simply on a current technical requirement

that the agreement be "contemporaneous" with the original loan's signing. Again, this proposed amendment is consistent with current FDIC policy, which bars use of the contemporaneous requirement in those circumstances.

Third, the amendment would eliminate the current statutory requirement that all binding agreements be approved by the bank's board of directors or loan committee. Instead, consistent with sound business practices, the amendment simply would require that the agreement have been approved by an authorized officer of the bank. This would prevent loan commitments by an unauthorized bank employee while insuring that legitimate agreements are recognized.

Fourth, the amendment would address the few cases where someone has obtained a written agreement signed by an authorized bank officer, but the agreement for some reason is never included in the bank's records. The amendment would insure that, in such cases, the agreement would be recognized even though it is not in the bank's records. It would protect the borrower or claimant who has taken every step within his control to record that agreement. Consistent with this intent, however, the amendment excludes insiders from the statutory exception because they have the ability to ensure proper inclusion of the agreement in the records. Therefore, a corrupt insider could not take advantage of his or her position to manipulate the bank's records.

In our view, the FDIC's proposed amendment preserves the important public purpose served by permitting bank examiners and receivers to rely on the bank records, while addressing those cases where an overly strict application of the current statute could result in unfairness. Statutory changes that completely eliminate the requirement of a written or recorded agreement, or which include a blanket exception if a misrepresentation or some deception is claimed, will not permit Section 1823(e) to fulfill its important public policy goals. In addition, statutory changes will not necessarily address the use of a judge-made rule such as D'Oench.

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

There are three general public policy goals accomplished by the D'Oench doctrine and section 1823(e). First, the D'Oench doctrine ensures that the banking regulators can rely on a financial institution's records for supervisory purposes and in order to protect the deposit insurance funds they administer. This goal encompasses the supervision of open banks, the determination of the least cost resolution of failing banks, and the efficient disposition of assets and payment of creditors of failed banks. Second, the D'Oench doctrine promotes careful consideration of lending practices, assures proper recordation of various banking activities and protects against collusive or erroneous structuring or restructuring of terms. Third, the D'Oench doctrine protects the innocent depositors and creditors

of a failed institution, including the FDIC, from absorbing the losses resulting from agreements that do not appear in the records and books of the institution.

If an obligation of an insolvent institution is not properly recorded in the institution's records, the banking regulators cannot accurately evaluate the institution's assets and liabilities. By allowing the federal regulators to rely on the accuracy of a failed institution's records, the D'Oench doctrine permits them to quickly and accurately evaluate an institution's assets and hopefully to avoid its failure. Should an institution ultimately fail, the D'Oench doctrine is critical to the FDIC's ability to quickly and accurately evaluate the institution's assets and liabilities and determine the most efficient resolution for that institution.

In 1991, Congress enacted the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). The prompt corrective action provision of FDICIA requires the appropriate federal banking agency, to appoint a receiver for the institution within 90 days of an insured institutions becoming "critically undercapitalized". If a deposit insurance fund incurs a material loss, a review is required of the circumstances and actions taken. This requirement puts a premium on quick action to prevent losses to the deposit insurance funds and requires efficient evaluation of the bank's capitalization.

If a bank fails, FDICIA requires the FDIC to determine how to "satisfy the Corporation's obligations to an institution's insured depositors at the least possible cost to the deposit insurance fund" and to document that analysis. This means that the FDIC must be able to rely on the bank's records to identify and establish the value of the bank's assets and liabilities. If the assets are worth less or the liabilities more extensive than evidenced in the bank's records due to the existence of undocumented agreements, the FDIC as the receiver of the failed bank may have difficulty in structuring a resolution without providing additional rights to acquiring banks to return assets or obtain indemnification from any costs. This will certainly raise the costs of resolving failed banks.

The FDIC's ability to properly value the assets and liabilities also assists it in promptly resolving failed institutions. As a result, depositors typically have access to their money the following day. In addition, the FDIC also often advances funds, known as advance dividends, to uninsured depositors or creditors based on the recovery it anticipates from the liquidation of the institution's assets. The efficient resolution of a failed bank and the prompt availability of deposits and advance dividends can be vitally important in a community that would otherwise be devastated by the closure of its primary bank. Without the ability to rely on the failed bank's books to value the assets, it would be considerably more

difficult for the FDIC to achieve prompt resolutions or to pay advance dividends.

DEVELOPMENT OF THE _D'OENCH_ DOCTRINE

In an effort to protect the federal deposit insurance funds and the innocent depositors and creditors of insured financial institutions, the courts fashioned a judge-made rule that bars a party who fails to fully document or record his or her agreement with a bank from relying on that agreement to assert a claim against a failed bank or to avoid payment of a debt owed to the bank. The courts phrased the test in terms of the failure to fully document or record the agreement as creating an arrangement that would tend to mislead the banking authorities because the arrangement would be secret.

The classic case is a borrower who signs a written loan agreement, but later claims that he or she had an unwritten promise from the bank that repayment could be on different terms or deferred completely, or that the bank would provide some additional services or sweetener not contained in the documents. If enforceable, this secret agreement would seriously undermine the ability of regulators and receivers to accurately determine the value of a bank's assets and liabilities.

The United States Supreme Court adopted and extended these principles in D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447 (1942). In D'Oench, the FDIC brought an action to enforce payment of a promissory note which it had acquired from a failed institution. As a defense to the action, the borrower claimed that it was not liable because the notes were given pursuant to an undocumented agreement that the notes would not be called for payment. The borrower raised the secret agreement and failure of consideration as defenses to the FDIC's action. The United States Supreme Court held that the secret agreement could not be a defense to a suit by the FDIC because, by simply entering into that agreement, the borrower allowed him or herself to create a transaction that could mislead the banking authorities. The Court refused to require intent to defraud by the borrower or claimant because the public purpose of requiring records in the bank's files would not be served by limiting the doctrine to those cases only.

ENACTMENT OF SECTION 1823(e)

Congress first enacted Section 1823(e) in 1950. Section 1823(e) currently imposes four requirements for an agreement to be enforceable against the bank receiver:

(1) The agreement must be in writing.

(2) The agreement must be executed by the bank and any person claiming under it contemporaneously with the

acquisition of the asset by the bank, which generally means the closing on the loan.

(3) The agreement must be approved by the board of directors or loan committee and reflected in the appropriate minutes.

(4) The agreement must be continuously an official record of the bank.

Effectively, this section bars any claim or defense to an agreement with the bank that is based on facts outside the documents contained in the institution's files. Like the D'Oench doctrine, section 1823(e) is designed to protect the federal banking regulatory authorities from undocumented agreements that impede the regulatory authorities' ability to perform their congressionally mandated functions.

Section 1823(e) was enacted to clarify and to provide the public with notice of the requirements for enforceable agreements. In particular, while D'Oench and later court decisions had involved debtors who had lent themselves to questionable arrangements, there was uncertainty as to the enforceability against the FDIC of "good faith" unrecorded side agreements. In fact, the final version of section 1823(e) was enacted because Congress concluded that simply limiting the statute to cases where the borrower or claimant committed fraud would not serve the goal of insuring reliable bank examinations

and immediate availability of depositor funds through prompt resolutions of failed banks.

From the congressional debates leading to the enactment of section 1823(e), it is clear that the statute was intended to provide the FDIC with additional assurance that it could rely on bank records. As recently as 1987, Justice Scalia, speaking for a unanimous Supreme Court, stated in Langley v. FDIC, 484 U.S. 86 (1987):

> [O]ne purpose of § 1823(e) is to allow federal and state bank examiners to rely on a bank's assets . . . Neither the FDIC nor state banking authorities would be able to make reliable evaluations if bank records contained seemingly unqualified notes that are in fact subject to undisclosed conditions.
>
> A second purpose of § 1823(e) is implicit in its requirement that the "agreement" not merely be on file in the bank's records at the time of an examination, but also have been executed and become a bank record "contemporaneously" with the making of the note and have been approved by officially recorded action of the bank's board or loan committee. These latter requirements ensure mature consideration of unusual loan transactions by senior bank officials, and prevent fraudulent insertion of new terms, with the collusion of bank employees, when a bank appears headed for failure.

It is instructive to note that this issue was apparently first brought to Congress's attention by Representative Frances E. Walter, a member of the House Judiciary Committee in 1949. One of Rep. Walter's constituents, Mr. Alker, had lost a case against the FDIC on the ground that D'Oench prevented use of certain oral agreements, even though he claimed that he had not participated in any deceptive scheme or arrangement.

Rep. Walter introduced a bill that, in addition to amending certain provisions of the criminal code, would have subjected the FDIC as receiver for a failed bank to any defense that could have been raised against the open bank, unless the borrower or claimant committed actual fraud. The bill would have been retroactive to 1933 and, hence, to Mr. Alker's case.

Hearings on the bill were held on August 10, 1949, and on June 12, 1950. The FDIC opposed the bill because it "would encourage secret agreements between a bank and its debtors, which conceivably might be short of actual fraud, to the detriment not only of [the FDIC], but also of general creditors and uninsured depositors."

The FDIC explained that insured banks:

> are examined by governmental authorities which in turn publish reports and statistics concerning their condition. All of such reports are intended to be and are relied upon by the public generally. This reliance of necessity is based upon what records of the bank disclose and the public invests or deposits its money accordingly. Even the most fundamental principles of honesty, aside from any technical rules governing distribution of property of an insolvent bank, require that these creditors be protected against any arrangements, understandings, or agreements which are not disclosed in the records of the banks and, therefore, would not be reflected in these reports.

The bill was also opposed by the Departments of Justice and Treasury, the Federal Reserve Board and the National Association of Supervisors of State Banks.

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Other witnesses and members of the Committee repeatedly expressed similar concerns about the bill and stressed the importance of the FDIC's ability to rely on the written records of the bank as well as the minimal burden a writing requirement would have on banks and their customers. One bank president testified:

> [T]he bank examiner is a representative of the public, and he has a right to rely on [the note], and I do not care whether he is an examiner for the FDIC, whether he is an examiner for the Comptroller's Office, or whether he is an examiner for one of the State Departments, I do not care who he is representing, he is still representing the American public and he has a right to know that within the four corners of the note that is all there is, that there is no more.

Rep. Walter's bill never left the Judiciary Committee.

On June 20, 1950, one week after the second of the hearings on H.R. 5811, the House Banking and Currency Committee held hearings on S. 2822, which was to become the FDI Act. Although S. 2822 as introduced contained no provision concerning the protection of the FDIC against unrecorded agreement, Rep. Multer, referring to the recent Judiciary Committee hearings, raised the issue in a question to FDIC Director Cook:

> Mr. Multer: There has been considerable litigation through the years during the existence of the Corporation in which contentions have been made that agreements between the banks and debtors have not been lived up to after the banks were closed down and that the FDIC, in collecting the assets of the bank, was put in a more favorable position than the bank itself would have been and that the FDIC could ignore the agreements with the debtors. I think some legislation has been introduced in a hearing held before another committee of the House on the subject. Can you tell us briefly whether or not there is any objection to putting into this proposed law an amendment to require the FDIC to comply with

any such agreements that have been made in good faith and which are properly recorded between the debtors and the banks closed up, or taken over, or merged?

Mr. Cook: I think that statement of yours covered the ground entirely — where you are properly supported by such agreements and not dependent upon oral agreements that have no binding effect. If the bars are once let down on that, there would not be a safe bank in the United States today, because anybody could claim that so-and-so had happened and there would be no evidence to support it. . . .

Mr. Multer: I think the policy of your bank is to honor any such bona fide agreement.

Mr. Cook: We never back away from a bona fide agreement , and when the record is clear we inherit that obligation and stand by it. We cannot be bound when there is no record.

The bill that the Banking Committee reported to the House contained the provision that has become Section 1823(e). The provision went beyond the ideas expressed in the Judiciary Committee hearings by opponents of Rep. Walter's bill and required more than merely a writing to support variations from the text of written obligations. It also required that such side agreements be executed by the bank and the debtor simultaneously with the execution of the note, that it have been continuously an official record of the bank, and that official minutes show that it was approved by the bank's board of directors or loan committee. With one minor change in language, the Committee provision became law.

Section 1823(e), strikes a careful balance between protection of borrowers and protection of depositors and bank creditors nationwide. On the one hand it precisely delineates

the means by which borrowers can protect themselves; on the other hand, it enables the FDIC to rely on the bank's records when assessing the true condition of FDIC-insured banks.

POTENTIAL IMPACT OF A STATUTORY AMENDMENT
TO LIMIT SECTION 1823(e) TO FRAUDULENT AGREEMENTS

A statutory amendment that would limit Section 1823(e) to agreements obtained by fraud could have an impact on the validity of asset information provided on Call Reports submitted by banks each quarter to regulators and on the FDIC's resolution and asset disposition activities. Such an amendment would severely limit the application of the D'Oench doctrine and section 1823(e) and eliminate the ability of bank examiners and the FDIC as bank receiver to rely on the bank's records in establishing the assets and liabilities of the bank. Just as it did 45 years ago, the FDIC would oppose a statutory change to limit section 1823(e) to fraudulent agreements because it would encourage secret agreements between a bank and its debtor to the detriment of the validity of asset reports by banks, to the FDIC as fiduciary of the Bank Insurance Fund, and to the general creditors of a bank in a resolution of a failed bank. The prompt corrective action and least-cost resolution requirements of FDICIA make this argument even more compelling today than it was then.

The FDIC should not have to prove fraud in order to achieve the important public policies underlying D'Oench and section

1823(e). To permit a borrower to avoid payment on a loan based upon some secret agreement or promise that does not appear on the face of the document would gut the fundamental federal policy underlying the D'Oench doctrine. As a federal appellate court colorfully noted in support of the D'Oench doctrine a few years ago:

> The dangers of a contrary policy should be obvious... Unrecorded agreements -- those rooted in the loose soil of casual transactions as much as those that spring from the malodorous loam of outright fraud -- are a threat to the ecology of the banking system that we can ill-afford. D'Oench forces borrowers to bear the risk that their unorthodox plants will bear no fruit. Those who till these soils may not shift the cost of their peculiar agronomy to the FDIC, the bank's depositors and unsecured creditors, and the taxpayers and depositors who fund the FDIC. [Emphasis added]

To remove the FDIC's ability to rely on the books and records of financial institutions would be to open the FDIC to claims based on oral representations and other secret agreements. A very rough estimate of the exposure which the FDIC has avoided through the use of D'Oench and 1823(e) in just the last two years is more than $1 billion in claims and counterclaims.

CONCLUSION

The D'Oench doctrine and section 1823(e) serve important public interests in the supervision, resolution and liquidation of banks. They involve a balancing of public interests against assuring fairness to private interests. The FDIC has implemented

guidelines and is offering legislative language in an attempt to achieve an appropriate balance between these competing interests.

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

PROPOSED AMENDMENT TO SECTION 1823(e)

(e)(1) IN GENERAL. No agreement which tends to diminish or defeat the interest of the Corporation in any asset acquired or the defenses of the Corporation to any liability assumed by it under this section, or section 11, or by purchase or by assumption, or as receiver of any insured depository institution, shall be valid or form the basis for a claim against the insured depository institution or the Corporation, unless such agreement --

(A) is in writing,

(B) was executed in the ordinary course of business by the depository institution through an officer with actual authority and any person claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition, release, or incurrence of the asset or of the liability by the depository institution, and

(C) has been, continuously, from the time of its execution, an official record of the depository institution.

(2) APPROVED AGREEMENTS.

(A) Notwithstanding subsection (e)(1)(C), an agreement which otherwise complies with subsection (e)(1) may be valid or form the basis for a claim against the insured depository institution or the Corporation only if the proponent of such agreement shall establish by clear and convincing evidence that the agreement was properly executed by the depository institution through an officer authorized by the board of directors to execute such agreements, as reflected in the minutes of the board, pursuant to the policies and procedures of the depository institution.

(B) INAPPLICABLE TO INSIDERS. The provisions of subsection (e)(2)(A) shall not apply to any agreement executed by the depository institution and any officer, director, shareholder, owner, affiliate, subsidiary, or other insider of such depository institution claiming an adverse interest thereunder.

(3) VENDOR AGREEMENTS. This subsection shall not apply to an agreement for goods and services actually received by or delivered to the depository institution prior to appointment of any receiver under section 11 in the value of $20,000 or less.

(4) EFFECTIVE DATE. Notwithstanding any other provision of law, this amendment shall apply only prospectively to any assets acquired or liabilities assumed by the Corporation from insured depository institutions for which the Corporation is appointed receiver after the enactment of this amendment.

TESTIMONY

OF

WILLIAM M. DUDLEY
VICE PRESIDENT OF THE ATLANTA OFFICE
OF THE RESOLUTION TRUST CORPORATION

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF
GOVERNMENT MANAGEMENT AND
THE DISTRICT OF COLUMBIA
OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS

OF THE UNITED STATES SENATE

2:00 P.M.
JANUARY 31, 1995
432 HART SENATE OFFICE BUILDING

Mr. Chairman and members of the Subcommittee. My name is William M. Dudley, and I am the Vice President of the Resolution Trust Corporation's ("RTC") Atlanta Office. I appreciate the opportunity to present testimony on behalf of the RTC regarding our experience with the legal principle concerning claims against failed financial institutions commonly referred to as the D'Oench doctrine. I have worked as a banking regulator for over 25 years and am very familiar with the use of the D'Oench doctrine from the regulatory perspective.

The D'Oench doctrine, and its statutory counterpart, 12 U.S.C. 1823(e), establishes that the RTC and Federal Deposit Insurance Corporation ("FDIC") are not subject to claims and defenses premised upon agreements allegedly made with a failed financial institution which are not properly recorded in the institution's official books and records. The D'Oench doctrine has provided a safeguard for taxpayer funds and, without it, the final cost of the RTC's mission would be significantly higher.

The issue that brings us here today is summarized aptly in a 1992 memorandum of the Counsel to the RTC's Inspector General ("IG"), during the IG's review of a D'Oench matter: "The savings and loan crisis has meant financial losses, and even ruin, for many people. It has also been a severe burden to the American taxpayer. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") directed the RTC to take all

reasonable steps to maximize return on institution assets and minimize taxpayer costs in the process of resolving institutions. At times, that means the RTC will take positions in litigating cases which will not be beneficial to individual opposing parties."

Having said that, the RTC understands the Chairman's concerns about D'Oench. While the RTC believes that D'Oench has, in general, served the public interest well, we also agree that it is appropriate to review the 44 year old statutory counter-part to D'Oench, and we would like to participate in that process. I will outline some suggested amendments later in my statement.

The RTC was created by the FIRREA. This legislation, enacted on August 9, 1989, was in response to widespread savings and loan failures and the resulting large financial deficit of the savings associations' insurance fund, the Federal Savings and Loan Insurance Corporation ("FSLIC").

This legislation, and subsequent funding bills, provided the RTC with the $89 billion dollars of taxpayer funds which have been expended thus far in the resolution of 744 institutions, and the protection of over 24 million deposit accounts. In providing these funds, the Congress directed the RTC, in addition to other important mandates, to conduct its activities in a manner that results in the greatest return to the United States on the

sale of institutions and assets. The Congress bestowed important tools upon the RTC to maximize the return on assets, including an explicit authority to utilize 1823(e), the statutory counterpart to the D'Oench doctrine (see appendix for legal and legislative background on the D'Oench doctrine).

The D'Oench doctrine ensures that receivers of failed federal financial institutions can rely on the institution's records. The doctrine promotes the federal policy of protecting taxpayers, depositors and creditors of failed financial institutions and federal deposit insurance funds from absorbing the losses resulting from unrecorded defenses and liabilities that would tend to diminish the assets of such institutions.

In the past, the D'Oench doctrine has also guarded against the haphazard or collusive restructuring of loans to the detriment of the institution and its creditors. As an institution nears failure, borrowers can bring pressure on individual employees or officers of the institutions to alter the terms of their loans to the advantage of the borrowers. This problem can be particularly acute when the borrowers are major customers or directors of the institution. Moreover, for regulatory reasons, it can also be to an institution's advantage to restructure a non-performing or poorly performing loan to mask its true condition. By requiring properly authorized and recorded written

loan amendments, D'Oench helps to insure that those with ultimate responsibility for the institution's health agree to loan modifications in a thoughtful and considered manner.

D'Oench is also helpful in defeating borrower defenses in cases in which secret side agreements were intended to aid in the fraudulent schemes of thrift insiders. For example, the RTC recovered $50 million in settlements with certain developers and borrowers who acted in collusion with Charles Keating to defraud Lincoln Savings. The D'Oench doctrine served to eliminate arguments that Lincoln was bound by Keating's unrecorded promises not to collect on the indebtedness.

The D'Oench doctrine encourages prudent consideration of lending practices and assures proper recordation of various banking activities. It also satisfies the need of banking regulators to be able to determine the face value of the assets of a failed institution. Should an institution ultimately fail, the D'Oench doctrine enables the FDIC and the RTC to evaluate the institution's assets and liabilities quickly and accurately to determine the most efficient resolution for that institution. This is important since the longer a failed institution remains in government control its value diminishes.

<u>RTC's Applications of D'Oench and 1823(e)</u>

Application of the <u>D'Oench</u> doctrine arises in the receivership claims process and in the context of litigation, where it is used in responding to claims and counterclaims by debtors. Virtually all claims against the failed institution are processed, and most are resolved, through the administrative claims process. Decisions to employ <u>D'Oench</u> in a particular claim are carefully made on a case-by-case basis in accordance with applicable law. In the course of this process, RTC receivership claims personnel work closely with Legal Division staff.

If litigation is brought, the case is assigned to an RTC in-house attorney in the appropriate field office. The field office attorney generally retains private counsel to handle the matter under the field attorney's supervision, pursuant to the RTC's "Guide for Outside Counsel". Decisions regarding the routine use of <u>D'Oench</u> and 1823(e) may be made by the field attorney and outside counsel.

In situations where the applicability of <u>D'Oench</u> and 1823(e) is unsettled or where the proposed assertion is novel or expanded, approval must be obtained from the Division of Legal Services in Washington, D.C. In Washington, the matter is assigned to the RTC in-house counsel with special expertise and experience in

this area. Decisions regarding availability of D'Oench and 1823(e) are guided by statute, opinions of the federal appellate courts and RTC policy. The facts of a particular case are analyzed to determine whether they support the use of D'Oench and section 1823(e) in that circumstance.

Thus, the RTC's procedure is that every lawsuit involving D'Oench and 1823(e) undergoes review and monitoring by an RTC attorney. That monitoring is most extensive in cases where the proposed application is novel or expanded, or where the law is unsettled. In a large organization such as the RTC - which has handled tens of thousands of claims and tens of thousands of lawsuits - occasional deviation may occur. However, the RTC strives for consistency in its handling of D'Oench and 1823(e).

The RTC understands that the Chairman is particularly interested in the treatment of claims by vendors and general trade creditors. These claims are governed by written guidelines in the RTC's Claims Manual, Conservator's Operations Manual and Directives. It is the RTC's practice to pay small vendor claims whether or not a written contract was approved and on the records of the institution, provided it can be established that the services were performed to the satisfaction of the receiver or the goods were delivered and accepted. The RTC recognizes that agreements with small vendors and general trade creditors are often not, in the normal course of business, reduced to writing.

However, in instances where a written contract would be a normal part of the business transaction, then RTC generally does require that the institution have a copy of the written contract.

Public Policy Implications of Continuing D'Oench

Mr. Chairman, your letter of invitation asked us to discuss the public policy implications for the continued application of the D'Oench doctrine. If the D'Oench doctrine and 1823(e) were eliminated, collusive side deals made on a wink or a handshake would flourish in a manner that could not be discovered by federal regulators, possibly encouraging the impairment of an institution's financial condition. Mr. Chairman, we agree with your floor statement of August 5, 1994, that "It (D'Oench) legitimately exists to prevent bad actors from using secret informal agreements that were clearly meant to defraud the failed bank, to defraud the government." Section 1823(e)'s requirements that the institution's transactions be approved by officially recorded action ensure that unauthorized side deals will not be given effect.

Without D'Oench and 1823(e) there also could be a substantial increase in litigation against failed banks and thrifts. Innumerable claims which otherwise might not have been brought, based upon the strength of the D'Oench doctrine and 1823(e), would likely be instituted. In addition, the RTC's ability to

recover on assets of a failed institution, e.g., defaulted loans, would be greatly diminished because defenses which would have been ineffective as a result of D'Oench and 1823(e) would then be available.

Litigation also would be more costly, reducing the funds available to pay legitimate creditors of the failed institution, and increasing the costs to taxpayers. In the vast majority of cases involving the RTC, claimants almost routinely include fraud, misrepresentation, or deception as part of the defense or counterclaim. Under D'Oench, most cases involving such allegations, where not based on a written document, are resolved on motion without the expense of a trial. Repeal of D'Oench and 1823(e) would in many cases preclude such prompt, cost-effective resolution.

Outstanding litigation may also discourage potential purchasers from purchasing assets of failed thrifts or greatly diminish the value of such assets, thus reducing the receiver's recovery for the receivership estate. Some courts have afforded the protections of the D'Oench doctrine to purchasers of a failed institution's assets. The rationale given is that this fosters the development of a secondary market for such assets, assisting the receiver to maximize their value and efficiently resolve failed institutions. Purchasers of assets from the RTC or FDIC may pay less for those assets if there is a greater chance that

the assets may be involved in litigation and that D'Oench would not be available.

In its deliberations on this subject, Congress should consider some of the cases in which D'Oench and 1823(e) have had a significant impact on the outcome. For example, in one case in which the FDIC sued to collect on notes and guarantees, the D'Oench doctrine precluded the defendant, who previously had been criminally convicted of bank fraud, from asserting - solely through oral testimony - that the bank had fraudulently induced him to enter into further loan transactions to satisfy his indebtedness. Based on D'Oench, the district court vacated a jury award in favor of the defendant and ordered a new trial which resulted in a verdict in favor of the RTC and FDIC of $11.9 million. Without recourse to the D'Oench doctrine and 12 U.S.C. 1823(e), the FDIC and RTC would have been at the mercy of whatever undocumented representations a convicted felon could have fabricated in order to further enrich himself at the expense of taxpayers.

Suggested Changes to Section 1823(e)

In enacting 1823(e), Congress sought to balance the interest of the public in the integrity of its financial institution regulatory system and the interest of people with legitimate claims against failed institutions. For the reasons stated

earlier in this testimony, we believe that D'Oench has served the insurance funds and the taxpayers well. After more than 40 years of experience, we believe it is appropriate to reexamine and perhaps refine the balance that was struck in 1950. At the same time, however, we urge caution in amending such a time tested doctrine.

Certain categories of claims could be exempted from 1823(e) without creating a significant risk of an increase in illegitimate claims or litigation. Small suppliers of goods and services to a financial institution are unlikely to take the precautions necessitated by 1823(e) to protect their claims for payment in case the institution fails. As discussed above, the RTC recognizes this fact of commerce and allows such claims when there is reliable evidence that the goods and services were actually provided. The RTC would support an amendment to 1823(e) exempting claims for goods and services of $20,000 or less.

In certain respects, the requirements of 1823(e) do not entirely reflect the manner in which many institutions legitimately operate today. The criterion in 1823(e) that a claim be based on an agreement approved by the board of directors or loan committee does not reflect current accepted business practices. Individual officers and employees often have specific written authority to approve certain types of transactions. 1823(e) could be expanded to permit claims based on agreements approved

by such persons, provided those claims otherwise meet the statute's requirements.

Finally, the requirement of 1823(e) which mandates that a claim must be based on a writing executed "contemporaneously" with the institution's acquisition of the associated asset fails to recognize that lenders and borrowers frequently adjust their agreements and renegotiate loans. This requirement could be eliminated from 1823(e) to reflect this commercial reality.

The RTC believes that amendments such as these would permit fair consideration of legitimate claims, while protecting the interests of the public. A more dramatic shift, however, could lead to more litigation and more costly resolutions of failed financial institutions. Similarly, any retroactive changes to the statute could impede the imminent completion of the RTC's mission, foster litigation, and increase the cost of the thrift clean-up effort.

Limiting D'Oench to Fraud Cases

Another proposal you have asked us to address is the concept of limiting the availability of D'Oench and 1823(e) to cases in which the claimant engaged in intentional fraud in his or her banking transactions. We have serious reservations regarding this proposal. Such an amendment would drastically reduce the

number of transactions to which D'Oench and 1823(e) would apply, and would essentially read them out of the law. Agreements obtained through fraud are already, in most cases, unenforceable. If D'Oench and 1823(e) were restricted to such claims, the RTC would have to establish its fraud claim through a judicial proceeding before it could be determined whether either doctrine would apply. However, having already proven a fraud case, there would then be no utility to using D'Oench or 1823(e).

Second, such an amendment would make the task of dealing with failed thrift litigation far more time consuming and expensive than it is now. If the key inquiry becomes whether there is intentional fraud on the part of the claimant in dealing with an institution, the FDIC and RTC would be forced to make case-by-case determinations to attempt to locate or identify any potentially legitimate side agreements. This could transform the administrative receivership claims process into a more formal, cumbersome and time consuming tribunal. The problems inherent in this task would be no less easy to deal with in court. Cases which would previously have been dismissed on motions for summary judgement could only be decided after taking testimony at lengthy trials.

An additional effect of an "intentional fraud" standard -- and the likely attendant increase in litigation -- is that it could delay termination of receiverships, perhaps for many years.

Another side effect is that potential purchasers of assets from FDIC and RTC -- who in the past have been able to use D'Oench and 1823(e) with respect to assets that they acquired from the RTC and FDIC as receiver of failed institutions -- may be more reluctant to purchase assets of failed thrifts, or would pay less for those assets. In sum, reducing D'Oench and 1823(e) to an intentional fraud standard would have consequences substantially similar to an outright repeal.

Similarly, an amendment which would make D'Oench and 1823(e) inapplicable in instances when a claimant asserts fraudulent conduct by the failed institution would effectively nullify the doctrine. It is our experience that in a very large percentage of cases in which the RTC has asserted D'Oench, the claimants have raised allegations of fraud by the failed institution or by third parties as a defense to their obligations to the failed institution or as the basis of an affirmative claim against the institution. If this defense were codified, we believe that fraud would be asserted in virtually all instances by claimants, effectively eviscerating the rule.

Mr. Chairman, thank you for the opportunity to appear today to present the RTC's views. I would be happy to answer any questions you or any Member of the Subcommittee may have.

Appendix

The *D'Oench Duhme* Doctrine

The D'Oench Common Law Doctrine

The *D'Oench* doctrine is a long-standing rule of federal law created by the U.S. Supreme Court in 1942 in the case of *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942). It has been applied broadly to a wide variety of claims against failed financial institutions for almost fifty-three years by courts all across the country. Under the *D'Oench* doctrine and 12 U.S.C. section 1823(e), its statutory counterpart, the RTC and FDIC are not subject to claims and defenses premised upon agreements allegedly made with a failed financial institution which are not properly recorded in the institution's official books and records.

In the original *D'Oench* case, a debtor executed several notes which were placed on the bank's books. Although the notes appeared valid and unconditional on their face, the debtor and the bank had an unrecorded side agreement that the notes would never be called for payment. The agreement was in writing, but did not appear in the institution's files. After the bank failed, the FDIC brought suit to collect on the notes and the debtor asserted a defense based upon the alleged side agreement. The Supreme Court ruled that the debtor was estopped from raising

the unrecorded side agreement to defeat collection on the notes because it was part of an arrangement which might tend to mislead bank examiners. The Court determined that such a rule was necessary to protect the deposit insurance funds against misrepresentations as to the securities or other assets in the portfolios of the banks.

The Supreme Court determined that regardless of whether the debtor intended to deceive the federal banking authorities, it should not be permitted to assert its defense because it was responsible for the creation of the false status of the note in the hands of the bank. The Court stated that the test is whether the note was designed to deceive the creditors or the public authority or "would tend to have that effect," regardless of whether creditors or the banking authorities were deceived or specifically injured. Numerous cases following the original D'Oench decision have held that D'Oench applies without regard to malfeasance, recklessness or negligence on the part of the claimant.

The Statutory Counterpart - 12 U.S.C. 1823(e)

In 1950 Congress enacted 12 U.S.C. 1823(e), the statutory counterpart to the D'Oench doctrine. It was made applicable to the RTC in 1989. The statute is more specific than the D'Oench common law rule in enumerating the recording requirements which

must be satisfied in order for an agreement to be enforceable against the FDIC or RTC. Section 1823(e) precludes claims against the RTC or FDIC based on an agreement unless the agreement:

> (1) is in writing,
>
> (2) was executed by the depository institution and any person claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the depository institution,
>
> (3) was approved by the board of directors of the depository institution or its loan committee, which approval shall be reflected in the minutes of said board or committee, and
>
> (4) has been, continuously, from the time of its execution, an official record of the depository institution.

All four requirements must be met for an agreement to be enforceable. Furthermore, an agreement which does not satisfy the requirements of section 1823(e) may not form the basis of an affirmative claim against the RTC or FDIC. 12 U.S.C. 1821(d)(9)-(A).

Legislative history on the provisions that ultimately were enacted as section 1823(e) reveals that Congress was persuaded by the public policy concerns articulated by the Court in D'Oench. In addition, the Supreme Court, in 1987, had the opportunity to revise the scope and policies of D'Oench as set forth in its statutory counterpart, section 1823(e), and confirmed the underlying principles of preventing the fraudulent insertion of new

terms with the collusion of bank employees, when a bank appears headed for failure.

As a result of section 1823(e), a federal receiver need only look to the express terms of the insolvent institution's official documents regarding its obligations. Any attempt to vary the express terms of those documents is barred because obligations not expressly manifested on the face of documents properly recorded in the institution's files are not enforceable.

File: 1/3/91

COMMONWEALTH OF MASSACHUSETTS

MIDDLESEX, ss.

SUPERIOR COURT
CIVIL ACTION
No. 89-2424

RHETTA B. SWEENEY,
Individually and as Trustee of the
MAPLE LEAF REALTY TRUST and of the
CANADIAN REALTY TRUST;
and
JOHN SWEENEY, Individually,
Plaintiffs

vs.

COMFED SAVINGS BANK,
COMFED MORTGAGE CO., INC.,
COMFED ADVISORY CO., INC.
and
DENNIS FUREY,
Defendants

OPINION AND ORDER ON POST-TRIAL AND POST-JUDGMENT MOTIONS

This opinion disposes of a number of post-judgment motions following a jury verdict on March 19, 1990, and following a hearing on presentation of arguments, affidavits, and memoranda submitted and filed by the plaintiffs and the defendants on those motions and upon the plaintiffs' claims under M.G.L. c. 93A.

For the facts in this action and upon which this opinion is based, this court refers to its Findings of Fact, Rulings of Law and Order filed this day. This action arose on several theories. Those causes of action submitted to the jury are as follows:

Count I: breach of contract

Count II: specific performance of contract to give partial releases (against defendant ComFed Savings Bank)

Count II: specific performance of contract to give partial releases (against defendant ComFed Savings Bank)

Count III: fraud in connection with $1.6 million loan against defendants ComFed and Furey

Count IV: breach of fiduciary duty with respect to $1.6 million dollar (against defendants ComFed and Furey) this count was waived by plaintiffs prior to submission of case to jury

Count V: breach of contract relating to the forward commitment in relation to the payment of $65,000 in interest (against defendant ComFed)

Count VI: breach of fiduciary duty with respect to the forward commitment in relation to the payment of $65,000 in interest; constructive trust (against defendants ComFed and Furey). This count was waived by plaintiffs prior to submission of case to the jury,

Count VII: interference with advantageous business relation (against ComFed and Furey),

Count VIII: Unfair and deceptive trade practices (against ComFed),

Count IX: Intentional infliction of emotional distress by plaintiff Rhetta Sweeney (against ComFed and Furey).

Prior to trial upon the plaintiffs' application and after hearing the court issued a preliminary injunction against ComFed precluding that bank from foreclosing on the $1.6 million loan which was in default. A memorandum of this court was filed at that time and is docketed as No. 47. Said preliminary injunction is

still in force. On March 16, 1990, the plaintiffs waived Counts IV and VI of their complaint.

A trial before a jury was commenced on February 26, 1990 and continuing until March 19, 1990, wherein the jury rendered a verdict by way of special questions. A copy of that verdict is hereby attached, marked "A" and made part of this decision. The court did not submit to the jury any questions with respect to Counts II and VIII and this court sat during the trial as judge without jury on those counts with the consent of all parties.

Subsequent to the trial and specifically on April 26, 1990, the court heard arguments as to Counts II and VIII and received in June 1990 suggested findings of fact and rulings of law from all parties. The court now makes findings of fact and rulings of law in this action with respect to Counts II and VIII.

GENERAL FACTS

I adopt as findings of fact those which are stipulated to by and between the parties as follows:

1. The plaintiff, Rhetta B. Sweeney as trustee, is the record owner of the real estate located at 776 Bay Road and 24 Meyer Lane in Hamilton, Massachusetts. Mrs. Sweeney is trustee of the Canadian Realty Trust and Maple Leaf Realty Trust, which trusts own these properties.

2. The real estate consists of a large house at 24 Meyer Lane and three acres of land; an antique house at Bay Road; three

buildable house lots and one buildable remaining lot with two barns on it.

3. Plaintiff John Sweeney is the husband of Rhetta Sweeney and brings this action as an individual.

4. Defendant, ComFed Savings Bank, is a federally charted savings and loan bank with a principal place of business in Lowell, Massachusetts. Defendants, ComFed Mortgage Company, Inc. and ComFed Advisory Company, Inc., are Massachusetts corporations with a principal place of business in Lowell, Massachusetts. Defendants ComFed are to be considered one group. The defendant Dennis Furey was and is an employee of ComFed.

5. In early 1987, Rhetta Sweeney entered into partnership negotiations with a professional developer, Congress Group Properties, Inc. ("Congress Group"). The negotiations led to a preliminary agreement on March 20, 1987, between Rhetta Sweeney and Congress Group for the development of the Sweeneys' real estate.

6. Congress Group acquired the then existing first mortgage on the Bay Road parcel to hold off foreclosure.

7. As of the summer of 1987, Rhetta Sweeney and Congress Group had failed to reach agreement on a partnership arrangement and terminated their relationship.

8. In July of 1987, Rhetta Sweeney retained Richard D. Simmons, Sr., a real estate appraiser and certified real estate counselor.

9. At the time, Harbor Equity Funds, Inc., which held a mortgage on the Bay Road parcel, was proceeding with a foreclosure action against that property.

10. In June, 1987, Rhetta Sweeney also retained the services of Cape Cod National Mortgage, a professional mortgage brokerage house. Mr. John Meldon, the President of Cape Cod National Mortgage, performed the services for the Sweeneys.

11. In July of 1987, Mr. Meldon contacted ComFed and thereafter a meeting took place between Mrs. Sweeney, Mr. Meldon, and Mr. Dennis J. Furey, an officer of ComFed.

12. Through the assistance of Mr. Meldon, the Sweeneys secured a written commitment dated August 20, 1987 from ComFed for a commercial loan of $1,600,000. The loan was intended to discharge the pre-existing debt and facilitate the work required to secure sub-division approval of the property from the Town of Hamilton.

13. The Sweeneys' loan with ComFed closed on August 27, 1987 in time to prevent the scheduled foreclosure by Harbor Equity Funds, Inc. The mortgages, liens, and pre-existing claims against the property which were discharged at or shortly after the closing totalled approximately $1,250,000.

14. In February of 1988, the Town of Hamilton approved the plaintiffs' proposed subdivision of the real estate. To date no sales have taken place of either of the pre-existing residences, structures or unimproved lots.

15. In August of 1988, the Sweeneys' loan with ComFed came due.

16. In the fall of 1988, Rhetta Sweeney and ComFed had negotiations regarding an additional loan of $175,000 for the purpose of implementing certain physical improvements to the existing homes and the site. This loan was the source of disagreement and never closed.

17. The total amount of principal, interest, and related charges claimed to be due as of February 1, 1990 is approximately $2.1 million.

18. In this case, the Sweeneys allege that ComFed failed to honor a commitment to provide further construction financing. The lawsuit seeks damages for breach of contract and other claims. ComFed has denied all the plaintiffs claims and seeks recovery on plaintiffs' Promissory Note to ComFed.

I make further findings as follows:

19. The plaintiff, Rhetta B. Sweeney, brought this action individually and as Trustee of the Canadian Realty Trust and Maple Leaf Realty Trust, the record owners of 776 Bay Road and 24 Meyer Lane respectively both in Hamilton, Massachusetts, and the plaintiff, John Sweeney, brought this action individually (both hereinafter collectively referred to as the "Sweeneys").

20. The corporate defendants ComFed Mortgage Company, Inc., and ComFed Advisory Company, Inc., are Massachusetts corporations wholly owned and controlled by the defendant, ComFed Savings Bank, (hereinafter collectively referred to as "ComFed").

21. The defendant, Dennis Furey, was at all times relevant hereto a corporate officer of ComFed, acting as agent, servant or employee of ComFed within the scope of his employment, (hereinafter referred to as "Furey").

22. Prior to July of 1987 the real estate, which is the subject matter of this litigation, consisted of a large home at 24 Meyer Lane in Hamilton, Massachusetts, situated on an approximately nine acre parcel of land and an antique home at Bay Road situated on a four acre parcel of land.

23. John and Rhetta Sweeney acquired the real estate involved in this case over a period of time beginning about 1966. Certain of the property was inherited by John Sweeney and other portions were purchased from family members. Prior to July 1987 both properties were encumbered by mortgage debts. In July of 1987 the mortgage in the sum of approximately $400,000 encumbering the Bay Road parcel was in default and in danger of foreclosure.[1] The mortgage encumbering the Meyer Lane parcel was not in default and not the subject of foreclosure.

24. Prior to July 1987 the plaintiff, John Sweeney, had experienced a period of business reversals owing to the failure of a business he and a partner had established in the early 1980's. In furtherance of that business the Sweeneys had placed virtually all of their savings and investments into John's business and had encumbered both of the parcels of land, which are the subject of

[1] Harbor Equity Funds, Inc. held a mortgage on the real estate located on Bay Road, Hamilton.

this litigation, in order to provide capital for that business venture. During this period of time the Sweeneys caused their property to be placed into trusts, which are also plaintiffs in this action (Exhibits 113, 123).

25. The Sweeneys encumbered the property with debts relating to personal and business expenses. Between 1983 and 1986, they placed on the property additional debt of approximately $760,000.

26. By July, 1987, the property had accumulated secured and unsecured debts of approximately $1,137,400 (Exhibit #151).

27. Prior to July 1987 the plaintiff, John Sweeney, was employed in the Philadelphia area and was commuting to the Sweeneys' Hamilton home on weekends only. Both Sweeneys were knowledgeable about business affairs.

28. In July of 1987, Rhetta Sweeney embarked on a program of trying to save her family's home and assets by seeking ways of doing so by the development, the refinancing, and the partial sale of the family's holdings. Rhetta had been engaged in some aspects of the advertising business in the early 1980's.

29. Rhetta Sweeney had been engaged in negotiations with a company known as Congress Group toward a joint venture project designed to construct condominium-style residences on the subject parcels. However, when the Town of Hamilton rejected such a concept, Rhetta terminated negotiations with the Congress Group in July, 1987. These facts concerning the financial background of the Sweeneys and their properties and their intention to construct

homes on the subject property were made known to Furey from the outset of his contact with the Sweeneys.

30. The Congress Group, in the context of a preliminary written agreement with Mrs. Sweeney, had assumed the existing first mortgage position of Eastern Bank on the Bay Road property.

31. By July, 1987, another mortgagee, Harbor Equity Funds, Inc., initiated, through public notice and the usual legal process, a foreclosure of the Bay Road property. A foreclosure sale was noticed and scheduled for September 1, 1987 (Exhibits 2 and 120). The prospect of imminent foreclosure sale caused the Sweeneys to look for immediate financing to refinance so much of the debt as would be necessary to avoid foreclosure.

32. The imminent foreclosure and the need to consolidate the existing debt caused Mrs. Sweeney to retain a mortgage broker, John Meldon of Cape Cod National Mortgage, to locate refinancing and a certified real estate consultant, Richard D. Simmons, Sr. to advise her on values and to assist in securing refinancing.

33. In July of 1987 through the efforts of Meldon, the plaintiff, Rhetta Sweeney, was introduced to ComFed's construction loan officer, Furey. Furey represented himself at that time and at all relevant times as a construction loan expert, who knew what was involved in the operation of real estate development. He did so deceptively and unfairly to get Rhetta to trust him and his expertise.

34. Meldon's initial request to ComFed on behalf of the Sweeneys for $725,000 was processed and resulted in a preliminary

commitment letter. Thereafter, in late July or early August, 1987, the Sweeneys, again through Meldon, increased their request to $1.6 million (Exhibits 1, 3, 114).

35. Negotiations between Rhetta Sweeney and Dennis Furey led to an agreement which provided in part that ComFed would provide a commercial mortgage loan in the amount of $1.6 million dollars, and that the Sweeneys would immediately undertake to secure subdivision approval by combining the two parcels and applying to the Town of Hamilton for permission to construct a flexible subdivision anticipated to consist of six to eight building lots.

36. ComFed issued a commitment letter dated August 10, 1987 for the $1.6 million refinancing (Exhibit 114).

37. The Sweeneys were not satisfied with various provisions of the August 10th Commitment Letter. At a meeting on August 20, 1987, they expressed their desire to change the term of the loan from eight months to twelve months; modify the language of the "non-use" provision to avoid any penalty effect; and eliminate the requirement that certain portions of the property be sold by December 31, 1987, to reduce indebtedness. Dennis Furey and Karen McCormack were the representatives of ComFed at that meeting.

38. At the conclusion of the August 20, 1987 meeting, ComFed issued another commitment letter which the Sweeneys signed (Exhibit 3). This letter contained various terms and language which gave rise to the Sweeneys' belief that they would get more financing in the future for construction purposes. For example, there was under paragraph 17(s) a provision for a "1% nonuse fee

in the event ComFed does not finance the development and construction of the 7 plus/minus additional lots;" and "(t) the property must be actively marketed on the MLS system or it's (sic) equivalent within 30 days after final approval of the master plan is attained from the Town of Hamilton."

I find that the terms set out above, the testimony of the plaintiffs and Furey, together with the added use of a "Construction Loan Agreement", which was entered into between the parties at the time of closing, affirm the contention of the plaintiffs that they were relying on ComFed for the commitment to them for loan construction funds once the subdivision approval was received.

39. In an August 21, 1987 letter to Mr. Furey, Rhetta Sweeney identified the existing liens, mortgages, and debts on the properties. Mr. Furey sent Mrs. Sweeney's letter, which also contained a list of liens to be discharged, to counsel engaged by the bank to close the loan (Exhibits 4, 151).

40. On August 27, 1987 the $1.6 million loan was closed. The closing was approved and arranged by Furey who acted in violation of procedures established by ComFed and his superiors, Raymond Miller, William Porter and Frederick Maloof.

FINDINGS OF FACT RELATIVE TO COUNT VIII
UNFAIR TRADE PRACTICES

I make the following findings of fact which pertain to Count VIII of plaintiffs' complaint (unfair trade practices):

41. William Porter, a senior vice president of the ComFed Mortgage Advisory Board and member of ComFed 's loan committee, testified that they (the Bank) had "a very tight system"; that ComFed would not close a loan without an appraisal first; and that was a strict rule of ComFed. James Baldini who was president of ComFed Mortgage Co. also testified that ComFed could not close without an appraisal being done first.

42. Furey was on an incentive program to close loans. He was one of three vice-presidents who received commissions as a loan originator; this was incentive for loan originators to close loans.

43. ComFed received approximately $78,000 in a variety of fees and points[2] charged at that closing of the Sweeney loan and placed into escrow the sum of approximately $200,000 without interest to cover interest on the loan during its proposed term of one year (Exhibit 9). Unbeknownst to the Sweeneys, Furey received a $1,600 commission for this loan.

44. ComFed knew or should have known prior to August 27, 1987 that based upon its representations the Sweeneys believed that ComFed would provide construction mortgage financing once subdivision approval had been obtained for the subject parcels.

[2] ComFed's profits were dependent in large measure on the points charged on loans.

45. ComFed encouraged the Sweeneys not to obtain independent counsel for the closing of the $1.6 million loan but suggested they accept the services of the bank's own closing attorney. ComFed knew or should have known that independent counsel may have determined that the actions and inactions, both written and oral, of ComFed upon which the Sweeneys were relying were inadequate to protect them in their expectation of subsequent construction financing. ComFed also knew that its bank counsel would provide little or no guidance to the Sweeneys regarding their personal rights and obligations under the loan documents.

46. ComFed's profits were dependent in large measure upon the points charged on loans. Testimony from various officers of ComFed revealed that their aggressive marketing of loans expanded the ComFed Mortgage Co.'s assets from $350,000,000 in 1982 to $2.5 billion in 1987. Most of the officers such as Furey, Baldini, Porter, and Maloof benefited from this large volume of loans receiving their commissions based on these amounts.

47. As part of the loan transaction with the Sweeneys, there was a reserve established in the amount of approximately $400,000 for interest and other costs associated with subdivision approval. These monies were not disbursed at closing, but instead were disbursed over the course of the loan term after requisitions were approved for payment.

48. The reserve feature of this loan was essentially an accounting device. The Sweeneys were not paying interest on the reserve until amounts in the reserve category were actually

disbursed; nor did they receive interest on this money held by ComFed.

49. The said actions and inactions of ComFed were unconscionable and oppressive and breached the bounds of substantive fairness in that ComFed:

a. Placed in its original and amended loan commitment letters substantial penalties for failure to accept construction mortgage financing from ComFed when ComFed knew that it did not intend to provide such financing, and that the Sweeneys would be deceived into believing that such financing was forthcoming (Exhibits 3 and 114,)

b. Permitted bank counsel at the closing to prepare an opinion letter reciting the existence of building permits and other language unfairly and deceptively designed to deceive the Sweeneys into believing that construction mortgage financing would subsequently be forthcoming. (Exhibit 59).

c. Had the Sweeneys execute a Construction Loan Agreement without the benefit of independent counsel, which Construction Loan Agreement contained provisions which by their nature would tend to deceive the Sweeneys into believing that their anticipated construction financing would be forthcoming (Exhibit 7). The statement by Furey during his testimony suggesting that the use of this

document was in error or mere happenstance occasioned by the time constraints of the closing is not credible.

50. The Construction Loan Agreement[3] provided in pertinent part:

1. <u>Borrower's Covenants</u>

(a) <u>Construction</u>

To have a certain building or buildings and improvements constructed and equipped on the mortgaged premises in accordance with plans and specifications submitted to Lender for its written approval, using materials of the best quality called for by said specifications and first class workmanship, both satisfactory to Lender.

4. <u>Construction Advances</u>

Lender agrees, subject to the provisions of this Agreement that it will advance the mortgage proceeds as the construction progresses . . . .

9. <u>Cessation of Construction</u>

Borrower agrees that if construction subsequently ceases for fifteen (15) successive days due to any cause within Borrower's control, such cessation shall constitute a breach of this Agreement.

51. ComFed knew or should have known that the Sweeneys would be deceived by the writings above-mentioned and by its conduct. ComFed failed to correct such deception when it could have:

a. Advised the Sweeneys that they should have independent counsel to examine the documentation;

b. Informed the Sweeneys that in spite of the contents of the documentation ComFed did not intend to

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[3] Exhibit 7, pp. 1, 3-4, 6.

provide construction mortgage financing once subdivision approval had been received.

52. The documents delivered and executed at the closing can not be explained away (as asserted by the defendant Furey) by the fact that the Sweeneys requested moneys for cosmetic repairs or that the documents were used by the bank's attorney because of the imminence of foreclosure proceedings alluded to in Finding No. 31. There is no credible reason to believe that ComFed would permit erroneous documents for a $1.6 million loan merely for convenience.

53. I find that the use of these documents, letters of commitment and actions of Furey and other bank officials are unfair business practices designed to deceive the plaintiffs into entering into a debt which could not be paid off by the plaintiffs based on their present financial circumstances.

54. ComFed scheduled the mortgage loan closing on August 27, 1987, the day before the contemplated foreclosure of the mortgage encumbering the Bay Road parcel, and ComFed did not provide the mortgage documentation in advance of the closing to the Sweeneys knowing that both of these actions would induce the Sweeneys to execute the documents at the closing.

55. Prior to August 27, 1987 and on August 27, 1987, ComFed unfairly and deceptively induced the Sweeneys to believe that the loan documentation executed at the closing was not intended by ComFed to contain the entire agreement between the parties, and that the documentation itself was not to be strictly interpreted. ComFed knew or should have known that such inducement would

persuade the Sweeneys to believe in ComFed's intention to provide construction mortgage financing even if the provisions of the same were not fully set forth in the documentation. Additionally, ComFed's unfair and deceptive actions with respect to this loan are:

a. The Sweeneys were required to execute a document swearing that they did not occupy the subject premises as a residence even though ComFed knew that the Sweeneys did in fact occupy the premises as a residence.

b. ComFed promised to provide partial releases in exchange for payments of 80 percent of the value or sales price of any home or lot sold within the subdivision once approved (Exhibit 114). This promise was contained in ComFed's initial commitment letter but removed in the subsequent letter. ComFed encouraged the Sweeneys to rely upon its good faith and to rely upon representations made outside the written documents.

56. In order to grant the $1.6 million loan, the Sweeneys property had to be appraised in excess of $2,000,000. ComFed knew that the Sweeneys had never obtained a formal appraisal of the premises. ComFed unfairly and deceptively induced the plaintiffs to rely upon its assessment of values in determining whether the contemplated project would be viable and successful. Toward that end ComFed promised the Sweeneys that an appraisal would be

performed by an independent appraiser and that that appraisal would be a complete R41C[4] appraisal of the property. ComFed knew that the Sweeneys were relying upon an appraised value of $2.1333 million to induce them to accept the $1.6 million dollar loan and undertake the project contemplated. Bank policy and the Federal Home Loan Bank regulations prohibited the issuance of a loan in an amount more than 75 per cent of the appraised value (Exhibits 3 and 82).

57. The appraisal, however, did not confirm the values required by the commitment letter (Exhibit 80) and did not comply with R41C Standards and policies of the Federal Home Loan Bank Board (FHLBB) governing loans of institutions such as ComFed (Exhibit 82). The appraisal was completed after the closing and stated that the property had a fair market value of $1,960,000--a lower amount than was needed for this loan.[5]

58. I find that absent a proper appraisal being completed bank policy prohibited a closing. However, evidence given by James Baldini, the president of ComFed Mortgage Co., Inc., showed that during the period of time of the granting of the Sweeney loan the bank had grown substantially (in 1987 and 1988); that ComFed was servicing between 50,000 to 60,000 loans during that period; that in order to close on these loans at times the loan originator would

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[4] Such an appraisal is required by Federal Home Loan Bank regulations.

[5] The appraisal is dated "August 25, 1987"; however it also states that the "research of relative date was performed during the period from August 25, 1987, to August 28, 1987" (Exhibit 80).

tamper with the bank's rules and close on a loan without an appraisal.

59. Prior to the closing ComFed through Furey informed the Sweeneys that the appraisal had been completed and was satisfactory even though ComFed and Furey knew that statement to be false.

60. The various functions performed by the appraiser were not completed until August 28, 1987, one day after the closing of the $1.6 million loan (Exhibit 80). The closing was, therefore, held in violation of ComFed's policy and in violation of the FHLBB's regulations. The Sweeneys were not informed that the appraisal had not been completed. The Sweeneys never knew of the appraisal results until after the commencement of this litigation. I find that the appraisal was not completed until after the closing. I find this action by ComFed an unfair and deceptive practice.

61. On August 27, 1987 at the time of the closing of the $1.6 million loan the sum of $1,287,095.60 was disbursed in payment of bank fees and in repayment of the encumbrances on the subject properties. At all times thereafter the remaining funds were held by ComFed in a non-interest bearing account which regularly applied a portion thereof to interest payments and disbursed portions of the balance in accordance with the bank's approval of requests made by the Sweeneys. ComFed made certain errors in these disbursements causing the Sweeneys embarrassment and difficulties but eventually upon demands made by the Sweeneys corrected its errors.

62. Subsequent to the August 27, 1987, mortgage closing, the Sweeneys sought and obtained approval of a flexible subdivision plan from the Town of Hamilton allowing the Sweeneys to construct four new residences in addition to the two existing houses. The approval was orally granted in January 1988 and written approval issued shortly thereafter.

63. Commencing in January 1988 the Sweeneys took certain measures to prepare for anticipated construction of subdivision roads, landscaping, and the construction of houses contemplated on the vacant lots. Toward that end the Sweeneys engaged construction professionals anticipating that they would commence their work by April 1 (Exhibit 236), and obtained a full analysis of the cost which might be anticipated in renovating the existing homes and building four new homes on the premises. (See Fogarty Report, Exhibit 49c.) These acts, expenditures, and plans were entered into and in reliance upon ComFed's previous promises by the Sweeneys.

64. Following receipt of the Fogarty estimates the Sweeneys actually obtained construction bids for the work to be performed (Exhibit 49d).

65. ComFed knew in advance that the Sweeneys were engaging the services of such professionals and that the Sweeneys had no other source of financing this project but it did not inform them that it did not intend to provide them with construction mortgage financing.

66. At the behest of Furey in January or February 1988, Mrs. Sweeney met with Helen Pullin of ComFed who was then handling construction loan financing. Ms. Pullin gave Mrs. Sweeney construction loan application forms including, among other things, personal financial statements and a request for plans and specifications (Exhibit 198).

67. Much of the interaction between the Sweeneys and ComFed particularly the conversations and correspondence between Rhetta Sweeney and Dennis Furey concerned the construction and sale of the properties during the early months of 1988. That interaction consisted of:

a. Telephone calls from Rhetta Sweeney;

b. Letters from Rhetta Sweeney referring to such things as phase 2 and her attempt to begin construction, which clearly were indicative of her intention to inform ComFed of her readiness to accept the additional funds she anticipated;

c. Invoices tendered to ComFed for payment of such items as the Fogarty estimates which ComFed knew were being prepared for construction purposes (Exhibit 141L).

68. In spite of ComFed's knowledge of the Sweeneys continued reliance on its promises, ComFed failed to respond to the Sweeney letters sent to Furey, failed to inform the Sweeneys that no construction financing would be forthcoming, continued to expend the escrowed sums necessary to carry the interest on the subject

loan by approving payment for construction related activities including the Fogarty estimates when it knew it did not intend to provide future construction financing.

69. During the spring of 1988 ComFed routinely permitted the Sweeneys to draw upon the escrowed funds for purposes of making payments to professionals who had been hired to render advice or services in connection with the subject property, the subdivision process and actual construction expenses.

70. In January 1989 Dennis Furey received information from Rhetta Sweeney with reference to a sale transaction of the Meyer Lane property. There is no evidence that ComFed did anything to frustrate any arrangement between Mrs. Sweeney and the prospective buyer; but there is evidence that the bank stated that the proposed sales price of $775,000 was too low so that it would have an excuse not to grant a partial release to effect this sale to the plaintiffs' detriment. (Exhibit 41).

71. Dennis Furey and Rhetta Sweeney had a meeting at ComFed on or about August 25, 1988. Mrs. Sweeney brought with her a purchase and sale agreement for the 24 Meyer Lane home. The purchase price on the document was $1,000,000. Mrs. Sweeney told Mr. Furey that now that she had a purchase and sale agreement for a portion of the property she wanted to apply for further lending (Exhibit 144).

73. Dennis Furey asked Mrs. Sweeney if he could call Mr. Mammola, the prospective buyer, to confirm his interest and financial ability to purchase. Mrs. Sweeney agreed and at the same

time delivered to Mr. Furey a proposal for construction financing of approximately $3 million for proposed new homes on the vacant lots of the subdivision and additional improvements to existing structures.

74. Mrs. Sweeney concedes that she does not know what happened to Mr. Mammola's desire to purchase her property. There is no evidence that ComFed did anything to frustrate any arrangement between Mrs. Sweeney and Mr. Mammola.

75. On or about September 15, 1988, Dennis Furey and William Porter, a Vice President of ComFed met with Rhetta Sweeney and Scott Ainsworth. Mrs. Sweeney introduced Mr. Ainsworth as the person who was going to develop the property and that Ainsworth would work at his cost and share in the equity. Mrs. Sweeney and Mr. Ainsworth presented a new pro forma which identified a financing need of $2,500,000. It was contemplated that the $1.6 million loan would be repaid by the proceeds of this new loan.

76. Subsequently (between September 15, and 26, 1988), Dennis Furey informed Rhetta Sweeney and Scott Ainsworth that the Loan Committee would not approve a loan request in the additional amount of $663,750. He further stated that the Loan Committee would consider a smaller amount so long as the loan proceeds would be used to improve the two existing homes in order to help sell the properties.

77. ComFed informed them that bank policy made it impossible for ComFed to extend additional credit to the Sweeneys unless the $65,000 arrearage in the payment of interest was made current. No

proof of such bank policy was offered by the defendants. I find that such statements were made in furtherance of ComFed's bad faith and unfair practices to these plaintiffs.

78. The $65,000 interest arrearage existed at that time in part due to the fact that ComFed had permitted approximately $40,000 of the escrowed funds to be used for construction and renovation expenses on the existing dwelling houses. ComFed permitted the use of such knowing that a default in the $1.6 million loan would be accelerated thereby.

79. ComFed did not inform the Sweeneys at that time that it did not intend to provide additional construction mortgage financing.

80. It is undisputed that at the time of the loan of $1.6 million in August, 1987, and subsequently through the Spring of 1988, the Sweeneys had no outside source of funds with which to pay back the initial loan or even service the debt. The only source of contemplated pay back of the loan was the subdivision of the property into lots with subsequent development construction to render the property saleable. The actual advancement of funds for construction and renovation of the existing dwellings on the property effectively deceived the Sweeneys into believing that they would be provided with further construction financing sufficient to upgrade existing structures, construct subdivision roads, and build dwellings that could be sold to pay back the initial loan and make a profit for the plaintiffs.

81. In addition to ComFed's misrepresentations about bank policy concerning loan arrearages, ComFed also suggested that if the loan was made current by the payment of $65,000, ComFed would provide a $175,000 construction loan together with a forward commitment for construction financing of the entire subdivision project.

82. At the time of such suggestions, ComFed knew that no approval had been made as to a forward commitment to fund the Sweeney project, and that ComFed did not intend to provide a forward commitment for the entire project.

83. The Sweeneys relied on ComFed's representation that it would provide a forward commitment for the entire project upon the payment of the $65,000 loan arrearage to their detriment.

84. On October 3, 1988 Rhetta Sweeney borrowed $65,000 from another person paying two points as a fee and a 13 per cent per annum interest rate and pledging as security certain family heirlooms including her engagement ring to pay the entire $65,000 to ComFed. ComFed did not need to receive the payment of $65,000 in order to grant an additional loan to the Sweeneys. Nor at this time did ComFed obtain authority from its lending committee or any other person to provide a forward commitment for construction of the entire project.

85. I find that the testimony of Dennis Furey, Karen McCormack and Helen Pullin, the defendants' loan officers who also dealt with the plaintiff, Rhetta Sweeney, not credible in stating that there was no further construction loan commitment by the

defendants. In fact the jury also found that an agreement or agreements existed between the Sweeneys and ComFed under which ComFed agreed to provide construction financing in addition to the $1.6 million loan. (See Special question A.1, Appendix A)

86. Subsequent to the payment of $65,000 ComFed offered to carry out its promise to loan $175,000 toward construction, which promise has been set out in a commitment letter of September 30, 1988. That letter contained the terms and conditions under which ComFed would make such a loan. (Exhibit 17)

87. On October 18, 1988 ComFed prepared another commitment letter for a loan in the amount of $175,000 (Exhibit 18), which provided that at the time of the receipt of the $175,000 loan (only a small portion of which would actually be paid over to the Sweeneys) the Bank would also receive an escrow payment from the Sweeneys in excess of $175,000.[6] (Exhibit 18 pg. 9). ComFed inserted such provision in its commitment letter knowing that the Sweeneys were unable to make such a payment of funds into escrow.

88. The aforementioned commitment letter of October 18, 1988 (Exhibit 18) and the subsequent commitment letter of November 10, 1988 (Exhibit 20) each contained provisions which deviated from and expanded upon the simple conditions set forth in the commitment letter of September 30, 1988 (Exhibits 17, 18, 20). ComFed refused to close the $175,000 loan unless the new conditions set forth in

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[6] The provision in that letter (Exhibit 18) provided: The borrower agrees to escrow adequate funds in ComFed Savings to maintain the debt service on this loan as well as the first mortgage loan on the subject property for a period of nine months from the date of closing.

its subsequent commitment letters were honored, although the same had not been agreed to at the time of the commitment on September 30, 1988.

89. On November 14, 1988, ComFed presented to Rhetta Sweeney a document entitled Forward Commitment (Exhibit 33) at the commencement of the actual closing of the $175,000 loan which letter never had been made available to her or to her attorney prior thereto. The forward commitment letter contained provisions which made performance by the Sweeneys impossible and was actually meaningless on its face (Exhibit 37).

90. At the time of the loan of $1.6 million in August 1987 and through the Spring of 1988, the Sweeneys' financial history showed that they had no outside sources of funds with which to either pay the interest or the principal amount of the initial loan. The only source of payment of said principal and interest known to ComFed (or should have been known to ComFed) would have been the subdivision of the property into lots with the subsequent of sales of houses and/or the lots.

91. To their detriment the Sweeneys acted in reliance upon these unfair and deceptive practices and acts committed by the defendants.

92. I find that the actions of ComFed recited above are acts or practices unfair or deceptive in nature under G.L. c. 93A, §§2 and 11.

93. I find that Furey at all times acted on behalf of ComFed and not individually.

94. ComFed is guilty of unfair and deceptive trade practices by loaning $1.6 million to the plaintiff's knowing full well that the Sweeneys could never service the debt from their income or other assets; that they were not in the construction business; that the property as it was in its undeveloped stage and without subdivision was not worth the amount of the loan of $1.6 million. True in July 1987 the property may have had the potential of selling for $1.6 million or more but that was purely speculative.

95. Bank regulations and practices require that loans of this type be predicated on the securing a subdivision plan from the Town which was a speculative plan at best. That Rhetta Sweeney did secure approval within six to seven months after the loan is no doubt due to her tenacity, hard work and ability to deal with diverse elements in her town.

96. After the bringing of this instant action, the defendant ComFed refused to give the plaintiffs a partial release on the sale of one parcel with the house thereon on Meyer Lane, when an offer was received for $775,000.00 (Exhibits 41). I find that ComFed's refusal to do so was unfair and deceptive practice.

97. ComFed's behavior in its dealings and practices with the plaintiffs from the inception of these dealings was to doom the plaintiffs to become financially bereft and to lose their property.

98. ComFed knew or should have known that the loan would go into default at the end of the year.

99. The total amount of principal, interest, and related charges owed to ComFed by the Sweeneys as of March 1, 1990 was $2,069,581.33 (Exhibit 303).

100. In response to special questions, the jury found that there was no breach by ComFed of any obligation owed to plaintiffs under any agreement, whether oral or in writing. The jury found that neither ComFed nor its employees or officers committed fraud or interfered with any business relations the plaintiffs may have had. The jury found that ComFed had inflicted emotional distress upon Rhetta Sweeney and awarded her damages of $65,000. The jury found that the Sweeneys were liable to ComFed under the terms of the $1.6 million loan and awarded damages to ComFed of $2,069,581.33, which amount included principal, interest, late charges and attorney's fees (Exhibit 303).

101. No question with respect to Count VIII of the complaint was submitted to the jury as advisory or otherwise for the purposes of this decision.

102. By a letter of June 7, 1989, ComFed made a tender of settlement to the Sweeneys. A copy of ComFed's tender is attached hereto as Exhibit B.

103. By its tender, ComFed offered the following three alternative settlement proposals to the Sweeneys:

a. ComFed proposed to tender a release to the Sweeneys in exchange for deeds to the Sweeneys' real estate in lieu of foreclosure.

b. ComFed proposed to forebear foreclosure proceedings for six months to facilitate sales and to agree to partial discharges for amounts equal to of 90% of bona fide selling prices, not less than the following:

24 Meyer Lane $700,000

226 Bay Road $400,000

Lots each at $200,000

In addition, ComFed offered to suspend and not charge interest during the forbearance period.

c. ComFed offered to forbear foreclosure proceedings for 3 months, charge no interest during this period and reduce accrued interest and charges to $125,000, thereby limiting the debt to $1,725,000, a reduction of approximately $125,000 at that time.

104. The Sweeneys rejected ComFed's tender.

105. At the time it was made, ComFed's tender respecting settlement could not be considered fair and reasonable under the circumstances of this case.

FINDINGS OF FACT AS TO DAMAGES

I make the following findings on damages:

106. I find that since ComFed should have known or did know that the Sweeneys could not service the $1.6 million loan and deceptively granted them the loan, ComFed is not entitled to any interest on that loan from June 6, 1989, the date of the C. 93A Notice to date. The amount of interest payment due is $20,666.70 monthly. The plaintiffs are to recover as damages the 19 months

interest at $20,666.70 which totals $392,667.30. In addition, the plaintiffs are to recover damages for the closing fees made on this loan in the amount of $79,651.92.

107. I find that the plaintiffs' expert witness Pamela McKinney was well-qualified as an expert witness as to real estate values and as to quantifying and estimating future development costs and estimated profits of the subject real estate.

108. McKinney's testimony was credible and her evaluation and report as to the development's potential of the Sweeneys' property was well-reasoned, precise, and based on accurate and precise facts of the market at the time she prepared her report.

109. McKinney's estimated profit which the Sweeneys would make from the loss of opportunity to develop their property amounted to the sum of $1,009,964.00. I find that this amount is fair and reasonable in the circumstances.

110. I find that the $1,009,964.00 as stated in the previous paragraph is a fair summary of loss of profit suffered by the plaintiffs and are damages recoverable under G.L. c. 93A.

111. I find that the defendants offered no contrary evidence as to the development costs and made no showing of any difference in the profit estimates.

112. I find that the payment of $65,000 to ComFed for the arrearage of interest for the ostensible reason to get further financing gives rise to another element of damages suffered by the plaintiffs under G.L. c. 93A.

113. I find that the additional interest and fees accruing to secure that $65,000 loan in the amount of $11,455.00 to make the $5,000 payment to ComFed is another element of damages suffered by the plaintiffs under G.L. c. 93A.

114. I find that the defendants' acts of unfairness and deceptive practices are obvious and wilful in three levels in violation of M.G.L. c. 93A, §2:

<u>First</u>: The granting of the $1.6 million loan;

<u>Second</u>: The refusal to grant additional construction financing; and

<u>Third</u>: The demand for payment of $65,000 interest to enable the plaintiffs to secure additional loan funds.

115. Therefore, I make the following findings as to punitive damages:

First: As to the loan with its charges of interest and closing fees, the plaintiffs are entitled to double damages in the amount of $944,638.44 (See Paragraph 106 above).

Second: As to the value of loss of profit of $1,009.964. the plaintiffs are entitled to double damages in the sum of $2,019,928.00. (See Paragraph 107, 108, 109, 110. 111, above); and

Third: Plaintiffs are entitled to treble damages as to the amount of $11,455.00 which amounts to $34,365. (See Paragraph 113 and 114, above).

RULINGS OF LAW AS TO COUNT II

1. For several independently sufficient reasons, ComFed is entitled to judgment on Count II of plaintiffs Complaint seeking a decree of specific performance requiring ComFed to give partial releases of its mortgage.

a. First, Count II, even if it were an appropriate equitable claim, is moot because there is no pending or proposed sale which requires a partial release of ComFed's mortgage.

b. Second, this Court cannot order specific performance of any purported implied undertakings to give partial releases "on reasonable prices" as requested by plaintiff. (Verified Complaint, paragraph 169). Specific performance can only be sought with respect to express contracts. Baseball Pub. Co. v. Burton, 302 Mass. 54 (1938); Berry v. Nardozzi, 362 Mass. 145 (1972). It is not a matter of strict or absolute right, Forman v. Gadouas, 247 Mass. 207, 211, 142 N.E. 87 (1924). McCormick v. Proprietors of Cemetery of Mt. Auburn, 285 Mass. 548, 189 N.E. 585 (1934).

RULINGS OF LAW AS TO COUNT VIII

1. Chapter 93A, §11 reads in pertinent part:

> Any person who engages in the conduct of any trade or commerce and who suffers any loss of money or property, real or personal, as a result of the use or employment by another

person who engages in any trade or commerce of an unfair or deceptive act or practice declared unlawful by section two or by any rule or regulation issued under paragraph (c) of section two may, as hereinafter provided, bring an action in the superior court, or in the housing court as provided in section three of chapter one hundred and eighty-five C, whether by way of original complaint, counterclaim, cross-claim or third-party action for damages and such equitable relief, including an injunction, as the court deems to be necessary and proper.

2. Chapter 93A, §2 reads in part:

> (a) Unfair methods of competition and unfair or deceptive acts or practices in the conduct of any trade or commerce are hereby declared unlawful.
>
> . . . .
>
> (c) The attorney general may make rules and regulations interpreting the provisions of subsection 2(a) of this chapter.

3. The attorney general has promulgated such rules and regulations. Under such regulations an act or practice is a violation of G.L. c. 93A, §2 if it:

> Fails to comply with existing statutes, rules, regulations, or laws meant for protection of the public's health, safety or welfare promulgated by the Commonwealth or any political subdivision thereof intended to provide consumers of this Commonwealth protection; or
>
> Violates the Federal Trade Commission Act, the Federal Consumer Credit Protection Act or other federal consumer protection statute within the purview of G.L. c. 93A, §2.

See 940 CMR, Sections 3.16(3) and (4).

4. Violation of a statute intended to protect the public interest constitutes a violation of G.L. c. 93A. See MacGillivary v. W. Dane Bartlett Ins. Agency, 14 Mass. App. 52, 61 (1982).

5. A negligent violation of a statute is to be taken to constitute a violation of G.L. c. 93A, §2, for which recovery under §11 is allowable. MacGillivary, supra at 61. See also Piccuirro v. Gaitenby, 20 Mass. App. Ct. 286, 290 (1985).

6. This court finds that it has jurisdiction to render a decision and that the case before the court is properly pleaded. It is for the trier of facts (and in this case the judge) to determine if the conduct of the defendants was an unfair or deceptive act or practice. DiMarzo v. American Mutual Ins. Co., 389 Mass. 85, 96 (1983); Nei v. Burley, 388 Mass. 307, 311-317 (1983).

7. Relief under G.L. c. 93A is additional to that received under any common law remedies. Linthicum v. Archambault, 379 Mass. 381 (1979).

8. Although I have considered essentially the same evidence that the jury considered, I have come to the opposite conclusion in most areas. The jury's verdicts on the other claims will stand. My findings of fact are based on the statutory claim (c. 93A) and have an opposite result as to the outcome of the case. The Chapter 93A claim is one for the trial judge. Wallace Motor Sales, Inc. v. American Motor Sales Corp., 780 F.2d 1049, 1063-67 (1st Cir. 1985). See also Turner v. Johnson & Johnson, 809 F.2d 90, 102 (1st

Cir. 1986) and Shaw v. Rodman Ford Truck Center, Inc., 19 Mass. App. Ct. 709 (1985).

9. The conduct undertaken by the defendants in this action constitutes violations of the Federal Home Loan Bank Act, 12 U.S.C. 1421, §216. This act was initiated to protect the public interest by regulating federal home loan banks[7] in their granting of mortgage loans. It set up a Federal Home Loan Bank Board which promulgated rules and regulations such as requiring a mortgage loan not to be more than 75 per cent of appraised value.[8]

10. Only a single award of joint or several damages will be granted against all the defendants where there were no independent wrongs and some of the defendants were liable only because of vicarious liability, or where the individual active independent wrongdoers were acting for the defendant corporation or its alter ego. Pepsi-Cola Metro. Bottling Co. v. Checkers, Inc., 754 F.2d 10 (1985).

11. In the instant case that court finds wrongdoing by the defendant Furey was on behalf of ComFed and finds that such wrongdoing was further exacerbated by the conduct of other employees of the defendant banks. The court finds, however, that in each instance the wrongdoing was performed by the individuals

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[7] The defendants ComFed were federal home loan banks.

[8] 12 U.S.C. 1421, 1441, §21. The language of the statute states "whoever makes any statement knowing it to be false or whoever willfully overvalues any security for the purpose of influencing in any way the action of a Federal Home Loan Bank or Board upon any application . . . or loan, under this Act, . . . shall be punished by a fine of not more than $5,000. or by imprisonment for not more than two years, or both.

acting for the defendant banks and, accordingly, will award only a single award of damages.

12. The standards of harm to be applied are not limited to traditional common law tort or contract concepts. Slaney v. Westwood Auto Inc., 366 Mass. 688, 689 (1975). Such relief is an addition to and not in substitution for traditional tort and contract remedies. Linthicum v. Archambault, 379 Mass. 381 (1979).

13. Since the court finds that there has been actual loss to the plaintiffs in the instant case, the claims of the plaintiffs fall properly within section 11. The actual loss as stated in the findings of fact consist of (a) the debt of the plaintiffs in having judgment for the principal, interest, late fees, legal fees and cost for $2,069,581.33 entered by the jury on the defendants' counterclaim; the payment of closing costs, commissions of the August 27, 1986 closing in the amount of $78,000., the loss of profit on the development of the property, and the loss of sale or sales of parcels of the property by the unwillingness to grant a partial release because the defendant bank thought the sale price was too low, and finally, the interference with a contractual right to develop the properties and loss of profit therefrom, causing the plaintiff Rhetta Sweeney's emotional distress (this fact was found by the jury). DiMarzo at 94-95, Wolfberg v. Hunter, 385 Mass. 390, 398 (1982), Smith v. Caggiano, 12 Mass. App. Ct. 41 (1981).

14. In order for the plaintiffs to recover, no intent to violate the act by the defendants need be shown. In fact a

violation may be committed in good faith and still be actionable. Slaney, supra, 366 Mass. at 703.

15. Even a negligent misrepresentation of fact when the truth could be reasonably ascertained is an unfair and deceptive act within the meaning of Chapter 93A. Reliance upon the misrepresentation is unnecessary; merely proof of causation between the misrepresentation and the plaintiffs' damages need be shown. Reymer v. Bay State Nat'l Bank, 384 Mass. 310 (1981), Glickmen v. Brown, 21 Mass. App. Ct. 229, 235-236, (1985).

16. In determining whether an act or practice is unfair as opposed to deceptive, the equities of the party should be weighed. That is calculation should be made as to what each reasonably should have known. Swanson v. Bankers Life Co., 389 Mass. 345, (1983). The court finds that in weighing the knowledge of the plaintiffs versus the greater knowledge of the defendant Furey and other bank officers the acts and practices of ComFed were both unfair and deceptive.

17. The court finds that the actions of ComFed with respect to the plaintiffs "attain a level of rascality that would raise an eyebrow of someone inured to the rough and tumble world of commerce" Levings, Trustee v. Forbes & Wallace, Inc., 8 Mass. App. Ct. 498 (1979).

18. Assuming that the plaintiffs were more sophisticated than found by the court (or indeed were as sophisticated as the defendants wish to claim) the unfair and deceptive practices of defendants as alleged by plaintiffs are sufficient to state claims

for relief since 93A "did not limit the statutes protection to small, unsophisticated businesses." VSH Realty, Inc. v. Texaco, Inc., 757 F.2d 411 (1st Cir. 1985).

19. In addition to being clearly unfair, the acts of the defendants as related to the plaintiffs within the findings of fact set forth above are deceptive in nature since they "could reasonably be found to have caused a person to act differently from the way he otherwise would have acted" See also York v. Sullivan, 369 Mass. 157, 162 (1975); Lowell Gas Co. v. Attorney General, 377 Mass. 37, 51 (1979).

20. Deceptive acts or practices also consist of failures to disclose important information, York v. Sullivan, 369 Mass. 157, 162-163 (1975).

21. Failure to fulfill promises and misrepresentations of material and other facts are rampant in the transactions between the defendants and plaintiffs and also constitute deceptive acts within the meaning of the statute. Slaney, supra at 702; Brandt v. Olympic Const., Inc., 16 Mass. App. Ct. 901 (1983). Glickman v. Brown, 21 Mass. App. Ct. 229 (1985).

22. In fixing damages, lost profits as set forth by expert testimony are a proper basis for an element of recovery where it appears that the loss was a probable consequence of the unfair and deceptive practices. Gagnon v. Sperry & Hutchinson Co., 206 Mass. 547 (1910); Knightbridge Marketing v. Promociones Y Proyectos, 728 F.2d 572, 575 (1984).

23. The prospective profits need only to be shown by the plaintiffs that they have lost such profits by reasonable facts and evidence and need not be proven with mathematical accuracy. Rombola v. Cosindas, 351 Mass. 382 (1966). Gagnon, supra at 555.

24. "Expert testimony alone has been explicitly recognized as a method of proving prospective damages." Knightbridge Marketing, supra at 576. See also City Welding and Manufacturing Co. v. Gidley-Eschenheimer Corporation, 16 Mass. App. Ct. 372 (1983).

25. Multiple damage provisions of c. 93A are designed to impose a penalty. Liability under §11 for multiple damages ought to vary with the culpability of the defendant. International Fidelity Ins. Co. v. Wilson, 387 Mass. 841, 856-857 (1983); Linthicum, supra at 385; Heller, supra at 627-628.

26. In any case where there is a finding for the plaintiff, irrespective of the amount, the plaintiff shall be entitled to be awarded reasonable attorney's fees and costs. Raymer v. Baystate National Bank, 384 Mass. 310 (1981); Patry v. Liberty Mobile Home Sales, Inc., 15 Mass. App. Ct. 701 (1983), modified, 394 Mass. 270 (1985); Burnham v. Mark IV Homes, 387 Mass. 575 (1982).

27. Under §11, attorney's fees may be awarded in the case where a reasonable written offer of settlement was rejected. G.L. c. 93A, §11 states "If the court finds in any action commenced hereunder that there has been a violation of section two, the petitioner shall, in addition to other relief provided for by this section and irrespective of the amount in controversy, be awarded

reasonable attorneys' fees and costs incurred in said action." Kohl v. Silver Lake Motors, Inc., 369 Mass. 795 (1976).

28. The amount of reasonable attorneys' fee and costs is within the broad discretion of the court. DiMarzo, supra at 85; Linthicum, supra at 388; Heller v. Silverbranch Constr. Corp., 376 Mass. 621, (1978); McLoughlin v. Disarro, 7 Mass. App. Ct. 853, (1979); Levy v. Bendeton, 6 Mass. App. Ct. 558, (1978); Patry v. Liberty Mobile Home Sales, supra at 706-707; Morse v. Mutual Federal Sav. & Loan Assn., 536 F. Supp. 1271 (D. Mass. 1982).

29. Since this c. 93A claim is made under §11, a demand letter is not required and, therefore, there is no need to decide the sufficiency of the plaintiffs' demand. Nader v. Citron, 372 Mass. 96 (1977).

30. In this case the Court has examined defendant's letter of June 7, 1989 submitted to this Court on April 25, 1990, (Defendant's App. 63) which is submitted as defendant's tender of a reasonable settlement offer. This offer was rejected by the plaintiffs. Such a rejection would bar attorney's fees if tender was adequate. Kohl v. Silver Lake Motors, supra at 801-802.

31. A careful examination of the defendant's tender shows that it is inadequate as a matter of law in the following respects:

a. The tender makes reference to conduct before and after the letter is written, and the failure to consider reasonable solutions. The defendants make no offer of proof concerning the background

surrounding the forwarding of the tender letter. The court finds it inadequate.

b. The primary basis of the proposed settlement would have exchanged the property in question for a discharge of the $1.6 million dollar debt plus interest and fees. The appraisal by defendants in August of 1987 demonstrated the value of the property in its then state in an amount in excess of the debt at the time of the tender some 17 months later (Exhibit 80). The approval of a flexible subdivision by the Town of Hamilton in February, 1988, added substantial value to the property. Accordingly, the said offer actually agreed to exchange property valued in excess of $2,600,000 (claimed by the plaintiffs) for a debt of approximately $1,900,000 or less makes such an offer unfair and inadequate.

c. A portion of the offer purports to waive interest while giving the plaintiffs an opportunity to sell the premises. The court finds, however, that a proposed sales price for the Meyer Lane home of $700,000 was an offer too little, too late. By rejecting a purchase price of $775,000 (Exhibit 41) earlier, defendants had made known that partial releases would not be forthcoming and thereby chilled prospective purchasers as to this real estate.

32. The prime goal of c. 93A, §11 is to promote reasonable settlement. "[T]he conduct proscribed by the statute is as much the failure to make a reasonable settlement offer as it is the substantive violation of c. 93A." International Fidelity, supra at 857.

FINDINGS AS TO ATTORNEYS' FEES

In making a finding on attorneys' fees, the Court has discretion to grant the plaintiffs reasonable attorneys' fees and costs incurred in connection with this action with respect to services rendered as to Count VIII, the c. 93A claim as to unfair practices.

In setting the fees, I have taken into account the following factors: how long the trial lasted, the complexity of the legal and factual issues involved and the degree of competence and skill demonstrated by the attorneys. Also I have considered the result obtained, the experience, reputation and abilities of the attorneys, the necessity of the plaintiffs having more than one attorney, and the usual fees charged for similar services by other attorneys in the same area.

My assessment of legal fees is based on the lengthy and detailed affidavits of Attorneys James A. Freiden, Christopher Weld, Jr., and Robert M. Axelrod which are part of the papers and records of this case (Documents #83A, 83B, and 83C).

I am factoring out of the award the considerable amount of time spent on the other aspects of the case. For that reason, I am excluding the major portion of the work done by Attorney James A. Frieden. As his detailed bills show, his work was mostly the

initial drafts of complaint, interviews with clients and with other persons. He is being, however, credited with the taking of depositions of the bank officers and the costs incurred therefor.

As to Attorney Christopher Weld, it was necessary for this attorney to appear before the court in order to have Massachusetts counsel at the bar to allow Connecticut counsel, Attorney Axelrod to appear. There was also need for additional counsel to assist lead counsel in this very complex litigation involving 12-14 days of trial; several days of hearings; with the handling of more than 140 documents filed with the court; and with over 300 exhibits used in this case.

The task of deciding which fees are to be apportioned between the various claims is not easy of definition because of the many areas of trial and the many overlapping claims. Attempting to sort these factors by examination of the various affidavits is difficult but the attorneys have made a good faith effort in their affidavits to describe their work.

Therefore, I make the following findings of fact as to legal fees and costs:

1. As to Attorney James A. Frieden, I award and grant the total legal fees of $7,300.00 and for the costs of depositions $2,300, for a total sum of $9,600 for legal fees and costs.

2. As to Attorney Christopher Weld, Jr., I award and grant for legal fees the sum of $6,500.00, and the sum of $404.00 for costs, for a total sum of $6,904.00 for legal fees and costs.

3. As to Attorney Robert M. Axelrod, I award and grant for legal fees the sum of $70,200.00 and for costs the sum of $11,000.00, for a total sum of $81,200.00.

4. The total sum granted above for legal fees and costs is $97,704, which the plaintiffs are entitled to recover from the defendants, ComFed, under M.G.L. c. 93A, Count VIII of the plaintiffs' complaint.

ORDER

It is therefore ORDERED, ADJUDGED, and DECREED as follows:

(1) I find for the defendants on Count II of the plaintiffs' complaint and deny specific performance and damages. The defendant is not to have costs.

(2) I find that the plaintiffs are entitled to judgment against the defendants ComFed on Count VIII in the sum of $2,998,931.44 with interest from the date of filing and costs.

(3) I find that the plaintiffs are entitled to the total sum of $97,704.00 for legal fees and costs.

(4) On Count VIII judgment shall enter in the amount of $2,998,931.44 for the plaintiffs, plus interest from the date of filing and costs and in the amount of $97,704.00 for attorney fees and costs without interest and costs.

K. L. I.

Katherine Liacos Izzo
Justice of the Superior Court

DATED: January 30, 1991

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

March 21, 1995

Honorable William S. Cohen
Chairman
Subcommittee on Oversight of Government
Management and the District of Columbia
Committee on Governmental Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your recent letter enclosing questions following the hearing on reform of the D'Oench Duhme doctrine. Enclosed is a report prepared by the Legal Division of the Federal Deposit Insurance Corporation in response to questions which you have posed with respect to the FDIC's exercise of the D'Oench Duhme doctrine.

If you have further questions or concerns, please let me know.

Sincerely,

Ricki Helfer

Ricki Tigert Helfer
Chairman

Enclosure

**Report of the Legal Divison of the
Federal Deposit Insurance Corporation
in Response to Questions Posed by Chairman Cohen**

Q.1: **Provide the following information:**

Q.1(a): **The number of claims submitted through the administrative claims process since 1989 and a breakout of how many were paid, partially paid, and rejected.**

A.1(a): The following claims were submitted and determined through the FDIC's receivership claims process since the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. Dollar amounts are in millions.

Total number of claims filed	80,436
Total dollar amount of claims filed	$31,879
Number of claims allowed	39,032
Dollar amount of claims allowed	$ 6,561
Number of claims disallowed	31,988
Dollar amount of claims disallowed	$25,067
Number of claims partly allowed	9,416
Dollar amount of claims partially allowed	$ 251

The FDIC does not maintain a centralized tracking system that identifies the basis on which each of the thousands of claims filed was denied and therefore cannot readily determine the number of claims denied under D'Oench or for any other specific reason. To isolate the basis for denial, the FDIC would have to review the file for each of the 31,988 claims denied and the 9,416 claims partially denied in hundreds of receiverships. In some cases, those claims records are stored in off-site storage facilities.

Q.1(b): The number of times D'Oench has been invoked to bar claims in administrative proceedings and in litigation since 1989 and an estimate of the value of these claims.

A.1(b): D'Oench and/or section 1823(e) has been invoked to bar claims in approximately 5,145 litigation cases since the enactment of FIRREA in 1989. The total estimated amount of the claims involved in those cases, including claims that were barred on grounds other than D'Oench and/or section 1823(e), equaled $12,523,889,496.

The foregoing information is limited to claims involved in litigation, and does not include claims that were not pursued through litigation after denial of a receivership claim. As noted above, the FDIC does not maintain a centralized tracking system capable of identifying the basis on which each of the thousands of claims filed was denied and therefore cannot readily determine the number of claims denied under D'Oench or for any other specific reason.

With respect to litigated cases, and the value of D'Oench claims raised in litigation, we note the following limitations. The statistics provided below in response to Questions No. 1(b) through 1(g) were derived from the FDIC's computerized Case Management System (CMS). CMS is designed to facilitate the tracking of pending litigation through the compilation of specified relevant data supplied by individual attorneys responsible for specific legal matters. The information recorded for a given matter includes, for example, the type of case, the amount of the claim, if monetary damages are sought, whether outside counsel has been retained and the amount of fees generated by that outside counsel, a brief description of the litigation and its current status. In addition, the attorney enters Issue Codes based on his or her assessment of the key controversies in the action. There are dozens of issue codes, including D'Oench, from which the attorney selects, with the objective of providing a useful snapshot of the dispute.

To produce the statistics for this answer, the FDIC searched for all cases where either D'Oench or section 1823(e) was indicated in the Issue Codes, as well as searching the Current Comment field for the same references. We believe that this approach has produced a substantially comprehensive response. Nevertheless, absolute accuracy is not feasible because, as described above, the individual attorney completing the CMS report exercises a degree of discretion in identifying the issues that he or she believes best characterize the controversy. It is possible that in a given matter the attorney may consider a D'Oench component to be secondary or peripheral to other contentions and may not record that Issue Code.

In addition, although the FDIC can provide overall claim amounts, it is not possible to attribute a dollar figure limited to D'Oench issues. Accordingly, the total amount of claims includes claims barred on grounds other than D'Oench and/or section 1823(e). The CMS report includes the amount of the claim, but the figure is not broken down by issue.

Q.1(c): The number, and a complete list, of state and federal cases in which the Corporation has invoked D'Oench since 1989 in which:

i. The court barred a claim under D'Oench;
ii. The court held that D'Oench had been improperly invoked.

A.1(c): "status" The following information was obtained from CMS fields:

Judgment in favor of FDIC	1,308
Judgment against FDIC	41
Settled	1,044
Dismissed	747
Still pending	691
Other (includes asset bulk sold and other categories)	1,314
Total	5,145

Although the CMS reports have a "status" field, the entries do not identify the issue on which the case was resolved. Consequently, the above-referenced specification of the results obtained in the 5,145 cases in which D'Oench and/or section 1823(e) was involved does not indicate whether D'Oench or section 1823(e) was the dispositive issue in the case. Thus, where a report listed D'Oench or section 1823(e) among other issues codes, notations in the status field such as "Judgment for FDIC" or "Judgment Against the FDIC" or "Settled" could not reliably be characterized as litigation where the court had barred or upheld a claim under D'Oench or section 1823(e).

To compensate for this limitation, the FDIC searched Westlaw for FDIC cases in which D'Oench and section 1823(e) were invoked. The FDIC then reviewed each listed case to determine whether the court rejected the FDIC's D'Oench and/or section 1823(e) arguments. Those cases are set forth in Attachment A, appended hereto.

Q.1(d): The amount spent in attorneys' fees litigating the applicability of D'Oench for both outside counsel and in-house attorneys for cases in category c(ii).

A.1(d): For the 41 cases identified in response to Question 1(c) as "judgment against the FDIC", the total outside counsel fees were $712,135.69, while in-house expenses were $32,017. These fees include legal expenses for all issues involved in those cases.

CMS tracks whether a case is handled in-house, by outside counsel, or jointly, and the outside counsel's fees. However, the CMS reports do not attempt to attribute outside counsel fees among the various issues in a case. Accordingly, the above legal fee information greatly overestimates the legal fees required for the D'Oench and/or section 1823(e) issues in these cases since it does not separately attribute fees to the much more expensive discovery, motions, trial, research and other legal work that may be required by other non-D'Oench or section 1823(e) aspects of the litigation. For example, D'Oench and section 1823(e) have generated a vast amount of FDIC in-house research over the years, and outside counsel operate under a strict obligation to utilize FDIC resources to avoid the expense of unnecessary legal research. Therefore, D'Oench and section 1823(e) cases are likely not to require significant research or fees by outside counsel on such issues.

Q.1(e): A complete list of cases, and the total value of claims, in which the Corporation invoked D'Oench to bar claims against a failed institution where officials from that failed institution were charged with a criminal offense.

A.1(e): The FDIC is not able to identify the officials of failed banks charged with a criminal offense, or whether such officials were involved in any D'Oench or section 1823(e) case arising from that failed bank. The FDIC currently tracks only criminal referrals.

The FDIC maintains a log of criminal referrals by institution and can cross-reference between that log and the list of cases in which D'Oench has been invoked. As a result, the FDIC can identify 752 closed banks in which a criminal referral has been made and in which a case(s) arising from that bank involved D'Oench or section 1823(e).

However, the criminal referral log is not designed to distinguish between borrowers and directors and officers as the subject of the referral. Further, there is no data cross-referencing the individual bank officer subject to a criminal referral and any D'Oench or section 1823(e) claims involving that specific former bank officer.

Q.1(f): The number of cases in which the Corporation invoked D'Oench and the claimant eventually declared bankruptcy or lost his or her home through foreclosure.

A.1(f): The FDIC has identified the following information in response to this question:

Bankruptcies where D'Oench identified as one issue: 336
Foreclosures where D'Oench identified as one issue: 265

Through the CMS reports, the FDIC can track both foreclosure and bankruptcy proceedings where it is a party. However, short of reviewing every individual file, the FDIC has no way of knowing what kind of real estate is the subject of the foreclosure proceedings (e.g., commercial, raw land, residential). Even if it were possible to identify the property as a residence, it would nonetheless require speculation to draw a connection between the invocation of D'Oench and the foreclosure action.

Similarly, the FDIC has no means to establish a causative link between its use of D'Oench and/or section 1823(e) and a claimant's decision to file for bankruptcy. In addition, the FDIC does not track bankruptcies in which it does not file a claim or otherwise participate.

Q.1(g): A complete list of cases in which the Corporation invoked D'Oench to bar claims after the claims had been successfully adjudicated against the depository institution in state or federal court, the total value of these claims, and the percentage of cases in which the claims were successfully barred.

A.1(g): In response to this question, the FDIC provides the following information.

The following cases involved the invocation of D'Oench and/or section 1823(e) to attempt to bar claims after the failed depository institution had received an adverse decision:

1. Olney S&L v. Trinity Banc Assn, 934 F.2d 1056 (11th Cir. 1991)
2. Grubb v. FDIC, 868 F.2d 1151 (10th Cir. 1989)
3. Thurman v. FDIC, 889 F.2d 1441 (5th Cir. 1989)
4. Gray v. FDIC, 841 S.W.2d 72 (Tx. App-Houston, 1992)
5. FDIC/Manager Fund v. Larsen, 835 S.W. 2d 66 (Tex.Sup.Ct., 1992)
6. Baumann v. Savers Fed. S&L Assn, 934 F.2d 1506 (11th Cir. 1991)
7. In re Geri Zahn, 25 F.3rd 1539 (11th Cir. 1994)
8. FDIC v. Zoubi, 792 S.W.2d 825 (Tex.App.--Dallas, 1990)
9. FDIC v. F&A Equipment Leasing, 800 S.W.2d 231 (Tex.App.--Dallas, 1990)

The total value of the claims at issue in the above cases was approximately $40 million. Claims were barred by D'Oench in Baumann, Zahn, Zoubi, and F&A Equipment Leasing, which means that the FDIC prevailed in 44 percent of these cases. However, two of the cases were decided under Texas case law that has since been overturned by the Texas Supreme Court. See Larsen.

Q.2: Explain how the Corporation evaluates the assets of open depository institutions when there is pending litigation relating to an asset. Would it be possible for the Corporation to use this same procedure to evaluate assets after a bank is closed for the purpose of effectuating a purchase and assumption agreement?

A.2: The FDIC evaluates the effect of pending litigation on affected assets with respect to both open and failing depository institutions. In the case of an open financial institution for which the FDIC is the regulator, the objective of the examiner is to determine whether, and to what extent, litigation may impair the institution's capital and thus affect its soundness. Where an institution is failing, the FDIC must determine the value of the assets to decide which resolution transaction results in "least possible cost to the deposit insurance fund." 12 U.S.C. § 1823(c)(4)(B).

When the FDIC examines an operating insured institution, it requires the institution to complete an Officer's Questionnaire, which inquires, inter alia, as follows:

> 16. If the institution is a defendant in any suit in law or equity, list the names of the plaintiffs, amount sued for, nature or basis for litigation, and expected result including any probable loss.

The institution is asked to summarize the information in response to the questionnaire and to provide "complete details" to the examiner. The latter may be, but are not required to be, supplied by the institution's attorney. The examiner's instructions explain that the purpose of Question No. 16 is to "[d]etermine the impact of contingent liabilities, the likelihood of becoming a direct liability, and the potential impact on capital".

Should an examiner conclude, as a result of the review of the response to Question 16, that litigation involving an asset adversely affects the book value of the asset, the examiner may classify the asset as "substandard," "doubtful," or "loss," or may reclassify the asset.[1] Such classification may lead to an adjustment to capital including, where a "loss" classification is involved, a deduction from capital of the entire book value of the affected asset.

On the other hand, when the FDIC evaluates the assets and liabilities of a failing insured depository institution, it is no longer concerned with the safety and soundness of the former institution's banking practices but rather must determine how to "satisfy the Corporation's obligations to an institution's insured depositors at the least possible cost to the deposit insurance fund." 12 U.S.C. § 1823(c)(4)(B). Historically, a purchase and assumption transaction has been the preferred method of resolution for a variety of reasons. Such a transaction frequently permits failed bank depositors to have access to their accounts within two business days through an acquiring bank, thereby alleviating cashflow problems and adverse impacts on the local economy. In a purchase and assumption transaction, certain assets and liabilities are transferred to an acquiring open depository institution, while others are retained by the FDIC as receiver. In structuring resolution transactions, one of the FDIC's primary goals is to preserve public confidence by maintaining the stability and continuity of banking activities in the area served by the failed institution.

Pursuant to the FDIC's statutory obligation to resolve failing institutions in a manner resulting in the "least possible cost to the deposit insurance fund," the FDIC must evaluate any proposed resolution transaction based upon a valuation of all of the institution's assets and liabilities. To make this statutory judgment, the FDIC must evaluate its potential liability in a purchase and assumption versus its potential liability in a "payout" of deposit insurance claims or other resolution transaction. Such a comparative evaluation is necessary to determine the validity of book values claimed by the failed institution and to estimate anticipated losses.

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[1] The reverse is also true: an examiner could conclude that the progress of particular litigation is so favorable to the institution that, all other factors being equal, the asset need no longer be classified or that its classification level should be less severe.

To minimize the impact on depositors and on the local economy, a resolution transaction should be completed promptly. Because of the time constraints involved, the only method of evaluating potential losses available to the FDIC is through reliance on the books and records of the failed bank to estimate the assets that would be returned by a purchasing bank and to estimate which of those assets ultimately would be collectible.

Integral to this determination is an assessment of ongoing litigation relating to booked assets, with the practice of the FDIC being to take a cautious and conservative approach. The necessity for prompt completion of resolution transactions does not permit the review process often available to bank examiners. In the FDIC's view, the conservative approach it uses to evaluate the impact of litigation on affected assets of a failing institution is well-suited to the resolution process and has worked successfully. As an examiner undertakes the evaluation of such litigation in an entirely different context, and with different objectives, it is not feasible to rely wholly on the examination method to permit evaluation of resolution alternatives under the "least cost" mandate.

Q.3: Explain how the Corporation determines whether D'Oench should be invoked to deny a claim. Does the Corporation consider whether the claimant intended to deceive bank examiners by misrepresenting the value of bank assets? Does the Corporation consider whether the claimant may have been defrauded by bank officials? Does the Corporation consider, to any extent, the fundamental fairness of invoking D'Oench under particular circumstances?

A.3: The FDIC examines each claim on its facts in order to determine whether D'Oench/section 1823(e) should be asserted. Under the FDIC's "Guidelines for Use of D'Oench and Section 1823(e)" (the Guidelines), the FDIC identifies seven categories of cases where the assertion of D'Oench or section 1823(e) requires approval by FDIC headquarters. In those categories, FDIC personnel, and FDIC servicers, are required to consult and seek prior approval through prescribed Legal Division procedures.

The D'Oench doctrine and section 1823(e) embody a public policy designed to protect diligent creditors and innocent depositors from losses that would result if claims and defenses based on undocumented agreements could be enforced against a failed bank. The requirement of a recorded agreement is central to the ability of the banking regulators to conduct effective evaluations of open banks and to the FDIC's ability to resolve failed banks accurately and quickly.

Under the Guidelines, a review of a proposed use of D'Oench or section 1823(e) considers whether the claimant took all reasonable steps to document and record the agreement or understanding with the bank. Under the Guidelines, as well as the proposed statutory amendment submitted by the FDIC, claimants

who have an agreement signed by an authorized bank officer may enforce that agreement against the FDIC as receiver even if the agreement is not contained in the bank's records. If the agreement is not documented and signed by the bank's authorized officers, however, it would generally be subject to rejection under D'Oench or section 1823(e) consistent with the public policy underlying the statute.

Similarly, where there is clear evidence that a pre-closing vendor supplied goods and/or services to the failed institution, D'Oench or section 1823(e) will not be asserted whether or not there are written records in the bank's files confirming a contract for the goods and/or services.

The policies underlying D'Oench and section 1823(e) do not focus on the culpability of either the claimant or the bank employee. Application of D'Oench and section 1823(e) must focus on the existence of written evidence of the alleged agreement in order to fulfill the public policy goals that underlie the supervision of open depository institutions, resolution of failing depository institutions, and liquidation of failed bank assets.

The FDIC believes that in establishing the Guidelines it has appropriately balanced the interest in individual fairness in invoking D'Oench and section 1823(e) under particular circumstances and the public policy interest in protecting diligent creditors and innocent depositors from bearing the losses that would result if claims and defenses based on undocumented agreements could be enforced against a failed bank. The Guidelines also support the important public policy of requiring written documents for insuring the safety and soundness of open institutions and effective resolution of failed institutions.

Q.4: One of the primary justifications cited for D'Oench in the Corporation's testimony was to reduce the cost of the bank and thrift failures. Does the Corporation believe it is good public policy to bar potentially valid claims brought by bank customers solely for the purpose of minimizing the cost of bank failures to the public-at-large? How can this policy be reconciled with the general purpose of the bank insurance programs -- to increase the confidence of American citizens in the nation's banks and to spread the risk of bank failure from individual bank customers to the public-at-large?

A.4: On January 31, 1995, Mr. John F. Bovenzi, Director of the Division of Depositor and Asset Services of the FDIC, testified before the Subcommittee that D'Oench and Section 1823(e) are important to the FDIC for three public policy reasons. First, the D'Oench doctrine assures that banking regulators can rely on a financial institution's records for supervisory purposes

and in order to protect the depository insurance funds that they administer. Second, the D'Oench doctrine promotes careful consideration of lending practices, assures proper recordation of various banking activities and protects against collusive or erroneous structuring or restructuring of terms. Third, the D'Oench doctrine protects the innocent depositors and creditors of a failed institution from absorbing the losses resulting from agreements that do not appear in the books and records of the institution.

The original purpose of creating deposit insurance was to protect innocent depositors by providing insurance up to a specified threshold for deposits in insured depository institutions. Assessments for deposit insurance are paid by the insured depository financial institutions, not by the general public. Deposit insurance was not designed to protect creditors of failed depository institutions. By statute, the FDIC is charged with protecting the deposit insurance fund, not the creditors of banks. See 12 U.S.C. §§ 1811, 1823(c)(4). Creditors, unlike depositors, may control their risks by careful documentation of agreements entered into with banks consistent with prudent business practices, including any warranties or facts relied upon in deciding to enter into the agreement.

Application of the D'Oench doctrine and section 1823(e) serves to protect the deposit insurance funds and depositors, along with prudent borrowers and creditors, by requiring documentation of agreements asserted against failed banks. Any cost savings realized through the use of D'Oench or section 1823(e) benefits those depositors and diligent creditors. In addition, the enhanced ability to supervise open institutions and to promote the maintenance of a safe and sound banking industry, along with the more effective resolution of failed institutions, permitted by application of the D'Oench doctrine and section 1823(e) serves significant national interests.

Q.5: Under the common law, oral agreements relating to bank transactions may be binding. Banks are also liable for negligent and intentional misrepresentations. Are bank customers warned, in any way, that these common law doctrines do not apply once a bank has failed? Are borrowers and small businesses warned that unless their agreements are in writing and approved by the board of directors the agreements will be unenforceable against federal banking agencies should the bank fail? Do bank customers have any way of evaluating whether their bank may be heading toward insolvency prior to entering into an agreement with it?

A.5: Although some oral agreements may be enforceable in certain circumstances, many others require written documentation by law. For example, real estate transactions and the creation of security interests, such as recorded financing statements provided by small businessmen to their financing bank, must be in writing.

Thus, apart from the fact that section 1823(e) is and has been the law governing transactions with insured banks since 1950, bank customers can reasonably be expected to exercise prudence when engaging in transactions of any consequence to their personal and/or business finances.

Further, there is no doubt that section 1823(e) was enacted to assure the accurate and timely documentation of banking transactions, regardless of what might otherwise be acceptable under common law. The national interest in a sound banking system, and a secure deposit insurance fund, has long required significant supervision of banks and transactions with banks. The Congressional debates prior to enactment of section 1823(e) establish clearly that Congress was concerned with achieving the goal of reliable bank examinations and rapid resolution of failed banks by imposing recordation requirements on banking transactions. Although efforts were made to condition these requirements on the presence of fraud, Congress rejected such a prerequisite as inconsistent with the important public policy necessitating written documentation of banking agreements. At that time, and ever since, the emphasis was on facilitating the reliance of federal and state examiners on a bank's assets, unfettered by "seemingly unqualified notes that are in fact subject to undisclosed conditions." Langley v. FDIC, 484 U.S. 86, 92 (1987).

Nevertheless, a bank customer may evaluate the financial strength of the institution with which he wishes to do business through review of current business reports. For example, the bank makes annual disclosure statements available, and a customer could also review the "Call Reports." These are short quarterly financial reports that contain balance sheets and income statements, together with some detailed schedule information for individual banks. The FDIC also publishes the Uniform Bank Performance Reports, which compare individual banks with their peer group banks.[2] Additionally, the customer could review the information produced by private firms that specialize in banking matters.

Q.6: A number of cases have held that when the Corporation acquires assets of a failed institution, it takes on the status of a holder-in-due-course, even though the Corporation would not qualify for such status under the normal operation of law. In fact, some cases have given the Corporation greater powers than a holder-in-due-course by enabling it to bar defenses related to non-negotiable commercial paper. Should the Corporation be treated as a holder-in-due-course even though it does not qualify for that status under state law? If so, should the Corporation be in a better position than a regular holder-in-due-course? If so, why and specifically to what extent?

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[2] Although the FDIC publishes both of these reports, requests for Uniform Bank Performance Reports are made through the Federal Financial Institutions Examination Council. Both the Call Reports and the Uniform Bank Performance Reports are available for a fee.

A.6: The FDIC should continue to be treated as a holder-in due-course under federal common law. The federal holder-in-due-course doctrine is a development of federal common law that provides the FDIC with the protections of a holder-in-due course under commercial law whether or not it satisfies the technical prerequisites of state law. Most cases have held that it does not grant to the FDIC greater rights than those provided to a holder-in-due-course under state law. The federal holder-in-due-course doctrine merely permits the FDIC to achieve "holder-in-due-course" status without meeting all of the technical requirements, such as the bar to "bulk" transfers, under state law. The federal holder-in-due-course doctrine is not contrary to commercial expectations because a "maker must anticipate that his note may be transferred to a holder-in-due-course." See FSLIC v. Murray, 853 F.2d 1251, 1256 (5th Cir. 1988).

Nonetheless, the federal holder-in-due-course doctrine should be distinguished from the D'Oench doctrine and section 1823(e). The federal holder-in-due-course doctrine developed independently from the D'Oench doctrine and section 1823(e), although based on the same public policy concerns. For example, the federal holder-in-due-course doctrine has been held inapplicable to non-negotiable instruments.

To facilitate the effective accomplishment of the FDIC's statutory responsibilities, it should be in a better position than a commercial law holder-in-due-course in one regard. The FDIC should not be required to meet "technical" requirements under state law to become a holder-in-due-course (e.g., the prohibition on acquisition through a "bulk sale"). Unlike commercial parties, the FDIC acquires assets in bulk upon its appointment as receiver, and not "voluntarily" or as an individual purchaser. Therefore, the FDIC could rarely, if ever, meet the Uniform Commercial Code requirements for holder-in-due-course status absent the federal common law rule. However, the substantive rights of a holder-in-due-course should not be extended beyond those available commercial parties.

Q.7: Does the Corporation believe that genuine victims of bank fraud who relied to their detriment on oral representations by bank officials are entitled to some avenue of redress after the bank fails? How should the D'Oench doctrine be amended to address this concern?

A.7: Genuine victims of bank fraud may seek redress against bank officials who perpetrate such fraud. The FDIC believes that its Guidelines, and its proposed statutory amendment, strike an appropriate balance between the interests of individual claimants and the public's interest in permitting bank regulators and receivers to rely on a bank's records to define its assets and liabilities.

Under the FDIC's Guidelines and its proposed statutory amendment, a claimant who has diligently obtained a written agreement signed by an authorized bank officer can assert that

agreement against the FDIC as receiver even if the agreement is not found in the bank's records. This exception to the records requirement protects those who have sought to document their agreement with the bank where, through no lack of diligence on their part, the bank failed to file the document in its records.

The FDIC believes that, as between a claimant of a failed institution who has taken every measure to insure that his or her agreement with a failed institution has been documented, and a claimant who has relied on an oral representation, the diligent claimant is entitled to protection. The amendment to section 1823(e) proposed by the FDIC would address concerns that truly diligent claimants be protected, while retaining the important requirement that agreements or representations must be in writing if reliance is to be placed on them in asserting claims or defenses against a failed bank.

Q.8: If a bank purchases an asset from the Corporation, but a claim against the asset based on unrecorded representations arises in the future, is that bank able to sell or "put" the asset back to the Corporation? If so, why does the Corporation believe that the D'Oench doctrine is necessary to facilitate purchase and assumption agreements?

A.8: The provisions of individual purchase and assumption agreements govern the ability of a purchaser to "put back" an asset, but currently the FDIC has not experienced significant "put backs" of assets involving claims or defenses based on undocumented agreements due to the availability of the D'Oench doctrine and section 1823(e). Purchase and assumption agreements frequently restrict the ability of purchasers to put back assets for any reason. The FDIC's purchase and assumption agreements contain provisions that some assets are never to be put back; that some can be put back only if the purchaser sells them back to the FDIC for less than they paid to the FDIC; or that some assets can be repurchased by the FDIC only at the FDIC's sole discretion. The FDIC's practice is not to permit an asset to be put back based solely on the fact that a debtor has raised unrecorded agreements or representations by the failed bank. Instead, the typical outcome when such a claim arises is that the FDIC as receiver may defend against the claim as a liability that did not pass to the purchaser, while the purchaser raises D'Oench, 1823(e) or holder-in-due-course as a transferee of the FDIC. See, e.g., Payne v. Security S&L Assn, 924 F.2d 109 (7th Cir. 1991); Porras v. Petroplex Savings Assn, 903 F.2d 379 (5th Cir. 1990).

If such undocumented claims could be asserted against the receiver or acquirers, however, potential acquirers of failed bank assets would either significantly reduce the price paid for such assets or demand additional rights to put such assets back to the FDIC. Either alternative would increase the cost of the resolution of failed insured depository institutions,

and potentially the losses to the deposit insurance fund. This result would also increase the uncertainty of any calculation of the "least costly" resolution transaction by expanding the unknown liabilities that could arise after completion of the transaction. As a result, by eliminating the necessity of purchasers to negotiate additional protections from undocumented claims or defenses, the D'Oench doctrine and section 1823(e) greatly facilitate purchase and assumption agreements, and reduce losses to the deposit insurance funds. The protections of D'Oench and section 1823(e) plainly enhance the value of receivership assets and thereby promote the more efficient and less costly resolution of failed depository institutions.

Q.9: Section 1823(e) is limited to agreements that relate to assets acquired by the Corporation. The common law doctrine, however, has been expanded to bar enforcement of unrecorded agreements relating to a host of other banking activities. What is the justification for this expansion? Should the "asset" requirement be read back into the D'Oench doctrine?

A.9: Although the original D'Oench case involved an asset, the Supreme Court did not set out a specific test to identify cases where application of the doctrine would be appropriate. Consequently, the courts have interpreted the doctrine to apply in a number of circumstances, including some which do not involve a particular asset. Such an interpretation is based upon, and consistent with, the well-established policy considerations behind the doctrine.

The D'Oench doctrine was designed to protect diligent creditors and innocent depositors from bearing the losses associated with claims and defenses against a failed bank based on undocumented agreements. This protection can be fully afforded only through application of the doctrine to agreements that affect the total assets of a receivership, even where a particular individual asset may not be involved. The requirement that any arrangement or agreement with a failed bank be in writing allows banking regulators to conduct effective evaluations of open banks and the FDIC to resolve failed banks accurately and quickly. The financial condition of a bank is not limited to the value of its assets, but is affected as well by the nature and extent of its liabilities. To the extent that such liabilities are based upon agreements that normally should be, but were not, reflected in the bank's records, such agreements are as likely to mislead bank examiners as agreements directly related to a specific asset. Such liabilities implicate the same policy considerations compelling the application of the D'Oench doctrine.

The D'Oench doctrine has never had an asset requirement and the FDIC does not believe that it should have one now. Nevertheless, the FDIC recognizes that there may be non-asset cases where the application of D'Oench may not be appropriate. Thus, the FDIC has formally recognized in section 5(d) of its D'Oench Guidelines that the application of D'Oench to non-asset matters should be limited through a careful evaluation of the facts in particular cases.

Q.10: Should third parties, such as banks that purchase assets from the Corporation, be entitled to invoke D'Oench? What is the justification for such an expansion of the doctrine?

A.10: The FDIC neither explicitly endorses nor prohibits the application of D'Oench by open banks that purchase assets from the FDIC. Purchasers have, however, asserted the right to the protections of D'Oench and section 1823(e) successfully in court. The availability of D'Oench and section 1823(e) to acquirers promotes the receiver's ability to dispose of assets without continuing liability for undocumented claims. In addition, purchasers are willing to bid a greater amount for the assets because they need not fear that the value of the asset will be reduced when a borrower later attempts to raise unrecorded conditions concerning the assets. Although a change is likely to increase the cost of resolving failed depository institutions, the FDIC will not object to restriction of the application of section 1823(e) to assets held by, or claims against, the FDIC.

Q.11: Prior to the recent issuance of specific guidelines, approval from Corporation headquarters has been required in novel cases when the application of D'Oench would expand the doctrine. Please provide a list of cases where such approval has been granted since 1989. Also, provide a list of cases where approval to invoke D'Oench has been sought since the issuance of the new guidelines and indicate whether approval was granted.

A.11: Although novel uses of D'Oench have required approval by designated officials in Washington since prior to 1989, no record has been kept of such requests or their disposition. Since the Guidelines went into effect in November 1994, approval by Washington has been sought in the cases listed in the following chart:

Case Name	**Disposition**
FCI International, Inc. v. First New York Bank for Business	Permission Denied
FDIC v. Marshall & Stevens, Inc.	Permission Granted
Tong v. Assured Thrift & Loan	Permission Denied
FDIC v. Kolfeld	Permission Granted in Part; Denied in Part
First New York Bank for Business v. Wrapwell Corp.	Permission Denied
Marik v. FDIC	Permission Granted

Q.12: The effectiveness of the FDIC's guidelines in addressing the inequities of the D'Oench doctrine will depend, to a great extent, on how they are enforced. Will the General Counsel consider the extent to which a claimant was an innocent victim of bank fraud, when deciding whether D'Oench should be invoked?

A.12: As Mr. Bovenzi stated in his January 31, 1995 testimony, the FDIC developed the Guidelines "to provide a structure for the FDIC to promote the exercise of sound discretion and consistency in the application of D'Oench and section 1823(e)." (Bovenzi testimony, p. 4)

Included in the seven categories of matters where prior approval from Washington must be received before D'Oench is asserted are matters involving individuals who have taken all reasonable steps to document their agreement with the failed bank. In utilizing the Guidelines the Legal Division of the FDIC in Washington, in consultation with the Division of Depositor and Asset Services, will take into consideration facts showing whether a borrower or claimant has attempted to document and record any agreement or understanding with the bank in determining whether to assert D'Oench. Where the third party individual dealing with the bank has acted diligently to document agreements or assurances on which he or she intends to rely, the FDIC will not assert D'Oench or section 1823(e).

Nonetheless, neither D'Oench nor section 1823(e) is premised on the fraud or wrongful acts of the bank or of the claimant. The doctrine and the statute look solely to the increased likelihood that banking regulators or receivers will be unable to accurately assess the assets and liabilities of the bank if an agreement, warranty, or assurance is not documented in writing. If a claimant makes no attempt to document his or her agreement, even if innocently, yet can enforce that agreement against the FDIC, the public policy necessitating written documentation to permit supervision and resolution of the insured depository institutions will not be served.

We believe that the Guidelines will permit the FDIC to avoid inappropriate and inconsistent application of D'Oench and section 1823(e) while insuring that secret agreements remain barred.

Q.13: One of the FDIC's proposed changes to the statute exempts from the D'Oench doctrine agreements for goods and services for less than $20,000. Why should this exemption be limited by the monetary value of the agreement? Would the FDIC support an exemption for all agreements for goods and services?

A.13: The FDIC does not intend to predicate the application of D'Oench/section 1823(e) to agreements for goods and services on an arbitrary dollar threshold. The $20,000 figure in the FDIC's proposed amendment was one which we believe was originated by the Republican staff of the Senate Banking Committee

in the 103rd Congress, and it may well be a useful benchmark both for vendors and financial institutions. If a vendor could establish that goods and/or services, regardless of the size of their claim, had in fact been provided to a bank prior to failure, it would not be the position of the FDIC to decline payment on the grounds that the agreement had not been memorialized consistent with the requirements of D'Oench and section 1823(e).

As discussed in Answer No. 5 above, ordinary business prudence typically leads businessmen to document in writing significant transactions with a bank. In particular, where a vendor is contracting with a bank or any other business to provide goods or services for tens of thousands of dollars, it is normal to document the agreement. Such substantial agreements may have a significant impact on the vendor's business, as well as on the bank's financial viability. For this reason, it may be appropriate for the Subcommittee to consider whether a dollar threshold for application of section 1823(e) serves the public interest in focusing closer scrutiny on large transactions that typically are fully documented in normal business practice.

Q.14: The FDIC's proposal also modifies the requirement that a written agreement must be entered into contemporaneously with the formation of an asset. Why should this requirement be maintained at all? Would the FDIC support a total repeal of this aspect of D'Oench.

A.14: The FDIC's proposal to modify the contemporaneous requirement of section 1823(e) is made in recognition of the commercial reality that events occur in the usual history of a loan, other than its initial acquisition, during which legitimate agreements may be, and often are, made. The purpose of the contemporaneous requirement of section 1823(e), as recognized by the Supreme Court in Langley v. FDIC, is to ensure mature consideration of loan transactions and prevent fraudulent insertion of new loan terms with the collusion of bank employees. Elimination of the requirement could create an opportunity for fraud, particularly when a bank is headed for failure and the interests of bank officials and borrowers may well coincide. The FDIC's proposed modification is thus designed to safeguard against such fraud, yet allow for legitimate agreements that do not meet the requirement in its present form. Nonetheless, the FDIC's policy precludes application of section 1823(e) to bar claims or defenses where the sole defect of the asserted agreement is that it failed to comply with the contemporaneous requirement. Accordingly, the FDIC is agreeable to eliminating this requirement as the sole basis for rejecting a claim or defense under section 1823(e).

It should be noted that the contemporaneous requirement is not an aspect of D'Oench, but is exclusively a requirement of section 1823(e).

Q.15: What relief would the FDIC's amended statute provide for the innocent victim of bank fraud who relied to their detriment on factual misrepresentations by bank officials?

A.15: The FDIC's proposed amendment would protect the individual who has acted diligently to protect his interests by documenting any assurances on which he relied. This includes obtaining a signed agreement with an authorized bank officer. Thus, for example, if a borrower had a written agreement duly executed by an authorized bank officer but, through no fault of the borrower, the bank officer failed to include the otherwise satisfactory agreement in the bank's records, the agreement would nonetheless be recognized as valid.

However, the proposed amendment would not provide protection to the individual who failed to put an agreement with a bank in writing. Exempting from the applicability of section 1823(e) oral arrangements that the customer willingly, if innocently, enters into is counterproductive and at odds with Congressional intent underlying the original enactment of the section. Such an exemption would invite fraud, render the books of a depository institution incomplete and unreliable, undermine the FDIC's ability to examine open banks with any degree of confidence, and impair the FDIC's efforts to evaluate a failing institution for purposes of a prompt resolution that protects depositors, creditors, the insurance fund, and shareholders.

Where a claimant has been misled by oral representations, and no diligent effort had been undertaken by that claimant to document an agreement, then he must look for redress from the offending bank official rather than from the assets of the failed institution.

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Attachment

ATTACHMENT A

ATTACHMENT A FOR QUESTION 1(c)

The following is based on a search conducted on "WESTLAW". This first section identifies cases in which a court ruled in favor of the FDIC that claims or defenses were barred by D'Oench or section 1823(e).

I.

1. Federal Deposit Insurance Corporation v. Patel (Vinodbhai T.), a/k/a Patel (Vino T.) v. Nationsbank, (5th Cir. Tex.), Mar 02, 1995)

2. F.D.I.C. v. Monterrey, Inc., (1st Cir. (Puerto Rico), Jan 18, 1995)

3. St. Hilaire and Associates, Inc. v. F.D.I.C. (D.N.H., Jan 17, 1995)

4. Brown Leasing Co. v. Cosmopolitan Bancorp, Inc., (7th Cir. (Ill.), Dec. 19, 1994

5. Florida Realty Trust v. Federal Deposit Insurance Corporation (D. Mass., Dec 16, 1994)

6. F.D.I.C. v Kisosoh Realty Corp., (S.D.N.Y., Dec 14, 1994)

7. FSLIC v. DeLuna, (E.D. La., Nov. 28, 1994)

8. F.D.I.C. v. Enventure V, (S.D. Tex., Nov. 14, 1994)

9. Vasapolli v. Rostoff, (1st Cir. (Mass.), Nov. 08, 1994)

10. F.D.I.C. v. O'Malley, (Ill., Oct. 27, 1994)

11. Nutro Products Corp. v. NCNB Texas Nat. Bank, (5th Cir. (Tex), Oct. 17, 1994)

12. F.D.I.C. v. Betancourt, (S.D.N.Y., Oct 17 1994)

13. Opton, Inc. v. F.D.I.C.. (D.C. App., Sep. 15, 1994)

14. F.D.I.C v. Oldenburg, (10th Cir. (Utah), Sep. 08, 1994)

15. F.D.I.C. v. Bay Street Development Corp. (st Cir. (Mass.), Aug. 26, 1994)

16. F.D.I.C. v. Giammettei, (2nd Cir. (Conn.), Aug 24, 1994)

17. Metro North State Bank v. Gaskin, (8th Cir. (Mo.), Aug. 19, 1994)

18. F.D.I.C. v Henry, (D.Kan., Jul. 28, 1994)

19. F.D.I.C. v. Rouse, (E.D.La., Jul. 18, 1994)

20. In re Geri Zahn, Inc., (11th Cir. (Fla.), Jul. 14, 1994)

21. F.D.I.C. v. Piccolo, (Conn. Super., Jun. 28, 1994)

22. Inn at Saratoga Associates v. F.D.I.C., (N.D.N.Y., Jun. 27, 1994)

23. FDIC v. National Consumer Alliance, Inc., D. Kan., Jun. 20, 1994)

24. Lemaire v. F.D.I.C., 5th Cir. (Tex.), May 17, 1994)

25. Swedbank (Sparbankernas Bank) v. F.D.I.C., (1st Cir. (Mass.), May 13, 1994)

26. F.D.I.C. v. Villemaire, (D.Mass., May 06, 1994)

27. F.D.I.C. v. Bathgate, (3rd Cir. (N.J.), May 05, 1994)

28. Sunbusrt Bank v. Executive Life Ins. Co., (Cal.App. 2 Dist., May 04, 1994)

29. F.D.I.C. v. Greenberg, (D.Mass., Apr. 29, 1994)

30. Ferber (Norman) v. Ehrlich (Nathan), Janover Rubinroit & Company, JRS Equities Ltd., Simon (Martin), First Women's Bank First New York Bank, (S.D.N.Y., Apr. 14, 1994)

31. F.D.I.C. v. Hulsey, (10th Cir. (Okl.), Apr. 13, 1994)

32. Norwalk Bank v. Constantine, (Conn.Super., Apr. 11, 1994)

33. F.D.I.C. v. O'Flahaven, (D.N.H., Apr. 08, 1994)

34. F.D.I.C. v. Schrag, (D.Kan., Apr. 06, 1994)

35. Albright v. F.D.I.C., (1st Cir. (N.H.), Apr. 01, 1994)

36. F.D.I.C., Receiver of Goldome v. Banks, (E.D.Pa., Apr. 04, 1994)

37. Krebs v. F.D.I.C., (M.D. Fla., Mar. 31, 1994)

38. McDougald v. F.D.I.C., (D.Mass., Mar 30, 1994)

39. F.D.I.C. v. Chisholm, (1st Cir. (Mass.), Mar. 29, 1994

40. Dendinger v. First Nat. Corp., (5th Cir. (La.), Mar. 16, 1994)

41. F.D.I.C. v. Monterrey, Inc., (D.P.R., Mar. 16, 1994)

42. Ostroff v. F.D.I.C., (D.R.I., Mar. 10 1994)

43. F.D.I.C. v. Smith, (D.Mass., Mar. 07, 1994)

44. First City, Texas Beaumont, (E.D.Tex., Feb. 24, 1994)

45. F.D.I.C. v. Kamas, (D.Kan., Feb 14, 1994)

46. Fleet Nat. Bank v. F.D.I.C., (D.Mass., Feb 01, 1994)

47. F.D.I.C. v. Eltrex Intern. Corp., (D.N.H., Feb 01, 1994)

48. Texas Commerce Bank Net. Ass'n v. Suarez, (E.D.La., Jan 31, 1994)

49. Crossland Federal Sav. Bank v. by F.D.I.C. v. 114 East Realty Co., (S.D.N.Y., Jan. 28, 1994)

50. Merchants Bank & Trust Co. v. Woodlake Partnership, (Conn.Super., Jan 27, 1994)

51. NCNB Texas Nat. Bank v. Johnson, (5th cir. (Tex.), Jan. 19. 1994)

52. F.D.I.C. v. Duffy, (D.Mass., Dec. 28, 1993)

53. F.D.I.C. v. Gilbert, (5th Cir. (La.), Dec. 16, 1993)

54. Smania v. Mundaca Inc. Corp., (Fla.App. 3 Dist., Dec. 14, 1993)

55. Gustin v. F.D.I.C., (W.D.Mo., Dec. 08, 1993)

56. Maniar v. Capital Bank of California, (N.D.Cal., Dec. 06, 1993)

57. Celtic Development Corp. v. F.D.I.C., (D.Mass., Nov. 12, 1993)

58. In re Beitzell & Co., Inc., (Bankr.D.Dist.Col., Nov. 09, 1993)

59. Gustin v. F.D.I.C., (W.D.Mo., Oct. 20, 1993)

60. Levy v. F.D.I.C., (1st Cir. (Mass.), Oct. 19, 1993)

61. McMillan v. MBank Fort Worth, (5th Cir. (Tex.), Oct. 14, 1993)

62. Crossland Federal Sav. Bank v. 62nd and First Associates, L.P., (S.D.N.Y., Oct 12, 1993)

63. F.D.I.C. v. Ludwig Family Trust, (9th Cir. (Ariz.), Sep. 17, 1993)

64. F.D.I.C. v. Lands, (9th Cir. (Cal.), Sep. 15, 1993)

65. FDIC v. Conant, (Conn.Super., Sep. 09, 1993)

66. Outer Banks Contractors, Inc. v. Daniels & Naniels Const., Inc., (N.C.App., Sep. 07, 1993)

67. Vasapolli v. Rostoff, (D.Mass., Aug. 31, 1993)

68. F.D.I.C. v. Delco Development Co., Inc., (Conn.Super., Aug 30, 1993)

69. F.D.I.C. v. Slay, (9th Cir. (Alaska), Aug. 27, 1993)

70. Hill v. Samuel Cabot, Inc., (D.Mass., Aug. 26, 1993)

71. F.D.I.C. v. Diamond C. Nurseries, Inc., (Fla.App. 4 Dist., Aug. 25, 1993)

72. F.D.I.C. v. Bodin Concrete Co., (Tex.App. - Dallas, Aug. 19, 1993)

73. Notrica v. F.D.I.C., (9th Cir. (Cal.), Aug. 17, 1993)

74. Brown Leasing Co. v. F.D.I.C., (N.D.Ill., Aug. 11, 1993)

75. Murphy v. F.D.I.C., (D.D.C., Aug. 10, 1993)

76. Nutro Products Corp. v. NCNB Texas National Bank, (S.D.Tex., Jul. 22, 1993)

77. F.D.I.C. v. Rhee, (S.D.N.Y., Jul. 12, 1993)

78. F.D.I.C. v. Levitas, (S.D.N.Y., Jun. 23, 1993)

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92. F.D.I.C. v. Wiley, (D.N.J., Jan. 19, 1993)

93. King v. F.D.I.C., (N.D.Ill., Dec. 30, 1992)

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219. <u>Federal Sav. and Loan Ins. Corp. v. Locke</u>, (W.D.Tex., Jun. 14, 1989)

220. <u>Federal Deposit Ins. Corp. v. Texarkana Nat. Bank</u>, (5th Cir. (Tex.), Jun 02, 1989)

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222. FSLIC v. Silverberg, (E.D.La., May 25, 1990)

223. In re Kanterman, (S.D.N.Y., May 18, 1990)

224. Aero Support Systems, Inc. v. Federal Deposit Ins. Corp., (N.D.Tex., Apr. 27, 1989)

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The following identifies cases in which a court ruled that claims or defenses were not barred by D'Oench or 1823(e).

II. N LIST

1. E.I. du pont de Nemours and Company v. Federal Deposit Ins. Corp., Receiver for United National Bank of Washington, (D.C. Cir., Jan. 27, 1995)

2. Federal Deposit Insurance Corporation, as Receiver of New Bank of New England v. Kagan, (Spencer M.), Rubin (Ronald S.), Linsky (George S.), as Trustees of Seacoast Realty Trust, Peatman (Dale), Finn (Alan), Belinfante (Sandra), Sandler (Arthur), Andler (Mark), Burba (Stanley), Linsky (Philip), (D.Mass., Jan. 03, 1995)

3. Motorcity of Jacksonville, Ltd. and Throuogh Motorcity of Jacksonville, Inc. v. Southeast Bank N.A., (11th Cir. (Fla.), Dec. 05, 1994)

4. Murphy v. F.D.I.C., (9th Cir. (Cal.), Oct. 26, 1994)

5. Fletcher Village Condominium Ass'n. v. F.D.I.C.,

6. F.D.I.C. v. McFarland, (5th Cir. (La.), Oct. 05, 1994

7. In re Berr, (9th Cir.BAP (Cal.), Sep. 14, 1994)

8. E.I. de Pont de Nemours and Co. v. F.D.I.C., (D.C.Cir., Aug. 26, 1994)

9. Stebbins Realty Corp. v. F.D.I.C., (D.N.H., Jan. 29, 1994)

10. F.D.I.C. v. Perry Bros., Inc., (E.D.Tex., Jun. 03, 1994)

11. Hartford Cas. Ins. Co. v. F.D.I.C., (5th Cir. (Tex.), Jun. 01, 1994)

12. Erbafina v. F.D.I.C., (D. Mass., May 11, 1994)

13. villafane-Neriz v. F.D.I.C., (1st Cir. (Puerto Rico), Apr. 04, 1994)

14. F.D.I.C. v. Sadlik, (Conn.Super., Mar. 31, 1994)

15. Lawlor Corp. v. F.D.I.C., (D.Mass., Mar 29, 1994)

16. F.D.I.C. v. Marine Midland Realty Credit Corp., (4th cir. (Va.), Mar. 02, 1994)

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24. Thigpen v. Sparks, (5th Cir.(Tex.), Feb. 16, 1993)

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30. Matter of Liquidation of City & County Bank of Know County, (Tenn.App., Oct. 07, 1992)

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73. Federal Deposit Ins. Corp. as Manager for FSLIC Resolution Fund, as Receiver for New Orleans v. Saxena, (E.D.La., Jan. 17, 1991)

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75. Agri-Tech Ltd. v. North American Bank, (Ariz.App., Dec. 20, 1990)

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88. Federal Deposit Ins. Corp. v. National Union Fire Ins. Co. of Pittsburgh, Pa., (E.D.Tenn., Jan 06, 1989)

89. Federal Deposit Ins. Corp. v. Jenkins, (11th Cir. (Fla.), Nov. 27, 1989)

90. Sibarium v. NCNB Texas Nat. Bank, (N.D.Tex., Nov. 02, 1989)

91. Federal Deposit Ins. Corp. v. Tennesseans for Tyree, (6th cir. (Tenn.), Sep. 21, 1989)

92. Federal Deposit Ins. Corp. v. Republicbank, Lubbock, N.A. Lubbock, Tex. ,(5th Cir. (Tex.), Sep. 20, 1989)

93. Federal Deposit Ins. Corp. v. Texas Bank of Garland, (Tex.App. - Dallas, Aug. 30, 1989)

94. California Concrete Co., Inc. v. Beverly Hills Sav. & Loan Ass'n., (Cal.App. 4 Dist., Aug 16, 1989)

95. Federal Deposit Ins. Corp. v. Percival, (D.NE, Jun. 27, 1989)

96. Jack Parker Industries, Inc. v. Federal Deposit Ins. Corp., (Tex.App. - El Paso, Apr. 19, 1989)

97. Commerce Federal Sav. Bank v. Federal Deposit Ins. Corp., (6th Cir. (Tenn.), Apr. 17, 1989)

98. Federal Sav. & Loan Ins. Corp. v. Derbes, (E.D.La., Mar. 27, 1989)

99. In re Kanterman, (Bankr.S.D.N.Y., Mar. 13, 1989)

100. Federal Deposit Ins. Corp. v. Grupo Girod Corp., (1st Cir. (Puerto Rico), Mar. 08, 1989)

101. Federal Deposit Ins. Corp. v. Turner, (6th Cir. (Tenn.), Feb. 7, 1989)

102. Grubb v. Federal Deposit Ins. Corp., (10th Cir. (Okl.), Feb 16, 1989)

103. Sowers v. Federal Deposit Ins. Corp., (S.D.Iowa, Feb. 09, 1989)

III.

The following identifies cases in which the court ruled that some of the claims or defenses at issue were barred by D'Oench or section 1823(e), but the remaining claims or defenses were not barred by D'Oench or section 1823(e).

1. F.D.I.C. v. Massingill, (5th Cir. (Tex.), Ju. 06, 1994)
2. F.D.I.C. v. Blonder, (Conn.Super., Apr. 28, 1993)
3. F.D.I.C. v. White, (N.D.Ga., Mar. 31, 1993)
4. F.D.I.C. v. Walker, (N.D.Tex., Mar. 18, 1993)
5. Oklahoma Radio Associates v. F.D.I.C., (10th Cir. (Okl.), Mar. 12, 1993)
6. Holden v. F.D.I.C., (D.Mass., Mar. 03, 1993)
7. F.D.I.C. v. Rusconi, (D.Me., Oct. 21, 1992)
8. F.D.I.C. v. P.P.S. Associates, (D.Conn., Sep. 25, 1992)
9. Connecticut Bank & Trust Co. v. Lee, (Conn.Super., Sep. 08, 1992)
10. F.D.I.C. v. Vernon Real Estate Investments, Ltd., (S.D.N.Y., Jul. 24, 1992)
11. Lancaster v. F.D.I.C., (E.D.La., Jun. 05, 1992)
12. Federal Deposit Ins. Corp. v. Laquarta, (5th Cir. (Tex.)
13. Clay v. Federal Deposit Ins. Corp., (5th Cir. (Tex.), Jun. 11, 1991)
14. Dollar Federal Sav. bank v. Green Tree Acceptance, Inc., (D.Minn., Mar. 21, 1991)
15. Federal Deposit Ins. Corp. v. Hudson, (D.Kan., Feb., 27, 1991)
16. AmWest Sav. Ass'n. v. Farmers Market of Odessa, Inc., (W.D.Tex., Dec 19, 1990)
17. Royal Bank of Canada v. Federal Deposit Ins. Corp., (N.D.Tex., Mar. 22, 1990)
18. Federal Sav. and Loan Ins. Corp. v. Smith, (E.D.Ark., Oct. 31, 1989)

19. <u>Federal Deposit Ins. Corp. v. R-C Marketing and Leasing Inc.</u>, (D.Minn., Jun. 23, 1989)

20. <u>In re Hunter</u>, (Bankr.S.D.Tex., May 24, 1989)

RESOLUTION TRUST CORPORATION

Resolving The Crisis
Restoring The Confidence

March 22, 1995

Honorable William S. Cohen
Chairman
Subcommittee on Oversight of
Government Management and
the District of Columbia
Committee on Governmental Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Deputy and Acting CEO John E. Ryan has asked me to respond to the questions you posed in connection with the Resolution Trust Corporation's testimony before your Subcommittee held on January 31 on reform of the D'Oench Duhme doctrine.

I am pleased to enclose the RTC's responses to your questions. As indicated in my letter dated March 8 to your Staff Director, the RTC appreciates Mr. Brubaker's assistance in exploring other means to obtain the information requested in questions 1b through 1g. As soon as further instructions and clarification are received with respect to question 11, the RTC will proceed with a response.

We look forward to working with your Subcommittee in the future. If you have any questions, please let me know.

Sincerely,

Peter E. Knight
Director
Office of Governmental Relations
(202) 416-2116

Enclosure

801 17th Street, N.W. Washington, D.C. 20434

RESPONSES TO CHAIRMAN COHEN'S SUPPLEMENTAL QUESTIONS IN CONNECTION WITH THE D'OENCH HEARING HELD ON JANUARY 31, 1995

1. **Provide the following information:**
   a. **The number of claims submitted through the administrative claims process since 1989 and a breakout of how many were paid, partially paid, and rejected.**

The number of claims submitted through the administrative claims process from RTC's inception through January 31, 1995 totals 48,312. Of these, 22,548 have been allowed, 1,508 have been partially allowed, and 14,633 have been disallowed. The remaining 9,623 claims are either pending a determination by the receiver or were filed by the claimants and subsequently withdrawn.

1. **b. through g.**

As discussed in our March 3, 1995 meeting with Committee staff, the RTC has great difficulty responding to the questions posed in 1(b) through (g). In the meeting, the RTC did commit to provide a list of all D'Oench cases that we could locate on Westlaw or LEXIS where: (1) the RTC (in any capacity), a subsidiary of an RTC conservator or receiver or a purchaser of assets from the RTC was a party; and (2) D'Oench or § 1823(e) was raised as an issue. The list is attached (Attachment "A"). We have tried to be as comprehensive as possible. Consequently, there may be some cases that appear more than once, either because the case was reported at both the district court and appellate level or because the case appeared on both reporting services. There are, of course, many additional cases that are not reported on Westlaw or LEXIS.

Also discussed were options for gathering data on claims where D'Oench has been invoked in the administrative claims process. In lieu of a manual review of all disallowed claims files, the RTC committed to conducting a review of the data on the claims tracking system to determine its degree of completeness. A manual file review may become necessary in some offices where information is not on the system. We will continue to work with Committee staff members to ensure your request for information is fulfilled.

2. **Explain how the Corporation evaluates the assets of open depository institutions when there is pending litigation relating to an asset. Would it be possible for the Corporation to use this same procedure to evaluate assets after a bank is closed for the purpose of effectuating a purchase and assumption agreement?**

The RTC prepares and markets institutions for resolution both while they are open and under the control of current management through the Accelerated Resolutions Program (ARP) and after they are closed and reopened in conservatorship under the

control of the RTC. Institutions are resolved through either method by placing the institution into receivership and, whenever possible, selling its deposits and some or all of its assets and other liabilities through a purchase and assumption agreement to an acquiring depository institution.

Assets subject to pending litigation essentially are evaluated the same way regardless of whether the institution is open and under the ARP program or operated in conservatorship. A net present value for various methods of disposition is determined for the asset based on information available in the asset credit file. Asset valuation adjustments, when appropriate, are made based on, among other things, information regarding the costs and chances of success on litigation concerning the asset. The ability to rely on the institution's records regardless of whether the institution is open or closed is a critical part of the resolution of failed institutions since the RTC's least-cost determination, pursuant to 12 U.S.C. § 1823(c)(4), is based on its valuation of the institution's assets, which is based primarily on the institution's records (e.g., the credit file, loan agreements and amendments) regarding the nature of each asset.

3. **Explain how the Corporation determines whether D'Oench should be invoked to deny a claim. Does the Corporation consider whether the claimant intended to deceive bank examiners by misrepresenting the value of bank assets? Does the Corporation consider whether the claimant may have been defrauded by bank officials? Does the Corporation consider, to any extent, the fundamental fairness of invoking D'Oench under particular circumstances?**

The RTC considers the factual circumstances of each case carefully in determining whether to invoke D'Oench or § 1823(e), and it has on occasion exercised its discretion to decline to invoke them. The RTC may decide not to apply § 1823(e) and D'Oench to claims by small vendors and in instances where the technical requirements of § 1823(e) were not met because an agreement was not approved by a loan committee or the board of directors, but was approved by an institution employee with written authority to do so.

The RTC is not often in a position to decline to use D'Oench and § 1823(e) if they apply for several reasons. First, when the RTC was created, Congress directed the RTC to obtain the greatest possible return on assets. This was accompanied by the explicit authority for the RTC to utilize 1823(e), the statutory counterpart of the D'Oench doctrine. Second, the RTC is operating within the legal and statutory framework struck by Congress and the Supreme Court that established the balance of equities between debtors on the one hand and the depositors and public on the other. This is described in greater detail later in this section.

Finally, it is not possible to determine quickly and accurately which claims are valid and which are not. Suits by the RTC to collect on assets are frequently met by debtors with allegations of fraudulent inducement or breach of an unwritten or unrecorded representation, warranty, or agreement. Some of the debtor allegations have a basis in fact; many do not. The RTC generally cannot tell from the records of the failed institution whether these allegations have any merit. To determine the validity of these allegations would be costly, time consuming, and, at times, impossible. This is due to the fact that the RTC frequently has no access to former thrift employees with knowledge of the transaction. Under the balancing of equities struck by Congress in § 1823(e) and the Supreme Court in D'Oench and Langley, these allegations, even if true, do not constitute a defense to a suit by the RTC.

The United States Supreme Court has twice addressed the type of equitable considerations raised in this question and has twice endorsed as fundamentally fair the balance of competing interests struck by D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447 (1942) and § 1823(e) favoring innocent depositors, creditors and taxpayers over borrowers and other persons who dealt directly with a failed institution. As confirmed by the Supreme Court in D'Oench and Langley v. FDIC, 484 U.S. 86, 108 S. Ct. 396 (1987), D'Oench and § 1823(e) do not require that a party intentionally engage in wrongful conduct for his alleged agreement to be barred. Nor is there an exemption in situations where a borrower has been defrauded by former officers of a failed financial institution.

In the original D'Oench decision, the Supreme Court determined that regardless of whether the debtor intended to deceive the federal banking authorities, it was barred from asserting its defense simply because "it was responsible for the creation of the false status of the note in the hands of the bank." Id. at 461. The Court stated that "[t]he test is whether the note was designed to deceive the creditors or the public authority or would tend to have that effect. It would be sufficient in this type of case that the maker lent himself to a scheme or arrangement whereby the banking authority . . . was or was likely to be misled." Id. at 460 (emphasis added). The Court further stated that whether creditors or the banking authorities were deceived or specifically injured was irrelevant: "it is the 'evil tendency' of the acts to contravene the policy governing banking transactions which lies at the root of the rule." Id. at 459.

The Supreme Court addressed this issue again in Langley, explicitly holding that § 1823(e) barred reliance on alleged unrecorded misrepresentations by bank officials and indicating that this ruling effectuated the purposes enunciated in the original D'Oench decision. Langley, 108 S.Ct. at 401-402 (1987). As the Court stated:

> We can safely assume that Congress did not mean "agreement" in § 1823(e) to be interpreted so much more narrowly than

> its permissible meaning as to disserve the principle of the leading case applying that term to FDIC-acquired notes. Certainly, one who signs a facially unqualified note subject to an unwritten and unrecorded condition upon its repayment has lent himself to a scheme or arrangement that is likely to mislead the banking authorities, whether the condition consists of performance of a counterpromise (as in D'Oench, Duhme) or of the truthfulness of a warranted fact.

Id. at 402.

Further, in Langley, the Supreme Court explicitly rejected the argument that the statute was inapplicable because the borrowers were the ones who had been defrauded and were themselves innocent of any wrongdoing. The plain terms of the statute did not support such an interpretation. Moreover, the Supreme Court stated that these were "not the equities the statute regards as predominant" and that:

> While the borrower who has relied upon an erroneous or even fraudulent unrecorded representation has some claim to consideration, so do those who are harmed by his failure to protect himself by assuring that his agreement is approved and recorded in accordance with the statute.

Id. at 403.

Moreover, this issue apparently has been considered by Congress, as reflected in the extensive Congressional hearings relating to H.R. 5811 on August 10, 1949 and June 12, 1950. Hearings Before the House Comm. on the Judiciary, 81st Cong., 1st and 2d Sess. (1949 & 1950) (unpublished). Among other things, the proposed legislation would have eliminated D'Oench protection except in cases of actual fraud.

The bill never left the Committee. Instead, shortly after the second hearing on H.R. 5811, the language which would ultimately become § 1823(e) (with one minor change, not relevant to the question) was inserted into the legislation amending the Federal Deposit Insurance Act. That language contained no limitation to the statute's applicability in instances of fraud.

4. **One of the primary justifications cited for D'Oench in the Corporation's testimony was to reduce the cost of the bank and thrift failures. Does the Corporation believe it is good public policy to bar potentially valid claims brought by bank customers solely for the purpose of minimizing the cost of bank failures to the public at large? How can this policy be reconciled with the general purpose of the bank insurance programs -- to increase the confidence of American citizens in the nation's banks and to spread the risk of bank failure from individual bank customers to the public at-large?**

As with many other public policy issues, statutory and judicial actions to enact FIRREA and establish D'Oench and § 1823(e) protection involved a balancing of competing interests and a determination of which interests were to be given priority in order to meet important national objectives. As previously stated, the use of 1823(e) was an important tool bestowed upon the RTC by Congress as it confronted the resolution of the largest financial disaster in this nation's history. The very stability of the nation's deposit insurance system was at stake. The RTC believes that the D'Oench doctrine has been absolutely essential in meeting the public policy goal of stabilizing the deposit insurance system for millions of Americans at the least possible cost to all taxpayers.

However, reducing the cost of bank and thrift failures is not the only public policy benefit that results from D'Oench. The D'Oench doctrine also ensures that federal receivers can rely on the integrity of a financial institution's bank examinations and records to set forth the rights and obligations of the institution. This enables the FDIC and the RTC to evaluate the institution's assets and liabilities quickly and accurately to determine the most efficient resolution for that institution. The D'Oench doctrine also encourages prudent consideration of lending practices, assures proper recordation of various banking activities, and guards against haphazard or collusive restructuring of loans to the detriment of the institution and its creditors. In addition, the D'Oench doctrine satisfies the need of banking regulators to determine the face value of the assets of a failed institution, and it protects innocent depositors and creditors of failed financial institutions, as well as the taxpayers, from absorbing the losses resulting from unrecorded defenses and liabilities that would tend to diminish an institution's assets. The lack of this type of protection would allow a self-serving, out-of-control management to mask the true financial condition of the institution thus allowing an insolvent institution to remain open and build further losses to the detriment of the insurance fund and ultimately the taxpayer.

Furthermore, it is not possible to determine quickly and accurately which claims are valid and which are not valid. Instead, the RTC would have to litigate the merits of each disputed claim. This litigation would be costly, difficult, time consuming, and would undercut the RTC's ability to meet its statutory mandate to resolve failed financial institutions expeditiously and cost effectively. Suits by the RTC to collect on assets are frequently met by debtors with allegations of fraudulent inducement or breach of an unwritten or unrecorded representation, warranty or agreement. Some of these debtor allegations have a basis in fact; many do not. The RTC generally cannot tell from the records of the failed institution whether these allegations have any merit.

In view of the practical obstacles to obtaining factual evidence from the former thrift to defend these claims (since its employees no longer work there), it is likely that the RTC would be unable to prevail, even in cases where the claims are invalid. Further, some claimants could be tempted to take advantage of an institution's failure by filing spurious claims. The RTC's inability to defend against invalid claims could result in a windfall to undeserving claimants, at the expense of the failed institution's creditors, depositors and the taxpayer. The primary role of federal deposit insurance programs is to safeguard depositors who entrust their deposits to banks and thrifts. Congress and the Supreme Court did not extend the same protection under D'Oench and § 1823(e) to debtors. Unlike depositors, debtors have at least some ability to avoid the harm addressed by D'Oench and § 1823(e) by making efforts to ensure that their agreements are in writing and properly recorded.

5. **Under the common law, oral agreements relating to bank transactions may be binding. Banks are also liable for negligent and intentional misrepresentations. Are bank customers warned, in any way, that these common law doctrines do not apply once a bank has failed? Are borrowers and small businesses warned that unless their agreements are in writing and approved by the board of directors the agreements will be unenforceable against federal banking agencies should the bank fail? Do bank customers have any way of evaluating whether their bank may be heading toward insolvency prior to entering into an agreement with it?**

While oral agreements in certain situations may be enforceable, there are many types of agreements which are not enforceable as a matter of general state commercial law unless in writing. For example, many states have a statute of frauds which provides that certain types of agreements, including agreements affecting interests in real property, must be in writing. In addition, the parol evidence rule precludes claimants from introducing oral testimony to contradict or modify the terms of fully integrated agreements. Thus, ordinary business prudence requires that agreements be committed to writing.

Ever since the D'Oench decision 53 years ago, oral or unrecorded agreements relating to bank transactions have not been binding upon a bank's insolvency. The D'Oench doctrine and § 1823(e) are well-settled, long-standing principles of banking law. The D'Oench doctrine, starting with the original Supreme Court decision, and its progeny, have been in existence for 53 years. Similarly, since 1950, the U.S. Code has explicitly provided that unless agreements are in writing and approved by the board of directors, they will be unenforceable against federal banking agencies should the bank fail. Finally, at least since the Langley decision in 1987, and arguably before, the law has been clear that the RTC and FDIC will not be liable for

unrecorded negligent or intentional misrepresentations allegedly made by former officers of a failed thrift or bank.

The RTC does not regulate or supervise open institutions. Consequently, the RTC does not know what warnings, if any, open banks or thrifts may give their customers regarding the requirements of D'Oench or § 1823(e). However, there are a number of ways that bank customers may obtain information regarding a thrift's financial condition from three general sources prior to entering into an agreement with it; (1) the institution itself, (2) the federal regulators, and (3) third parties, such as professional rating companies, brokerage houses and publications which rate the health of financial institutions.

For example, thrifts are required by law to submit Reports of Condition to the Director of the Office of Thrift Supervision ("OTS") and to make these reports available to the public upon request. Reports of Condition are available for public inspection at the institution's home and branch offices and may also be obtained by calling the OTS.

Insured savings associations or thrifts are also required to submit an Annual Report on Financial Condition and Management to the FDIC and OTS which includes an annual financial statement. These are also available to the public on request and may be obtained from the institution or OTS. Finally, publicly held stock institutions are required to submit certain public disclosure statements and other filings to the Securities Exchange Commission which are also available from the SEC or through the OTS.

The OTS, the FDIC, and the RTC have public reference rooms and public information specialists who can be reached by telephone to assist customers in obtaining the information they need.

There are also several private companies that will provide ratings of a given institution's financial condition over the telephone for a fee. These include Bauer Financial Reports, Inc., IDC Financial Publishing, Sheshunoff Information Services, Inc. and Veribanc. The RTC is listing these for informational purposes only and does not endorse any of these rating companies. The FDIC also has prepared helpful information such as the article entitled "Is Your Bank Healthy? Here Are Ways to Find Out" which was in the Spring 1994 edition of the FDIC Consumer News (Attachment "B"). In addition, several financial newspapers and other publications evaluate banks and thrifts. Indeed, prior to the enactment of FIRREA, USA TODAY published a list of all undercapitalized thrifts in the nation.

6. **A number of cases have held that when the Corporation acquires assets of a failed institution, it takes on the status of a holder-in-due-course, even though the Corporation would not qualify for such status under the normal operation of state law. In fact, some cases have**

given the Cc poration greater powers than a holder-in-due-course by en bling it to bar defenses related to non-negotiable commercial paper. Should the Corporation be treated as a holder-in-due-course even though it does not qualify for that status under state law? If so, should the Corporation be in a better position than a regular holder-in-due-course? If so, why and specifically to what extent?

The federal holder-in-due-course doctrine is a separate protection which has been afforded to the RTC and FDIC by some courts. The doctrine gives the RTC and the FDIC a status equivalent to that of a holder in due course under the Uniform Commercial Code ("U.C.C.") even though they acquire the assets of failed financial institutions in bulk transactions and, therefore, cannot technically qualify as holders in due course. Where appropriate under controlling law, the RTC has asserted the federal holder-in-due-course doctrine as an additional defense available to it along with D'Oench and § 1823(e) to defeat claims and defenses based upon unrecorded agreements.

Although there is some variation among the jurisdictions recognizing this doctrine, the requirements for federal holder-in-due-course status generally follow those under state law, except for the bulk transaction element. Some courts also read the U.C.C. requirement that the holder take the instrument without "notice" of any defenses against or claims to it as "without actual knowledge" and afford the RTC and FDIC a presumption of no actual knowledge. In addition, the RTC has followed the more recent cases and confined its use of the doctrine to matters involving negotiable instruments. Thus, the RTC does not claim that it is entitled to greater powers than a regular holder in due course. However, for the reasons that follow, the RTC believes that it should be accorded the status of a holder in due course even though it would not technically qualify under state law.

As explained by the courts, the federal holder-in-due-course doctrine is based on the federal policy of providing "depositors with sound, effective, and uninterrupted operation of the [nation's] banking system with resulting safety and liquidity of bank's deposits." U.S. Rep. No. 1269, 81st Cong., 2d Sess., reprinted in 1950 U.S.C.C.A.N. 3765, 3765-66. The purpose of the doctrine is to enable the federal banking authorities to value the assets of a troubled bank or thrift quickly and accurately in order to determine whether to arrange a purchase and assumption transaction or liquidate the institution. This would facilitate purchase and assumption transactions, an approach favored over liquidation, because it preserves the going concern value of a failed bank and avoids an interruption in banking services, thus promoting confidence and stability.

A second purpose of the doctrine is to increase the likelihood that there will be a secondary market for assets acquired after failure of a financial institution in order to facilitate resolution of insolvent institutions. Under ordinary

state law shelter principles, transferees from a holder in due course obtain the rights of their transferor. Thus, conferring this special protection on the RTC and FDIC preserves the value of a failed financial institution's assets for final disposition.

Courts that have afforded the protection of the holder-in-due-course doctrine to the RTC and FDIC have done so in part on the grounds that it does not disrupt the commercial expectations of borrowers. A person who signs a negotiable instrument, such as a negotiable promissory note, is always subject to the possibility that the instrument may be negotiated to a holder in due course other than the RTC or FDIC.

7. **Does the Corporation believe that genuine victims of bank fraud who relied to their detriment on oral representations by bank officials are entitled to some avenue of redress after the bank fails? How should the D'Oench doctrine be amended to address this concern?**

Genuine victims of bank fraud, who relied to their detriment on oral representations by bank officials, are entitled to seek redress against individual bank officials who perpetrated the fraud against them. D'Oench and § 1823(e) do not prevent these victims from seeking redress against individual bank officials.

An amendment to D'Oench or § 1823(e) that would allow alleged victims of bank fraud who claim oral misrepresentations by the failed institution to seek redress against the failed institution itself would effectively nullify the doctrine. In many cases involving D'Oench, the claimants have alleged fraud by the failed institution or by third parties as a defense to their obligations to the failed institution or as the basis of an affirmative claim against the institution. If this exception were codified, fraud would probably be asserted in virtually all instances by claimants. Because each case would have to be separately litigated in order to determine which claims were valid and which were not, and because the RTC frequently does not have access to proof necessary to defend these claims (because the thrift's employees with knowledge of the transaction are no longer employed), such an amendment would essentially eviscerate the rule. Also, legal costs incurred by the insurance fund would likely soar to the detriment of the public at large which, one way or another, ultimately pays for the cost of the RTC or the insurance fund.

8. **If a bank purchases an asset from the Corporation, but a claim against the asset based on unrecorded representations arises in the future, is that bank able to sell or "put" the asset back to the Corporation?**

The buyer (a bank or other purchaser) of an asset from the RTC only has a right to "put back" an asset to the RTC for unrecorded representations arising in the future if the buyer purchased the asset from the RTC under an agreement containing such a "put back" right. In fact, the RTC sells many of its

assets "as is" without any such "put back" rights. Therefore, a buyer often will not have the ability to "put back" assets based on unrecorded matters covered by the D'Oench doctrine.

If so, why does the Corporation believe that the D'Oench doctrine [is] necessary to facilitate purchase and assumption agreements?

Purchase and assumption agreements are typically used in the context of a resolution of a failed institution where its deposit franchise is sold along with other liabilities and assets. Assets sold through such a purchase and assumption agreement are usually sold "as is" without any representations or warranties, except a 180 day "put back" right for assets whose documents have forged signatures. Therefore, most assets sold through such purchase and assumption agreements cannot be "put back" because of the existence of unrecorded or undocumented terms or conditions. Accordingly, for assets sold in such purchase and assumption transactions, as noted by the courts, the D'Oench doctrine, where available to purchasers of those assets from the RTC, enhances the value and attractiveness of the assets and reduces the ultimate costs of the failed institution to the taxpayers. In those limited cases where the purchaser might have "put back" rights triggered by unrecorded matters covered by the D'Oench doctrine, the availability of the D'Oench doctrine to the RTC allows the RTC to maximize the value of the returned asset and reduce the loss to the taxpayer. As stated previously, it is absolutely critical that prospective buyers of RTC assets can rely exclusively and unequivocally on the books and records of the institution (or receivership) in order to formulate a value as a basis for a bid to buy such assets.

9. **Section 1823(e) is limited to agreements that relate to assets acquired by the Corporation. The common law doctrine, however, has been expanded to bar enforcement of unrecorded agreements relating to a host of other banking activities. What is the justification for this expansion? Should the "asset" requirement be read back into the D'Oench doctrine?**

All courts do not agree that § 1823(e) is limited to agreements that relate to a specific asset acquired from a failed financial institution. Furthermore, although the original D'Oench decision involved a promissory note, the D'Oench common law doctrine has never had a requirement that a particular asset be affected for it to apply. Every federal circuit court of appeals to address this question has rejected the argument that the D'Oench common law rule has such a requirement.

Application of D'Oench to agreements which do not affect a particular asset, but which may impair the overall assets of a receivership, serves the central purposes of the rule. D'Oench bars reliance upon unrecorded agreements which could mislead bank examiners even if the agreement does not relate to a specific debt owed to the institution. For example, claims that an

institution breached an alleged oral promise to finance a loan are precluded even if the institution held no note evidencing the loan. The federal banking authorities would not be able to reliably and efficiently evaluate and resolve financial institutions if such unrecorded obligations or liabilities of the institution which might affect its total net worth could not be detected.

10. **Should third-parties, such as banks that purchase assets from the Corporation, be entitled to invoke D'Oench? What is the justification for such an expansion of the doctrine?**

The RTC has not affirmatively advocated in court the application of D'Oench by third parties that purchase assets from the RTC. Nevertheless, a number of courts have extended D'Oench protection to purchasers. The justification generally given by the courts is that the availability of D'Oench protection makes assets of failed institutions more marketable by preserving their value in the hands of purchasers. This may facilitate the sale of a failed institution's assets by increasing the number of interested bidders and the amounts bid and may yield a higher return to the taxpayers. Alternatively, if purchasers could not invoke the D'Oench doctrine, the RTC (which attempts to liquidate assets as quickly as possible consistent with obtaining fair market value) could be forced to retain assets for long periods of time. The goal of the RTC to sell assets quickly would be thwarted since the assets could have much greater value remaining in the hands of the RTC, which can invoke the D'Oench doctrine, than they would being sold to purchasers, who, hypothetically, would be unable to invoke the D'Oench doctrine. The ability to sell assets on a timely basis is critical to the solvency of the FDIC's insurance funds.

11. **Approval from Corporation headquarters has been required to invoke D'Oench in novel cases that would expand the doctrine. Please provide a list of cases where approval has been granted since 1989.**

As explained in our meeting on March 3, 1995 with Committee staff, the RTC is unable to respond to this question because the information is not readily available. RTC headquarters does not maintain a list of cases that have been approved using the D'Oench doctrine. After the Committee staff were made aware of this problem, they agreed to provide further instructions and clarification before the RTC proceeds with a response.

12. **In the case Sweeney v. ComFed Savings Bank, et al., a state court found that ComFed had committed unfair and deceptive trade practices and entered an approximately $3 million verdict in favor of the Sweeneys. Prior to that time, the RTC had become conservator of ComFed bank and removed the case to federal court, where it succeeded in getting the case dismissed by invoking D'Oench. Were the state court findings that the Sweeneys had been victims of fraud by bank officials taken into account before the RTC decided to**

invoke D'Oench? Describe the process that was used to approve the decision to invoke D'Oench and what approvals were required? Why did the RTC determine that it was appropriate to invoke D'Oench in this case?

Before addressing specific questions regarding the Sweeney case, it is helpful to review and clarify the events chronologically. Prior to ComFed's failure on December 14, 1990, the case of Sweeney v. Comfed Savings Bank, et al. was tried to a jury verdict on March 19, 1990 in the Superior Court, Middlesex Division, Commonwealth of Massachusetts. All but two of the pending counts of the Sweeneys' complaint were submitted to the jury for decision. The jury returned a mixed verdict. It held that the Sweeneys were in default on their loan to ComFed and returned a verdict for ComFed in the amount of $2,069,580.33. The jury also returned a $65,000 verdict in favor of the Sweeneys on one count of their complaint--intentional infliction of emotional distress. The jury specifically considered, and rejected, the Sweeneys' claims that ComFed had breached an agreement to provide construction financing, that ComFed committed fraud, and that ComFed had interfered with the Sweeneys' business relationships. This jury verdict was the only verdict entered in the case before ComFed failed; the RTC was appointed receiver; and the case was removed to federal district court. The trial judge had reserved decision on two counts of the Sweeneys' complaint, but the judge had not entered any decision or judgment prior to the appointment of the receiver or the removal to federal district court.

On January 11, 1991, after ComFed failed, the RTC removed the case to the U.S. District Court for the District of Massachusetts. At that point, the jurisdiction of the state court ended as a matter of law, and it had no authority to issue any further rulings, decisions, or orders.

After the case was removed, the RTC moved for entry of judgment in accordance with the special jury verdict and for summary judgment on the two counts tried to the court but not decided before removal. The basis for summary judgment on these two counts was, in part, the D'Oench doctrine and § 1823(e). RTC staff attorneys in the Valley Forge Office discussed the use of D'Oench and § 1823(e) with the RTC's Washington Legal Office. No particular approvals from Washington were required as the use of D'Oench and § 1823(e) as a defense in the Sweeney case was not novel. The Sweeneys claimed that Comfed had orally agreed to provide them with additional financing over and above the $1.6 million that Comfed actually lent them. No such agreement appeared in Comfed's records.

The federal district court granted summary judgment to the RTC on the two unresolved counts and entered a judgment affirming the jury verdict. The federal district court's judgment was upheld in its entirety on appeal.

The finding was an action by the state court after its jurisdiction had terminated. Immediately upon removing the case to the federal district court on January 11, 1991, the RTC's outside counsel notified the state court clerk. On January 14, 1991, a courtesy copy of the removal was delivered to the state trial court judge's office. Thereafter, the state court had authority only to gather the then-existing state court record and forward it to the federal court. The state court clerk did so, and forwarded the record on January 30, 1991. At that point, the state court's involvement in the case should have ended.

Nevertheless on January 31, 1991, notwithstanding the termination of its jurisdiction twenty days earlier, the state court trial judge purported to render an opinion and judgment awarding damages to the Sweeneys on the two unresolved counts of the complaint. (The original opinion and judgment signed by the trial judge are dated January 31, 1991 and were placed under seal with the U.S. District Court for the District of Massachusetts.) The state court trial judge directed that this opinion and purported judgment be entered into the state court record. When it was discovered that the state court clerk had already forwarded the state court record, the clerk was directed to create additional docket entries making the opinion and purported judgment part of the record, and then to forward them also. On March 1, 1991, the Sweeneys filed a pleading which challenged the removal of the case. This pleading contained as an exhibit an initialed copy of the state judge's opinion and purported judgment. This "initialed" copy was dated January 30, 1991; one day earlier than the fully signed original dated January 31, 1991 which the clerk of the state trial court furnished the RTC for filing with the federal district court on February 1, 1991. The federal district court found that the state court docket entries had been altered after the fact to make the removal falsely appear to have been dated January 30, 1991.

After several hearings, the federal district court ruled that the removal was entirely proper, and that the state judge's opinion and purported judgment were null. The Sweeneys continued to pursue the issue before the federal district court, and the federal district court eventually imposed sanctions on them. These sanctions were upheld on appeal.

Aside from the manner in which it was entered and presented to the federal court, the state judge's opinion and purported judgment suffered from a number of other substantial deficiencies which undercut its conclusions, without regard to D'Oench and § 1823(e). A large portion of the purported judgment is an attempt to impose punitive damages on ComFed. Punitive damages, however, are generally unavailable after an institution has failed and a receiver has been appointed. The state court also justified its opinion and purported judgment by holding that ComFed had violated the Federal Home Loan Bank Board's (FHLBB) loan to value regulation. Even if this were correct, the effect was merely that the Sweeneys were permitted to borrow more money than they were otherwise likely to have received. The FHLBB

regulations, however, are not consumer protection statutes, do not create private rights of action, and cannot support a judgment in favor of the Sweeneys. Finally, the state judge recognized that the findings which underlay the purported judgment were, in a number of areas, directly contrary to the jury's resolution of the same factual issues in favor of ComFed. The state court judge gave no reason, however, for failing to follow the jury's factual findings.

13. How much money did the RTC spend litigating the Sweeney case in terms of RTC staff time and fees paid to outside counsel?

As of January 31, 1995, the RTC, as receiver for ComFed, has incurred $321,642 in outside counsel fees in the Sweeney case to date. There are no readily available figures to show how much money was spent on the Sweeney case in terms of RTC staff time.

14. The Sweeney property was foreclosed upon by the RTC and then auctioned. How many bids were received for the property? What was the amount of each bid?

The Sweeney property was auctioned off at a foreclosure sale. There was no separate foreclosure and later auction. There were three pre-qualified bidders for the Sweeney properties at the foreclosure sale. The winning bid for 24 Meyer Lane was in the amount of $455,000 by the RTC as receiver for ComFed; the only other bidder for 24 Meyer Lane bid $10,000. The winning bid for 776 Bay Road was in the amount of $334,000, again by the RTC as receiver for ComFed; there were no other bidders. It is typical that the holder of a mortgage will bid the minimum amount allowable under state law unless competitive bidding ensues in order to retain maximum flexibility to pursue deficiency rights.

15. The RTC hired ComFed's former counsel, Hanify & King, to litigate the Sweeney case after the RTC was appointed conservator for ComFed. The RTC Office of Inspector General determined that this action did not violate the RTC's conflict of interest regulations. Notwithstanding the IG's findings, explain why the RTC believes it was appropriate to hire the same law firm that advised ComFed, a failed thrift, and had a long standing adversarial relationship with the Sweeneys. Does the RTC still retain this firm? If not, why not? Have any members of this firm been criminally indicted, by state or federal authorities? If so, what were the nature of the charges and the results of any charges brought against them?

When the RTC takes over a failed institution it faces a conundrum concerning the employees of the institution. Obviously it must remove any employee who had engaged in wrongdoing or negligent business practices. Equally obvious is the difficulty in managing the institution if all knowledgeable employees are removed. The RTC attempts to retain trustworthy employees to carry out its mission. A similar rationale applies for use of fee counsel.

The question of the use of inherited counsel is one which the RTC treats very seriously. The RTC does not believe that the mere fact that an attorney or firm previously represented a failed institution is an automatic conflict. Such a position would not be well founded and would result in a tremendous increase in the cost to the taxpayers if implemented. Further, it is possible in litigation that a change of counsel can be detrimental to the success of the client's arguments. Such automatic disqualifying of firms could result in the RTC having a limited ability in some jurisdictions to retain unconflicted counsel.

Nevertheless, the RTC does disqualify counsel in a number of circumstances. After the RTC takes over a failed institution, the legal staff assigned to the institution attempts, as quickly as possible, to identify the attorneys and firms representing the institution. The legal staff seeks initially to determine three things about the firm. First, the RTC considers whether the attorney or firm is competent to handle the matter(s) assigned to it. Second, the RTC considers whether there is any reason to believe that the actions or inactions of the attorney or firm may have led to the failure of the thrift. Third, our attorneys determine whether the attorney or firm has any conflicts under established conflicts and ethics rules. The determination of an existing conflict is premised on work being done by the attorney or firm for other clients (not the failed institution) which would be in conflict with their current representation of the RTC. The consideration of these three factors is ongoing. If the RTC learns of any information which it believes raises doubts as to the propriety of the firm continuing to represent it, the counsel will be disqualified.

The allegations concerning Hanify and King's alleged conflict of interest were brought to RTC's attention shortly after it was appointed conservator. It should be noted that even the state judge found no improper conduct by the attorneys in this case. The misconduct which the state judge believed to have occurred was on the part of officers of ComFed, not counsel. Even if one subscribes to the state judge's view of the evidence, which the jury did not, there is no evidence that the firm advised or was even aware of the verbal misrepresentations which the Sweeneys alleged to have deceived them.

The RTC asked another law firm to look into the allegations and give it an opinion. On March 28, 1991, the RTC received the opinion which found no improper conduct or conflict of interest. The opinion found no conflict since the interests advocated by the firm in the state court litigation were consistent with, not adverse to, those of the RTC in the federal court litigation. The Sweeneys also raised the conflict of interest issue with the federal court but did not receive a favorable determination.

When Comfed failed, the RTC retained a number of the law firms that had been representing Comfed, as they were already familiar with the cases. This is a common practice with any

institution that fails. Hanify & King had tried the Sweeney case in state court and it made good business sense to continue to use the same firm rather than hire a different firm that would have to familiarize itself with the case. The law firm of Hanify & King made the business decision in 1992 that it no longer wanted to do legal work for the RTC. To the best of the RTC's knowledge, no member of Hanify & King has been criminally indicted by state or federal authorities.

16. What is the RTC's next course of action with respect to the Sweeney case?

The RTC recently met with the Sweeneys in an effort to reach a settlement. As part of that process, the RTC has asked its asset manager to retain a local appraiser to perform a new appraisal on the properties. Mrs. Sweeney is considering whether to agree to cooperate with the appraiser.

17. During the hearing, Mr. Dudley testified about a case where the RTC and FDIC invoke[d] D'Oench and obtained an $11.9 million verdict. What is the name of that case? Please provide any written opinions and findings of fact relating to application of D'Oench enter[ed] by the court in that case.

The case Mr. Dudley referred to during the hearing is FDIC v. Bayles & Co. of America, Inc., 1992 WL 161005 (D. Fla. 1992), appeal pending before 11th Circuit. Copies of the following are attached (Attachment "C"):

(1) Opinion of the District Court dated June 30, 1992 on Westlaw;

(2) Memorandum of the District Court dated October 4, 1993;

(3) Order of the District Court dated September 25, 1993; and

(4) Judgment of the District Court dated March 31, 1994.

Oral question posed by Senator Cohen during the hearing: Were any of the ComFed bank officers prosecuted for fraudulent behavior in the Massachusetts courts?

The RTC is aware of eight convictions against officers of ComFed leading to six orders to pay restitution in the Massachusetts courts. The referrals that led to these prosecutions were generated prior to the RTC's intervention. For further information contact the Department of Justice who handled the prosecutions.

ATTACHMENT "A"

RTC D'OENCH AND/OR 1823(e) CASES

Federal Cases

1. Security Sav. Bank v. Green Tree Acceptance, Inc., 739 F. Supp. 1342 (D. Minn. 1990).

2. Mery v. Universal Sav. Ass'n, 737 F. Supp. 1000 (S.D. Tex. 1990).

3. Commonwealth Fed. Sav. & Loan Ass'n of Fla. v. Brothers of Brooklyn Pine, Inc., Case No. 89-6972-CIV-JAG, 1990 U.S. Dist. LEXIS 18432 (S.D. Fla. March 19, 1990).

4. Castleglen, Inc. v. Commonwealth Sav. Ass'n, 728 F. Supp. 656 (D. Utah 1989), aff'd, 984 F.2d 1571 (10th Cir. 1993).

5. Vernon v. RTC, 907 F.2d 1101 (11th Cir. 1990).

6. Antin v. Commercial Fed. Sav. Bank, Civil Action No. 88-3721, 1990 U.S. Dist. LEXIS 18024 (E.D. La. Jan. 10, 1991).

7. RTC v. Oaks Apartments Joint Venture, 753 F. Supp. 1332 (N.D. Tex. 1990), aff'd in part, vacated in part, 966 F.2d 995 (5th Cir. 1992).

8. Delta Sav. & Loan Ass'n, Inc. v. Meade, Civil Action No. 89-3982, 1990 U.S. Dist. LEXIS 16009 (E.D. La. Nov. 7, 1990).

9. Tuxedo Beach Club Corp. v. City Fed. Sav. Bank, 749 F. Supp. 635 (D.N.J. 1990).

10. Delta Sav. & Loan Ass'n, Inc. v. A.C.V., Inc., 750 F. Supp. 759 (M.D. La. 1990).

11. RTC v. Ross, Civil Action No. 89-1431, 1990 U.S. Dist. LEXIS 14292 (E.D. La. Oct. 22, 1990).

12. Oliver v. RTC, 747 F. Supp. 1351 (E.D. Mo. 1990), aff'd, 955 F.2d 583 (8th Cir. 1992).

13. RTC v. Colorado 126 Partnership, 746 F. Supp. 35 (D. Colo. 1990).

14. Delta Sav. & Loan Ass'n, Inc. v. Meade, Civil Action No. 89-3982, 1990 U.S. Dist. LEXIS 16009 (E.D. La. Sept. 24, 1990).

15. RTC v. Ruggiero, No. 90 C 4054, 1990 U.S. Dist. LEXIS 11820 (D. Minn. Sept. 13, 1990).

16. RTC v. Madison Street, Civil Action No. 89-4212, 1990 U.S. Dist. LEXIS 11751 (E.D. La. Aug. 31, 1990).

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17. Adams v. Madison Realty & Dev., Inc., 746 F. Supp. 419 (D.N.J. 1990), aff'd, 937 F.2d 845 (3d Cir. 1991).

18. RTC v. Security Town Co., 745 F. Supp. 1216 (E.D. La. 1990).

19. RTC v. DuBois, 771 F. Supp. 154 (M.D. La. 1991).

20. RTC v. Dismuke, 746 F. Supp. 104 (N.D. Ga. 1990).

21. Santopadre v. Pelican Homestead & Sav. Ass'n, 741 F. Supp. 1252 (E.D. La. 1990), aff'd, 937 F.2d 268 (5th Cir. 1991).

22. Park Club, Inc. v. RTC, 742 F. Supp. 395 (S.D. Tex. 1990), aff'd in part, rev'd in part, 967 F.2d 1053 (5th Cir. 1992).

23. RTC v. Clark, 741 F. Supp. 896 (S.D. Fla. 1990).

24. Pavilion Nat'l Bank v. People's Homestead Fed. Bank for Sav. (In re Thomas), Case No. 389-35405-HCA-7, 1990 Bankr. LEXIS 2763 (Bankr. N.D. Tex. Dec. 12, 1990).

25. Ajootian v. Lamont Lions Club. (In re Ajootian), 119 B.R. 749 (Bankr. E.D. Cal. 1990).

26. Savers Fed. Sav. & Loan Ass'n v. Amberley Huntsville, Ltd., 934 F.2d 1201 (11th Cir. 1991).

27. Adams v. Madison Realty & Dev., Inc., 937 F.2d 845 (3d Cir. 1991).

28. Park Tuscon Investors Ltd. Partnership v. Ali, 770 F. Supp. 531 (D. Ariz. 1991).

29. Hawke Assocs. v. City Fed. Sav. Bank, 787 F. Supp. 423 (D.N.J. 1991).

30. Agri Export Coop. v. Universal Sav. Ass'n, 767 F. Supp. 824 (S.D. Tex. 1991).

31. Germania Bank v. Brehm, 763 F. Supp. 1030 (E.D. Mo. 1991).

32. RTC v. Swift, Nos. 89 C 4485, 89 C 4486, 89 C 4756, 89 C 5707, 90 C 3477, 90 C 3478, 1991 U.S. Dist. LEXIS 5178 (N.D. Ill. April 17, 1991).

33. Unruh & Assocs., Inc. v. RTC, No. 91-1008-K, 1991 U.S. Dist. LEXIS 5935 (D. Kan. April 17, 1991).

34. RTC v. Camp, Civil Action No. CA3-89-2059-D, 1991 U.S. Dist. LEXIS 20449 (N.D. Tex. April 5, 1991).

35. RTC v. Wellington Dev. Group, 761 F. Supp. 731 (D. Colo. 1991).

36. RTC v. Ford Mall Assocs. Ltd. Partnership, 819 F. Supp. 826 (D. Minn. 1991).

37. Dollar Fed. Sav. Bank v. Green Tree Acceptance, Inc., Civil No. 4-90-375, 1991 U.S. Dist. LEXIS 3827 (D. Minn. March 21, 1991).

38. RTC v. Medical Sys. Plus, Inc., Civil Action No. 90-1789, 1991 U.S. Dist. LEXIS 2732 (D. La. March 5, 1991).

39. Shuler v. RTC, 757 F. Supp. 761 (S.D. Miss. 1991).

40. RTC v. Crow, 763 F. Supp. 887 (N.D. Tex. 1991).

41. RTC v. Brentwood Historic Assocs., Civil Action No. 90-5742, 1991 U.S. Dist. LEXIS 2237 (E.D. Pa. Feb. 26, 1991).

42. Midwest Sav. Ass'n, F.A. v. National W. Life Ins. Co., 758 F. Supp. 1282 (D. Minn. 1991), aff'd, sub nom., RTC v. National W. Life Ins. Co., 994 F.2d 517 (8th Cir. 1993).

43. RTC v. Ruggiero, 756 F. Supp. 1092 (N.D. Ill. 1991), aff'd, 977 F.2d 309 (7th Cir. 1992).

44. RTC v. Liberty Homes, Inc., No 90-2255, 1991 U.S. App. LEXIS 20041 (10th Cir. August 23, 1991).

45. RTC v. Vandenberg, No. 90 C 1835, 1991 U.S. Dist. LEXIS 266 (N.D. Ill. jan. 8, 1991).

46. Sand Creek Partners, Ltd. v. American Fed. Sav. & Loan Ass'n, Case No. 89-C-732, 1991 U.S. Dist. LEXIS 20254 (D. Colo. Jan. 3, 1991).

47. Antin v. Commercial Fed. Sav. Bank, Civil Action No. 88-3721, 1990 U.S. Dist. LEXIS 18024 (E.D. La. Dec. 31, 1990).

48. RTC v. Shehu (In re Shehu), 128 B.R. 26 (Bankr. D. Conn. 1991).

49. 1301 Conn. Ave. Assocs. v. RTC (In re 1301 Conn. Ave. Assocs.), 126 B.R. 823 (Bankr. D.D.C. 1991).

50. RTC v. Murray, 935 F.2d 89 (5th Cir. 1991).

51. Bauman v. Savers Fed. Sav. & Loan Ass'n, 934 F.2d 1506 (11th Cir. 1991), cert. denied, ___ U.S. ___, 112 S. Ct. 1936 (1992).

52. RTC v. Associated Investment Group, 792 F. Supp. 796 (S.D. Fla. 1991).

53. RTC v. Toler, 791 F. Supp. 649 (N.D. Tex. 1991).

54. RTC v. Minassian, 777 F. Supp. 385 (S.D.N.Y. 1991).

55. Milligan v. Gilmore Meyer Inc., 775 F. Supp. 400 (S.D. Ga. 1991).

56. RTC v. Residential Developers Fund Partners, No. 90-1195, 1991 U.S. Dist. LEXIS 13068 (E.D. Pa. September 17, 1991).

57. Jenkins-Petre Partnership One v. RTC, No. 91-A-637, 1991 U.S. Dist. LEXIS 20240 (D. Colo. August 13, 1991).

58. Grant County Sav. & Loan Ass'n v. RTC, 770 F. Supp. 1374 (E.D. Ark. 1991), rev'd, 968 F.2d 722 (8th Cir. Ark. 1992).

59. Southwest Fed. Sav. & Loan Ass'n v. Sharif-Munir-Davidson Dev. Corp., No. CA3-90-1415-D, 1991 U.S. Dist. LEXIS 21037 (N.D. Tex. July 24, 1991).

60. RTC v. Driscoll, No. 90-12746-Y, 1991 U.S. Dist. LEXIS 15756 (D. Mass. July 19, 1991).

61. RTC v. Kling, No. 90-2436-LFO, 1991 U.S. Dist. LEXIS 9691 (D.D.C. July 15, 1991).

62. RTC v. Dubois, 771 F. Supp. 154 (M.D. La. 1991).

63. RTC v. National Western Life Ins. Co., NO. CIV. 4-89-806, 1991 WL 518100 (D. Minn. Aug. 14, 1991).

64. Commons W. Office Condos, Ltd. v. RTC, NO. CIV. A. SA-90-CA-0496, 1991 WL 538757 (W.D. Tex. July 26, 1991), aff'd, 5 F.3d 125 (5th Cir. 1993).

65. Garrett v. Commonwealth Mortgage Corp. of Am., 938 F.2d 591 (5th Cir. 1991) (FDIC, acting as managing agent for RTC, had filed motion to dismiss which was granted but reversed and remanded on appeal).

66. Santopadre v. Pelican Homestead Sav. & Loan Ass'n, 937 F.2d 268 (5th Cir. 1991).

67. RTC v. Montross, 944 F.2d 227 (5th Cir. 1991) (court stated that, since court found RTC was not federal holder in due course, defendant could raise personal defenses which, according to D'Oench, must be based on written agreements; but court did not discuss application of D'Oench to any defenses and there are no subsequent proceedings listed in Westlaw).

68. Central W. Rental Co. v. Horizon Leasing, 967 F.2d 832 (3d Cir. 1992) (FDIC as managing agent for RTC).

69. RTC v. Juergens, 965 F.2d 149 (7th Cir. 1992).

70. Oliver v. RTC, 955 F.2d 583 (8th Cir. 1992).

71. RTC v. McCrory, 951 F.2d 68 (5th Cir.), cert. denied, ___ U.S. ___, 113 S. Ct. 459 (1992).

72. FSLIC v. Mackie, 949 F.2d 818 (5th Cir. 1992).

73. Southwest Fed. Sav. Ass'n v. Royal-Beltine Joint Venture, Civil Action No. CA3-90-1589-D, 1992 U.S. Dist. LEXIS 11790 (N.D. Tex. June 28, 1992).

74. Washington Properties Ltd. Partnership v. RTC, 796 F. Supp. 542 (D.D.C. 1992).

75. RTC v. 1601 Partners, Ltd., 796 F. Supp. 238 (N.D. Tex. 1992).

76. Alpert v. RTC, 142 F.R.D. 486 (D. Colo. 1992).

77. Glenborough N. M. Assocs. v. RTC, 802 F. Supp. 387 (D.N.M. 1992).

78. RTC v. O'Hare Dev. Corp., No. 91 C 2512, 1992 U.S. Dist. LEXIS 6198 (N.D. Ill. May 5, 1992).

79. Williams v. RTC, No. 91 C 5439, 1992 U.S. Dist. LEXIS 6113 (N.D. Ill. April 29, 1992).

80. RTC v. Shield, C.A. 3:91CV00588, 1992 U.S. Dist. LEXIS 14413 (E.D. Va. March 16, 1992).

81. RTC v. Jet Stream, Ltd., 790 F. Supp. 1130 (M.D. Fla. 1992).

82. RTC v. Thompson, No. 89 C 4486, 1992 U.S. Dist. LEXIS 1314 (N.D. Ill. Feb. 5, 1992), aff'd, 989 F.2d 942 (7th Cir. 1993).

83. RTC v. Ford Mall Assocs. Ltd. Partnership, 796 F. Supp. 1233 (D. Minn. 1992).

84. Noonan v. RTC, No. 92-1541, 1992 U.S. App. LEXIS 32374 (1st Cir. Dec. 11, 1992).

85. RTC v. Krogh, No. 91-1213, 1992 U.S. App. LEXIS 32796 (10th Cir. Dec. 4, 1992).

86. RTC v. Shield, No. 92-1402, 92-1592, 1992 U.S. App. LEXIS 32940 (4th Cir. oct. 27, 1992).

87. Walden v. RTC, No. 91-16322, 1992 U.S. App. LEXIS 32664 (9th Cir. Sept. 14, 1992).

88. RTC v. Ruggiero, 977 F.2d 309 (7th Cir. 1992).

89. 5300 Memorial Ivestors, Ltd. v. RTC (In re 5300 Memorial Ivestors, Ltd., 973 F.2d 1160 (5th Cir. 1992).

90. Park Club, Inc. v. RTC, 967 F.2d 1053 (5th Cir. 1992).

91. Ward v. RTC, 972 F.2d 196 (5th Cir. 1992), cert. denied, ___ U.S. ___, 113 S. Ct. 1412 (1993).

92. RTC v. Oaks Apartments Joint Venture, 966 F.2d 995 (5th Cir. 1992).

93. Bakersfield Convention Ctr. Hotel Assocs. v. RTC, No. 91-55712, 1992 U.S. App. LEXIS 17537 (9th Cir. July 8, 1992).

94. RTC v. Camp, 965 F.2d 25 (5th Cir. 1992).

95. Integon Life Ins. Corp. v. Southmark Heritage Retirement Corp., 813 F. Supp. 783 (N.D. Ala. 1992).

96. Abrams v. RTC, No. 89 C 3020, 1992 U.S. Dist. LEXIS 18613 (N.D. Ill. Dec. 7, 1992), modified, 1993 U.S. Dist. LEXIS 10007 (N.D. Ill. July 19, 1993).

97. Muller v. RTC, 148 B.R. 650 (S.D. Ga. 1992), aff'd, 7 F.3d 241 (11th Cir. 1993).

98. Mid Kan. Fed. Sav. & Loan Ass'n v. Orpheum Theater Co., Ltd., 810 F. Supp. 1184 (D. Kan. 1992).

99. Hill v. Imperial Sav., 852 F. Supp. 1354 (E.D. Mich. 1992).

100. Coastal Realty & Mortgage Co., Inc. v. Altus Bank, Civil Action No. 91-0776-B-C, 1992 U.S. Dist. LEXIS 18410 (S.D. Ala. Nov. 18, 1992).

101. CMF Va. Land, L.P. v. Brinson, 806 F. Supp. 90 (E.D. Va. 1992) (RTC successor in interest).

102. RTC v. Southwest Dev. Co., 807 F. Supp. 375 (E.D.N.C. 1992), aff'd in part, rev'd in part, 14 F.3d 596 (4th Cir. 1993).

103. RTC v. Parrish, Civil Action No. 92-2050, 1992 U.S. Dist. LEXIS 16420 (E.D. Pa. Oct. 27, 1992).

104. Blackburn v. RTC, Civil Action No. 91-0310-B-M, 1992 U.S. Dist. LEXIS 15276 (S.D. Ala. Oct. 1, 1992).

105. Topolnycky v. Ukrainian Sav. & Loan Ass'n, 799 F. Supp. 36 (E.D. Pa. 1992).

106. RTC v. Hunters Ridge Income Investors, L.P., 796 F. Supp. 1261 (E.D. Mo. 1992).

107. RTC v. Parnell, File No. 92-562-A, 1992 U.S. Dist. LEXIS 22209 (E.D. Va. Aug. 18, 1992).

108. RTC v. Callaway, No. 91-0822C(6), 1992 U.S. Dist. LEXIS 12473 (E.D. Mo. Aug. 13, 1992).

109. Enclave, Inc. v. RTC, Civil Action No. 3:92-CV-0450-G, 1992 U.S. Dist. LEXIS 21229 (N.D. Tex. Aug. 7, 1992), aff'd, 986 F.2d 131 (5th Cir. 1993).

110. Spano v. RTC, Civil Action No. 92-3031, 1992 U.S. Dist. LEXIS 11454 (E.D. Pa. Aug. 4, 1992).

111. Gumowitz v. First Fed. Sav. & Loan Ass'n, 90 Civ. 8083 (MBM), 1992 U.S. Dist. LEXIS 10935 (S.D.N.Y. July 27, 1992).

112. Williams v. RTC, No. 91 C 5439, 1992 U.S. Dist. LEXIS 10222 (N.D. Ill. July 16, 1992).

113. Dixie Sav. & Loan Ass'n v. Parent, Civil Action No. 92-736 Section "A," 1992 U.S. Dist. LEXIS 9942 (E.D. La. July 8, 1992).

114. RTC v. Choudhury, C.A. No. 92-2046, 1992 U.S. Dist. LEXIS 10024 (E.D. Pa. July 6, 1992).

115. Gumowitz v. First Fed. Sav. & Loan Ass'n, 90 Civ. 8083 (MBM), 1992 U.S. Dist. LEXIS 9886 (S.D.N.Y. July 6, 1992).

116. Bender v. Centrust Mortgage Corp., 833 F. Supp. 1525 (N.D. Tex. 1992).

117. RTC v. Oliver (In re Oliver), 145 B.R. 303 (Bankr. E.D. Mo. 1992).

118. ALEF Delbar Trust v. Amalgamated Trust & Sav. Bank, no. 91 C 5635, 1993 WL 735809 (N.D. Ill. May 5, 193).

119. RTC v. Management, Inc., No. 8:CV 91-00185, 1993 WL 666700 (D. Neb. April 22, 1993), aff'd, 25 F.3d 627 (8th Cir. 1994).

120. RTC v. Sharif-Munir-Davidson Dev. Corp., 992 F.2d 517 (5th Cir. 1993).

121. Integon Life Ins. Corp. v. Browning, 989 F.2d 1143 (11th Cir. 1993).

122. RTC v. Driscoll, 985 F.2d 44 (1st Cir. 1993).

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132. Alten v. T.A.E.I., Inc., Civil Action No. 87-8343, 1993 U.S. Dist. LEXIS 2639 (E.D. Pa. March 3, 1993).

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News and Information On Consumer Issues from the Federal Deposit Insurance Corporation

SPRING 1994 VOLUME 1, ISSUE 3

IS YOUR BANK HEALTHY?

Here Are Ways To Find Out

Before the rash of bank and savings association failures in the late '80s, you probably didn't give much thought to the health of your bank In fact, you probably didn't think about it at all. There was little reason to. Bank failures were few and far between, even the term "bank failure" was unfamiliar to most people Then came the '80s, when the failure rate started to escalate By 1985 bank failures reached triple digits and stayed there through the next seven years, peaking at 206 in 1989 As the failure numbers grew alarmingly, people soon began to pay a lot of attention to the health of their bank. Even today, when the number of failures has declined to a trickle, one of the most frequently asked questions received at the FDIC is, "How can I tell if my bank is safe?"

Before we describe the various options and available information for assessing your bank's health, here are some important points to keep in mind.

(Continued on next page)

- There is no easy, one-stop answer

- Your ability to determine a bank's health from available records may depend on your financial I.Q. (Do you understand a financial statement? Most people don't. But don't despair; other indicators are available.), and

- Any financial assessment of a bank - or any other financial institution, OR any corporation or business, OR your own finances - is just a "snapshot" of what the scene looks like at the time you are looking at it. Each of these financial pictures changes over time - perhaps in minutes! So one rule of thumb when assessing the financial condition of your bank (or anything else) is to take several "snapshots" over time and compare them. How? More on that shortly.

Information about the condition of a financial institution (bank, savings association, credit union or other type) is available from three sources: (1) the institution itself; (2) the regulators, usually the institution's primary supervisor; and (3) third parties, such as professional companies that rate the health of financial institutions (for a fee), publications and brokerage houses. Here's what is typically available and the cost, if any (see where to write for what in the box below)

1. The institution: Makes available on request an annual financial statement, which is basically a balance sheet (assets and liabilities) and income statement and often may highlight some basic information like how profitable the institution is and how much capital there is to cushion any future losses. For many institutions, public availability of these statements is mandated by law or regulation. Larger institutions must include a narrative management discussion. A quarterly report also may be available and is often published in a

THESE DOCUMENTS ARE AVAILABLE FROM THE REGULATORS:

Report of Condition and Income Statement (Call Report) -- commercial and savings banks: Each report is $6.00; you can be billed. Write to the FDIC Disclosure Group, Room F-518, 550 17th Street, N. W., Washington, D.C. 20429. Provide institution's name and location, year and quarter (first, second, etc.) being requested, contact person, phone number and mailing address. For savings associations' Thrift Financial Reports, write to the Office of Thrift Supervision, Information Services Division, 1700 G Street, N. W., Washington, D.C. 20552.

Uniform Bank Performance Report (UBPR) (commercial banks): Each bank report is $45, payable in advance to the Federal Financial Institutions Examination Council. Mail request and check to: UBPR, Department 4320, Chicago, IL 60673.

Registered Bank filings (banks with more than 500 shareholders): A list of these institutions (there are about 200 of them filing with the FDIC) and copies of filings can be requested by writing to the FDIC Registration and Disclosure Section, Division of Supervision, 550 Seventeenth Street, N.W., Washington, D.C. 20429, or by calling (202) 898-8913. Filings also may be inspected between the hours of 8:30 a.m. and 5:15 p.m., Eastern Time, at Room 643, 1776 F Street, N. W., Washington, D.C. Call ahead to make sure the filings are available (if the number of shareholders drops below 300, an institution no longer may need to meet the SEC filing requirements). For similar filings by their institutions, see addresses of other regulators on Page 11.

■■■

local newspaper If your bank or savings association is owned by a holding company, you should be able to obtain an annual report of the parent company that explains its financial position in some detail There is usually no charge or a nominal copying fee for any of the reports available from the institutions.

2. The regulator: Provides on written request a financial institution's quarterly Report of Condition and Income - a detailed report (known as a "Call Report") of various data used to assess financial health, such as capital, reserves, net income, etc. (Each report is $6.00) Also available: various filings required by the Securities Exchange Act of 1934 for banks with more than 500 shareholders, including annual and quarterly reports, as well as annual proxy statements. Copies from the FDIC for state-chartered nonmember banks that file these forms are ten cents a page after 250 free pages For the same types of filings required from national banks, state member banks, or savings associations, contact the Office of the Comptroller of the Currency, the Federal Reserve Board or the Office of Thrift Supervision, respectively, at the addresses listed on Page 11

Another useful tool if you're mathematically inclined: the Uniform Bank Performance Report, which shows how the institution you're assessing compares to itself in prior periods and other institutions in its peer group (that is, institutions with similar characteristics, such as asset size or location). These reports can be ordered from the Federal Financial Institutions Examination Council. (See address information in the box on Page 2.)

3. Third parties: For non-mathematical folks, these sources may be the most useful.

- Several *rating companies* provide financial reports on specific banks for a fee. The FDIC does not endorse any of these entities, but a list of some of them is provided on Page 4 for our readers' convenience. Readers are cautioned, however, that some financial background and an understanding of financial terminology may be needed to gain the maximum benefit from these reports

- *Publications* that profess to give you the inside financial scoop are too numerous to mention. You may wish to subscribe to a financial newspaper or periodical, but look at a few issues in your local library first to make sure it meets your needs. Major newspapers in larger cities carry enough financial information to give readers some idea of major trends Local newspapers often carry stories about local financial institutions; these papers also may carry advertising from local institutions that includes some notable facts in addition to the usual rate and product information. Some examples: "Serving your community since 1950" tells you the institution has been around for a while (but doesn't necessarily mean it will be around forever). Or perhaps a bank or thrift sponsored a local civic event or demonstrated its commitment to the community in some other way. Activities like those should enter into your assessment of an institution even though they don't provide specific financial data or direct information about its financial performance.

- *Stock brokers*, another possible source, provide financial information to their customers, usually about companies, or financial institutions, whose securities they are selling, as well as the companies whose securities the customer already owns

(Continued on next page)

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If you're really intent on learning about your financial institution, and its stock is traded on an exchange (ask a bank officer if it is), you could buy some shares; then you might receive plenty of information about it, including not only its health, but perhaps its plans for the future, too.

ORDER BANK RATINGS BY PHONE

Here are some of the companies that provide them

[NOTE: Some financial background and familiarity with financial terminology may be needed to gain the maximum benefit from these reports. Readers are reminded that the FDIC does not specifically endorse any rating company.]

Bauer Financial Reports, Inc., Gables International Plaza, Penthouse 1-C, 2655 Le Jeune Road Coral Gables, Florida 33134 [1-800-388-6686] - Rates banks, savings associations and credit unions using a system of 0 (lowest) to 5 stars. Information free for certain banks. $10 for the first institution and $2 for each additional institution. Statewide and other lists also available.

IDC Financial Publishing, P.O. Box 140, 300 Cottonwood Ave., Hartland, Wisconsin 53029 [1-800-525-5457] - Rates all banks, bank holding companies, thrifts and credit unions reporting to the federal government. Rates institutions on a scale of 300 (best) to 1, based on financial statistics and ratios. Institutions also are classified into one of five peer groups, ranging from superior to lowest. Rating categories by phone ($30 each) are followed up with a five-page report.

Sheshunoff Information Services Inc., 505 Barton Springs Road, Suite 1100, Austin, Texas 78704 [1-800-456-2340] - Evaluates banks and savings associations based on capital adequacy, asset quality, earnings and liquidity. A rating report for one institution costs $25 For $50, ratings of all the banks or savings associations in one state will be provided.

Veribanc, P.O. Box 461, Wakefield, MA 01880 [1-800-442-2657] - For $10 you can find out where your bank, savings association or credit union falls in their 8 categories of safety. $5 more for each additional rating. Each $10 rating includes ratings for the past three quarters. For $25 you can get a short report that includes the rating and a paragraph of related financial data. For $35, you get a list of banks in your region (or any region you choose) that meet exceptionally high standards. The company will provide at no charge the definitions for its ratings, number of banks in each rating category and historical records of the number of bank failures in each rating category.

■■■

By now you're wondering why the regulators just can't say right out whether your institution is healthy or not. After all, the regulators must know the condition of the institution: they periodically send in examiners who write detailed reports about the institution's health. And they assign a rating to each institution according to an interagency system (see CAMEL box on Page 5) that would tell you instantly - if you could understand it - whether you should have concern, and if so, how much. Yet, this information cannot be disclosed to the public. Why not?

Let's suppose the agencies decided to give these ratings to the public. You find out that your financial institution is rated 4 or 5 (the two lowest ratings) on the CAMEL rating system. You now know your bank is having difficulties If it's a 4, it may well pull itself out of the hole; if it's a 5: Chances are slim. You'd probably run, not walk, to the nearest entrance and withdraw all of your money. Sure it's insured, but who wants to go through the hassle of filling out papers and waiting a few days for their funds and maybe even having to open new accounts and get new loans and lines of credit somewhere else? Other depositors come to the same decision, they all run to the bank and withdraw their funds, and Bingo! The bank is broke. No, "It's" NOT "A Wonderful Life" and you are not going to go to the rescue of your bank president. That only happens in the movies.

And the so-called "bank run" that Jimmy Stewart experienced isn't confined to sick institutions, either. Suppose your bank is experiencing temporary problems that could be solved within an acceptable (to regulators) time period. Somehow, you and other depositors get wind of possible problems at the institution and remove your funds, causing the bank's capital to fall below required minimum standards or become insolvent, thus forcing regulators to close it. The recovering patient, denied an air supply, dies.

CAMEL Ratings

The name comes from the first letter of each of the five following key criteria used by bank and thrift regulators to determine a bank's health:

- **Capital adequacy**
- **Asset quality**
- **Management/ Administration**
- **Earnings**
- **Liquidity**

After assesssing these and other factors, regulators assign a composite rating from one to five, with one-rated institutions considered sound in almost every respect and five-rated institutions considered in imminent danger of failing. A detailed description of the CAMEL rating system is available from the FDIC's Office of Corporate Communications. The actual rating for an individual institution, however, is not disclosed to the public (see accompanying story).

That's one reason - disclosure could cause unnecessary failures - why regulators don't reveal the names or ratings of ailing institutions. They also are prohibited by law from disclosing that information (except in specific circumstances), and if they do could face stiff fines, jail or both. The primary purpose of government supervision is to prevent problems and, if problems do develop, to get them corrected before the public or the economy are affected.

Now, how do you compare "snapshots" of your institution's financial health? If you're familiar with terminology like earnings, capital, assets and liquidity, you can use the institution's quarterly or annual reports or the Call Reports from the FDIC (or the Office of Thrift Supervision for savings associations' reports) to compare these and other "line items" that are used to assess financial health. Obviously, you want to see a steady maintenance or an increase over time in each of these categories, or a good explanation why there isn't one (perhaps the bank purchased a subsidiary that in the long run will make the bank more profitable). You also want to see that these items are in proper proportion to each other. For example, is capital increasing at the same or better ratio than assets, so that the *percentage* of capital protection is maintained or improved? Even if you're NOT comfortable with financial terminology, you certainly can compare the numbers on the abbreviated annual statements that the institutions themselves make available, to see if they're going up or down from year to year (you can request the annual financial statement for prior years).

But don't use these measurements as the only indicators. Try to obtain additional information from the third-party category described earlier (rating companies, publications, etc.). If you still don't like what you see after your comparison efforts, ask the institution for more information, although anything beyond what we've described is usually hard to come by.

Now, with all of this voluminous (or so it seems) information available, what if you are still not satisfied that you know whether your bank is healthy or not? And what about those of us who really are not comfortable with numbers, and even if we're okay with them, can't fully understand the information available? Simple: just make sure your funds are fully insured - that you don't have more than $100,000 in any one ownership capacity (e.g., single or joint) in the same bank (including its branches) and sit back and RELAX. You won't lose any of it if the worst - your bank fails - should happen.

The bottom line (that's a financial term we ALL understand). There is NO surefire way to predict when or if a bank will fail, even the closing authorities have had to deal with occasional surprises over the years. And by ensuring that your deposits are fully protected by FDIC insurance, you've really done all you have to do.

Your Finances: Nobody Else's Business?

Inquiring minds want to know more about you. Here's a guide to who can and cannot see your banking records

Illustration by: T. W. Ballard

If you think details of your personal finances are only of interest to some of your nosier relatives, think again

■ You've applied for a loan, a job or an apartment. Wouldn't the people involved want to know if you have a history of bad loans, bounced checks or other mischief? Can they find out from your bank?

■ You're involved in a dispute with people who look into your financial dealings or want to know if you have "deep pockets" that would make a lawsuit worth pursuing. Can they comb through your banking records?

■ Manufacturers, stores and other companies all over America want to know more about the products and services you (and millions of others) will buy. Can they look at your credit card or checking account transactions to get an idea about where you shop and how much you spend?

Nowadays, the demand for information is so great – and so much of it can be gained, altered or deleted thanks to computers – that financial privacy has become an important issue facing Congress, the courts and other government authorities. David Medine, Associate Director for Credit Practices at the Federal Trade Commission's Bureau of Consumer Protection, recently summed up the situation: "The challenge today is two-fold: to ensure that our laws are adequate to protect consumers' privacy in the face of an ever escalating technological revolution, and to ensure that the increasing amount of financial information compiled on consumers is accurate."

FDIC Consumer News has assembled the following overview of

some frequently asked questions about who, by law, can get information about you from your bank, and what they can or cannot do with that information.

But first, two notes of caution: (1) Privacy issues are highly complex and often subject to dispute, so this summary should not be relied on as a legal interpretation. (2) *DON'T PANIC.* As a general rule, most people don't have problems with the privacy of their financial records, and there are legal safeguards and banking industry practices to promote confidentiality.

ACCESS BY PRIVATE CITIZENS

Can your bank release aspects of your records to private firms or individuals?

Banks, as a matter of their protection and yours, typically won't release anything about you to a private citizen or company without your written consent or unless it is authorized by a particular law or court order. Although there's no federal law prohibiting the bank from releasing the records, many state laws say you first must be notified of such requests and give your approval. Private citizens and organizations can get key financial information about you *indirectly*, though, from credit bureaus and similar private reporting agencies that are authorized by law to obtain details about you from your bank, savings association or credit union.

What are credit bureaus and credit reports?

Credit bureaus have various functions, but they primarily gather information about individuals for use in reports to lenders, employers and others who have a legitimate need to know about that person's financial reliability. A credit report will contain such things as: how much you charge each month on your credit cards and how well you pay them back, how long you've worked for the same employer, and whether you've recently filed for bankruptcy or been sued or convicted. *Credit reports do not include information about how much money you have in your checking, savings or investment accounts.* Remember, the reports are intended to give an idea of how reliable you are, not how rich you are or how you deposit or invest your money.

Can ANYONE get a credit bureau's report on you?

No. The Fair Credit Reporting Act of 1970 says you're entitled to see your report if you request it in writing, but for anyone else to get it either: (1) a court or federal grand jury must order the release of the information, (2) a third party asks for it in connection with an application you filed for a loan, a credit card, a job, insurance or a government license that requires details of your finances, or (3) the person making the inquiry has a legitimate need for the information as part of a business transaction involving you, such as an application you've made for an apartment.

Credit reports also can be used to a limited extent in other areas, such as to help a bank decide which consumers should receive unsolicited offers of a credit card, a practice called "prescreening." Credit bureaus also can compile addresses and phone numbers and sell this information to companies or charities that may want to solicit your business, but cannot provide them your actual credit report with specific financial information about you or your borrowing and spending habits. There are, though, some "gray areas" that Congress, the Federal Trade Commission, consumer organizations and others are looking into. For example, Congress is considering giving the consumer the right to instruct a credit bureau not to provide his or her name, address or phone number to business marketers or charities.

Congress also is looking into new restrictions on so-called "resellers" of consumer reports. These are private services that purchase credit reports and then resell them to people who don't have a right to see this information. To prove how easy it can be for someone to get personal details through such services, journalist Jeffrey Rothfeder has written about how, using his personal computer, he got former Vice President Dan Quayle's credit report ("He shops at Sears a lot, hardly ever at Brooks Brothers"), Dan Rather's credit transactions for a month, and, as a bonus, Vanna White's home phone number for free.

(Continued on next page)

If a credit reporting agency provides a consumer report for an impermissible purpose, you can file a lawsuit and, if you win, recover damages and legal costs There also have been news reports of data being obtained from credit bureaus by theft and fraud, an area that the companies are clamping down on.

What if the credit bureau is giving out wrong or obsolete information?

Despite all the best intentions of the people who supply and collect the data, mistakes do happen It's important that errors are corrected, because they can result in a loan being rejected, a job opportunity lost or other problems The Fair Credit Reporting Act gives you specific rights and protections to ensure that what is being said about you is accurate and up-to-date. Generally, most information on your credit history must be deleted from your credit report after seven years, although a bankruptcy could be reported for 10 years

If you've been denied credit, insurance or employment because of information contained in a consumer report, you must be notified of that fact, and you are entitled to a free copy of that report if you request it from the credit bureau within 30 days. If you dispute the information in the report, the credit bureau must investigate. And if your credit report gets changed as a result, the law allows for the revised report to be sent to people who had received the earlier version.

Most experts recommend that everyone should get a copy of their credit report about once a year, just to keep an eye on things Where do you ask? Many credit bureaus around the country can be collecting and reporting information about you, but the three largest firms most likely to have your report are Equifax Inc. ($8 per copy, 1-800-685-1111), TRW Credit Data Services (one free copy per year, 1-800-422-4879), and Trans Union ($8 per copy, 1-800-851-2674 or 312-408-1400). The names of similar companies in your area can be found in your telephone book, under headings such as "credit reporting agencies." Among the consumer protections Congress is considering, making it easier or cheaper for you to get a copy of your own report, and imposing tougher penalties on companies that supply inaccurate information to a credit bureau.

What if you have a problem involving a credit bureau?

If you can't resolve the matter with the company directly, write to the Federal Trade Commission, Correspondence Branch, Washington, DC 20580. Or you can call the FTC at 202-326-3758.

ACCESS BY THE GOVERNMENT

What records can a financial institution give to the government?

The average citizen's banking records **are** sometimes obtained by the government Even if you're squeaky clean, the government has a right to review your records as part of an investigation of someone else

As you'd probably expect, if a federal law enforcement agency like the FBI suspects someone of illegal activity, it may want to look at income sources, checks written, debts and transactions that could help prove or trace a crime Bank regulators also can look at your records as part of an examination of how properly and safely your banking institution is operating But the bottom line is this. if you've done nothing wrong, you really shouldn't worry

In general, the Right to Financial Privacy Act of 1978 (RFPA) prohibits a bank, savings association or other financial institution from giving a government agency access to your banking records unless you authorize the release of the information or there is a subpoena, search warrant or other request authorized by law In most cases, you first must be notified of the request *and* be given the opportunity to approve the release of the information or seek a court order blocking it. Under certain circumstances, such as a criminal investigation, the bank can provide your records to the government without notifying you

Note: The RFPA specifically covers the release of bank records to a federal agency and, in limited instances, to a state agency. For the most part, though, state laws and your bank's own policies would govern the release of records to state and local agencies

Can a government agency share your records with others?

With another government agency? Generally, yes, if the information would assist in a legitimate law enforcement investigation. Depending on the circumstances, you may or may not get advance notice. Much also would depend on the kinds of records involved and whether they come under separate consumer protections. As for sharing the information with a private firm or individual, the answer for the most part is "no," unless you give written consent first.

What if you suspect your banking records have been released to the government improperly?

The FDIC and other regulators may be the first to spot a problem in their regular examination of the institution, such as if the bank released a document before giving the required advance notice. You, too, can do some investigating. A financial institution must keep a record of the disclosures of customer information, and generally, you have a right to obtain a copy of the record if the disclosure involves you.

If you find or suspect a problem, bring the matter to the attention of the financial institution or the government agency in question. If you're still not satisfied, contact the banking institution's primary federal regulator listed on Page 11 of this newsletter, or your state's banking regulator or Attorney General, which should be listed with the other state offices in your telephone book.

Mutual Funds

Despite a blitz of educational efforts by regulators, the media and others, some consumers and bankers are still confused about what bank products are - or are NOT - insured.

To help remedy that problem, the FDIC will soon publish a booklet (based on the article in the Winter 1994 issue of the ***FDIC Consumer News***) explaining that investment products (mutual funds, stocks, bonds, annuities) are not insured. The booklet also discusses insurance as it relates to Treasury securities and safe deposit boxes.

For a free copy, write: FDIC, Room 7118, Washington, DC 20429

Lending Discrimination

You may have been the victim of lending discrimination and not even have known it. That's because you may have been unaware of certain practices that are considered by regulators to be discriminatory. To deter institutions from continuing such practices, the bank and thrift regulators recently adopted a joint policy statement for detecting and preventing discrimination.

One example of the barred practice that appears in the policy statement: A lender tells minority loan applicants it would take several hours and an application fee to determine whether they'd qualify for a home loan, but non-minority applicants are qualified in minutes and without a fee.

"Consumers who have been the victims of discrimination may not realize it because they were treated in a friendly manner," says Robert Mooney, fair lending specialist in the FDIC's Office of Consumer Affairs. "The new policy statement explains the many forms subtle discrimination can take."

FDIC Joins Internet

If you have access to the worldwide computer network called Internet, you now also have electronic access to the FDIC and many of the consumer publications we issue.

Since April, users of Internet have been able to call up on a computer screen the text from ***FDIC Consumer News*** as well as various consumer pamphlets issued by the agency. Soon, FDIC economic reports, press releases and other publications will be available on Internet, as well as electronic message delivery to and from the FDIC.

Internet users can find the FDIC's offerings through the "file transfer protocol" (Internet ftp address: ftp.sura.net, then change to the /pub/fdic directory) or through "gopher" (address: fdic.sura.net 71)

A new feature in *FDIC Consumer News:* Answers to your questions about deposit insurance and other consumer protections

Joint Accounts

Q If my husband and I have a joint account in a bank with $100,000, can I have a joint account with my daughter in this same bank for $100,000 and still have each account FDIC-insured for $100,000? Also, if I understand *FDIC Consumer News* correctly (Fall 1993), my bank's records could be changed to clearly indicate that the funds are individually owned and that the other person was authorized to withdraw funds on the owner's behalf But my bank says that cannot be done Can you help?

- North Providence, RI

A As for your first question, under the insurance rules these two joint accounts *are* separately insured to $100,000 each because (1) they are jointly owned by different groups of people, and (2) your husband and daughter's half shares of the accounts each equal $50,000, while your interests equal $100,000, since you own half of each of the two $100,000 accounts

You're also correct that one or both of these joint accounts can be changed to individual accounts that permit one person to withdraw funds for the other, such as if the owner becomes ill. But for the account to be considered individually owned for insurance purposes, the second person must have a "power of attorney" to act on behalf of the account owner or the account records must clearly indicate that this second person is an "authorized signer" for convenience purposes only The deposit records must clearly indicate that the second signer is not a co-owner Otherwise, the account would be considered a joint account

Banks vs. Branches

Q I have $100,000 in one bank and $100,000 in another bank. Am I covered by federal insurance for $100,000 in each bank?

- East Boston, MA

A Yes, the $100,000 insurance limit applies to funds held in each separately chartered and insured institution, without regard to deposits in any other separately chartered and insured institution.

Many depositors also are confused about the difference between a bank and a branch when it comes to their insurance coverage Be aware that *a bank's main office and all branches of the same bank are considered one institution,* not separate institutions that provide separate insurance coverage

Cashier's Checks

Q If I have under $100,000 in a bank account insured by the FDIC and I withdraw it in the form of a certified bank check, is the money insured by the FDIC while in transit to be deposited in a second bank?

- Holt, MI

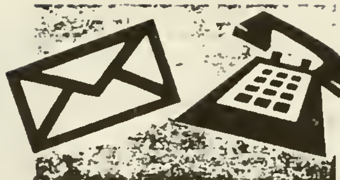
A A cashier's check, bank check or other official check issued to you is still considered a deposit at the original bank until it is deposited with another bank ***and the check "clears" through the payment system.*** This means that if you deposited the cashier's check from Bank A into Bank B, but Bank A fails before it is finally paid (cleared), the money would still be considered as being on deposit at Bank A. This could be important, because if you still had other funds at Bank A, your total could be over the $100,000 insurance limit If, on the other hand, the cashier's check was finally paid before Bank A failed, your funds would be considered part of your account at Bank B, and the closing of Bank A wouldn't affect that money

■■■

Got a question about banking or deposit insurance you'd like answered in this column? Send it to *FDIC Consumer News,* Office of Corporate Communications, 550 17th Street, N.W., Washington, DC 20429. We'll answer as many as possible.

87-821 0 - 95 - 11

The FDIC offers protection to consumers by insuring deposits up to $100,000 The FDIC, as well as other regulatory agencies, enforces rules that promote sound banking practices, compliance with consumer protection and civil rights laws. These protections include. prohibitions against discriminatory lending practices; initiatives to prevent unfair or deceptive practices in deposit taking or lending; and rules that encourage institutions to meet local credit needs.



For questions about deposit insurance coverage: Contact the FDIC at the appropriate regional office of the Division of Supervision, or the FDIC's Office of Consumer Affairs, listed below

For questions about consumer or civil rights laws, or complaints involving a specific institution:

First attempt to resolve the matter with the institution

If you still need assistance, write to the institution's primary regulator listed on this page. Although the FDIC insures nearly all banks and savings associations in the United States, the FDIC may not be the primary regulator of a particular institution.

Federal Deposit Insurance Corporation

Supervises state-chartered banks that are not members of the Federal Reserve System Operates the Bank Insurance Fund and the Savings Association Insurance Fund.

Office of Consumer Affairs
550 17th Street, N W ,
Washington, DC 20429
Phone 800-934-3342 or
202-898-3773

Atlanta Region (Alabama, Florida, Georgia, North Carolina, South Carolina, Virginia, West Virginia)
245 Peachtree Center Avenue, NE,
Atlanta, GA 30303

Boston Region (Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont):
200 Lowder Brook Drive,
Westwood, MA 02090

Chicago Region (Illinois, Indiana, Michigan, Ohio, Wisconsin):
30 S Wacker Drive, Suite 3100,
Chicago, IL 60606

Dallas Region (Colorado, New Mexico, Oklahoma, Texas).
1910 Pacific Avenue, Suite 1900,
Dallas, TX 75201

Kansas City Region (Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota):
2345 Grand Avenue, Suite 1500,
Kansas City, MO 64108

Memphis Region (Arkansas, Kentucky, Louisiana, Mississippi, Tennessee).
5100 Poplar Avenue, Suite 1900,
Memphis, TN 38137

New York Region (Delaware, D: Columbia, Maryland, New Jersey, New York, Pennsylvania, Puerto Rico, Virgin Islands)
452 Fifth Avenue, 19th Floor,
New York, NY 10018

San Francisco Region (Alaska, Arizona, California, Guam, Hawaii, Idaho, Montana, Nevada, Oregon, Utah, Washington, Wyoming):
25 Ecker Street, Suite 2300,
San Francisco, CA 94105

Some banking matters may involve state laws For assistance on these matters, please contact the appropriate state financial institution regulatory agency or state Attorney General's office These state offices usually are listed in your telephone book and other directories.

For information about credit unions, contact the National Credit Union Administration, Office of Public and Congressional Affairs, 1775 Duke Street, Alexandria, VA 22314-3428 Phone 703-518-6330.

Office of the Comptroller of the Currency

Charters and supervises national banks (Often the word "National" appears in ' ~ -ame of a national bank, or the s "N A." follow its name)

'iance Management Division,
St., S.W., Washington, DC 20219
·– 202-874-4820

Federal Reserve System

Supervises state-chartered banks that are members of the Federal Reserve System.

Division of Consumer and Community Affairs,
20th Street and Constitution Avenue, N W ,
Washington, DC 20551
Phone 202-452-3693

Office of Thrift Supervision

Supervises federally and state-chartered savings associations as well as federally chartered savings banks (The names of these institutions generally identify them as savings and loan associations, savings associations or savings banks Federally chartered savings associations have the world "Federal" or the initials "FSB" or "FA" in their names.)

Consumer Affairs Office,
1700 G Street, N W ,
Washington, DC 20552
Phone 800-842-6929 or
202-906-6237

Coming in the Next Issue...

- ***How senior citizens and young adults can be smarter and safer banking customers...***

- ***Who to contact at the FDIC for help and information related to closed banks...***

Read the next issue of FDIC Consumer News for news and information on these and other topics of interest to consumers from the Federal Deposit Insurance Corporation.

Please Write!

Is there an issue you'd like addressed or a question you'd like answered in *FDIC Consumer News?* Please send your thoughts and suggestions to:

Jay Rosenstein
Senior Writer-Editor
Office of Corporate Communications
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Federal Deposit Insurance Corporation
Washington, DC 20429-9990

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ATTACHMENT "C"

FEDERAL DEPOSIT INSURANCE CORPORATION, Plaintiff,
v.
BAYLES & COMPANY OF AMERICA, INC., Sectra, Inc. and Fred M. Bayles, Defendants.

No. 87-1468-CIV-T-17B.

United States District Court, M.D. Florida, Tampa Division.

June 30, 1992.

Henry A. Stein, Rudnick & Wolfe, Kenneth S. Siegel, Jerry Martin Gewirtz. Rudnick & Wolfe, Tampa, Fla., for plaintiff.

Richard M. Goldstein, Goldstein & Tanen, Miami, Fla., for defendants

Fred M. Bayles, pro se.

ORDER ON MOTIONS FOR SUMMARY JUDGMENT

KOVACHEVICH, District Judge.

*1 This cause is before the Court on the following motions, responses, and pleadings:

1. Plaintiff's motion for partial summary judgment on Counts I, II, III, IV, and VI of the complaint, and motion against defendants as to defendants' counterclaims, filed December 13, 1991.
2. Plaintiff's memorandum of law in support of the motion for summary judgment as to Counts I, II, III, IV, and VI, and memorandum in opposition to defendants' counterclaims, filed December 13, 1991.
3. Pro Se defendant Fred Bayles' answer to plaintiff's motion for summary judgment as to Counts I, II, III, IV, and VI of the complaint, and against plaintiff's memorandum in opposition to defendant's counterclaims, filed February 17, 1992.
4. Pro Se defendant Fred Bayles' memorandum of law in opposition to plaintiff's motion for summary judgment as to Counts I, II, III, IV and VI, filed February 17, 1992.
5. Defendants, Bayles and Company of America, Inc. (BCA) and Sectra, Inc., (Sectra) have not introduced any extrinsic facts by way of affidavit, deposition testimony or answers to interrogatories or request for admissions. In accord with Rule 2.03(d), Rules of the District Court of the United States for the Middle District of Florida, these defendants must be represented by counsel admitted to practice before this Court pursuant to Rule 2.01 or 2.02, therefore Defendant Bayles was precluded from representing these corporate defendants.

Summary judgment is appropriate if the pleadings, depositions, answers to interrogatories, and admissions on file, together with affidavits, if any, show that there is no genuine issue of material fact and that the moving party is entitled to judgment as a matter of law. Rule 56(c), Fed.R.Civ.P. The moving party has the burden of showing the absence of a genuine issue as to any material fact when all the evidence is viewed in the light most favorable to the nonmoving party. Sweat v. The Miller Brewing Co., 708 F.2d 655 (11th Cir.1983). Where this burden is discharged by showing there is absence of evidence to support the non-moving party's case, summary judgment is mandated. Celotex Corp. v. Catrett, 477 U.S. 317, 91 L.Ed.2d 265, 106 S.Ct. 2548 (1986). This burden then shifts to the nonmoving party to go beyond the pleadings and by his/her own affidavits, or by the depositions, answers to interrogatories, and admissions on file, designate specific facts showing there is a genuine issue for trial. Celotex Corp., 91 L.Ed.2d at 274; See also, DeCeullar v. Brady, 881 F.2d 1561 (11th Cir.1989), United of Omaha Life Ins. v. Sun Life Co., 894 F.2d 1555 (11th Cir.1990). All doubt as to the existence of a genuine issue of material fact must be resolved against the moving party. Hayden v. First Nat'l Bank of Mt. Pleasant, 595 F.2d 994, 996-7 (5th Cir.1979). Factual disputes preclude summary judgment.

The complaint in this cause was filed October 1, 1987. The complaint is based on a

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with and into Raritan Valley Savings and Loan Association which became the resulting association for which FDIC now is successor.

II: THE D'OENCH DOCTRINE

In the seminal case of D'Oench, Duhme & Co. v. Fed. Deposit Ins. Corp. (FDIC), 315 U.S. 447, 62 S.Ct 676, 86 L.Ed. 956 (1942) the Supreme Court first held that FDIC, as successor in interest in a failed bank, is not bound by agreements between borrowers and financial institutions that are not expressed in a written agreement between the parties. D'Oench, 315 U.S. at 457, 86 L.Ed. at 962. The court's holding was grounded in the federal policy to protect FDIC, as insurer for financial institutions, and ultimately the public funds against misrepresentations or secret agreements. Id.

The D'Oench Doctrine has subsequently been codified as 12 U.S.C. § 1823(e), which provides:

Agreement Against Interests of Corporation (FDIC)
No agreement which tends to diminish or defeat the interest of the FDIC in any asset acquired by it under this section or section 1821 of this title, either as security or loan or by purchase or as receiver of any insured depository institution, shall be valid against the FDIC unless such agreement:
(1) is in writing;
(2) was executed by the depository institution and any person claiming an adverse interest, thereunder, including the obligor, contemporaneously with the acquisition of the asset by the depository institution;
(3) was approved by the board of directors of the depositor institution or its loan committee, which approval shall be reflected in the minutes of said board or committee, and
(4) has been, continuously, from the time of its execution, an official record of the depository institution.

A. SCOPE OF THE D'OENCH DOCTRINE

Federal courts have had several opportunities to address the D'Oench issue as the number of failed financial institutions have increased. The rule that has emanated from the cases is that in a suit over the enforcement of an agreement originally executed between an insured depository institution and a private party, a private party may not enforce against a federal deposit insurer any obligation not specifically memorialized in a written document. FDIC v. McCullough, 911 F.2d 593, 600 (11th Cir.1990), cert. denied, 59 U.S.L.W 3658, 111 S.Ct. 2235, 114 L.Ed.2d 477 (1991). This guarantees the insurer would be aware of the obligation when conducting an examination of bank assets.

The critical question in application of the D'Oench doctrine is whether an agreement meets the codified statutory requirements of 12 U.S.C. § 1823(e). Where an agreement meets statutory requirements, the agreement shall prevail, with or without the insurer's notice of the existence of the agreement at the time of acquiring a note or security. Baumann v. Savers Fed. Sav. & Loan Ass'n, 934 F.2d 1506, 1513-4 (11th Cir.1991). A written document may yet fall within the D'Oench Doctrine where a bilateral obligation is not executed such as to evidence depository intent to be bound. Twin Construction, Inc. v. Boca Raton, Inc., 925 F.2d 378, 383 (11th Cir.1991) (citing Howell v. Continental Credit Corp., 655 F.2d 743, 746 (7th Cir.1981)). Where the agreement fails to meet the statutory requirements, the D'Oench doctrine applies to invalidate it, regardless of the insurer's knowledge of alleged misrepresentations at the time the asset was acquired. Langley v. FDIC, 484 U.S. 86, 95, 108 S.Ct. 396, 403, 98 L.Ed.2d 340 (1987), Victor Hotel Corp. v. FCA Mortgage Corp., 928 F.2d 1077, 1082 (11th Cir.1991), Federal Sav. & Loan Ins. Corp. (FSLIC) v. Two Rivers Ass'n, Inc., 880 F.2d 1267, 1275 n. 12 (11th Cir.1989). Even in the circumstance where a private party relies on a bank's misrepresentations, and is completely innocent of any bad faith, recklessness or negligence, the D'Oench doctrine applies to bar a private party's recovery on unwritten agreements. FSLIC v. Gordy, 928 F.2d 1558, 1566 (11th Cir.1991).

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series of loans obtained from Plaintiff and secured by notes and deeds of trust. The following Counts are alleged:

*2 I. Action on the note against Bayles & Company of America, Inc. ("BCA").
II. Action on the note against Sectra, Inc. (Sectra).
III. Action on the guarantee against Fred M. Bayles (Bayles).
IV. Common law fraud (negligent misrepresentation) against all defendants in Counts I, II and III.
V. Negligence action against all defendants in Counts I, II, and III.
VI. RICO Act violations against all defendants in Counts I, II, and III.

Plaintiff seeks summary judgment based on the D'Oench doctrine, theory of collateral estoppel, and RICO statutes, for all counts except, Count V.

I. FACTS

The following facts, as presented by Plaintiff and Defendant Bayles, are not in dispute. Plaintiff, First Federal Savings & Loan Association of Hammonton, New Jersey ("First Federal"), filed complaint (Counts I, II & III) seeking recovery upon three sets of promissory notes and personal guarantees for loans given to Defendants in July, August, and November, 1982, totalling in excess of nine (9) million dollars. First Federal claimed they relied on Defendants' negligent representation (Count V) of the values of certain timeshare deeds of trust, and was thereby induced by Defendants to enter into each of the three loans. First Federal alleged that Defendants' representations were intended to defraud the lending institution, and further, that Defendants' activities represent a conspiracy or scheme to defraud that would subject Defendants to treble damages under the provisions of the RICO Act. (Counts IV & VI).

Since the start of this action several events have transpired that are relevant to consideration of the motion for summary judgment. Defendant Bayles was indicted in the United States District Court for the District of New Jersey on June 4, 1987 on charges of bank fraud in violation of Title 18, U.S.C. § 1014, for fraudulently inducing First Federal to make the three loans which are the subject of this action. After conviction on January 26, 1988, the court denied Bayles motion for a new trial because he failed to satisfy the requirement that the basis for the motion be newly discovered evidence.

This case was administratively closed on April 6, 1990, pending the outcome of a bankruptcy proceedings filed by Fred Bayles in the United States Bankruptcy Court, Western District of Louisiana. Amid an adversarial challenge by Hansen Savings Bank, a successor by merger to First Federal, the bankruptcy court in accord with Bankruptcy Code § 523(a)(2)(A)(B) entered a final judgment on September 30, 1991, holding that debts owed by Bayles, as guarantor of the loan, were non-dischargeable. Bankruptcy Code § 523(a)(2)(A)(B), provides in relevant part that a debt will not be discharged where obtained by false pretenses or actual fraud in written statement of debtor's financial condition if: (i) the debtor made a materially false representation, (ii) respecting the debtor's financial condition, (iii) on which the creditor to whom the debtor is liable for such money, property, services or credit can reasonably have relied and, that (iv) the debtor caused to be made or published with intent to deceive. The bankruptcy court's ruling was limited to whether any obligation was non-dischargeable, and did not determine the amount of obligation on the promissory notes nor whether a later substitution of collateral constituted a release or relinquishment of any of the bank's rights against Bayles.

*3 Subsequently, the Federal Deposit Insurance Corporation (FDIC), was appointed receiver of the bank and this Court granted a motion to substitute FDIC as Plaintiff in this action on November 5, 1991. Before FDIC's appointment as receiver the Federal Home Loan Bank Board (FHLBB) authorized two mergers: the merger of Hansen Savings Bank with and into New Hammonton Federal savings and Loan Association (New Hammonton); and New Hammonton's merger

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B. APPLICATION OF THE D'OENCH DOCTRINE

*4 After appointment as receiver for the failed financial institution, Plaintiff requested summary judgment based on the D'Oench doctrine. When the FDIC is appointed receiver by a state banking authority, that agency acts in two separate capacities: as receiver and as corporate insurer of deposits of the failed financial institution. FDIC v. Harrison, 735 F.2d 408, 412 (11th Cir.1984), cited in, Bayshore Exec. Plaza Partnership v. FDIC, 943 F.2d 1290, 1291-2 (11th Cir.1991). This appointment changes the character of the litigation, and allows FDIC to assert the D'Oench doctrine where not previously available to private plaintiffs. Baumann, 934 F.2d at 1514.

FDIC, as moving party, through submittal of pleadings, exhibits and admissions have failed to satisfy their burden in showing that no genuine issue exists as to material facts when viewed in the light most favorable to Defendants. FDIC alleges entitlement to summary judgment on notes executed on July 12, August 12 and November 16, 1982, by Defendants to timeshare units in Pascagoula, Mississippi, as a matter of law. However, Defendant Bayles through exhibits alleges that FDIC's predecessors, through a demand made on them by FDIC, approved an agreement to substitute the Gulfside Club, Marco Island, Florida for the timeshare notes. Defendants allege that the completion and sale of the Marco Island properties absolved them of all indebtedness to FDIC, and resulted in a overpayment of approximately 4 million dollars over the balance of the loans.

The D'Oench doctrine is applied to prevent fraudulent insertion of new terms, with the collusion of bank employees, when a bank appears headed for failure. Langley, 484 U.S. at 92. Unlike the requirements of the D'Oench doctrine, where undocumented secret non-payment agreements can not be enforced by a private party, the issue in this case revolves around the interpretation of terms, conditions, of possible outstanding obligation under a written agreement, primarily the minutes of First Federal's Board meeting and subsequent collateral substitution documents. [FN1] Where the agreement is in writing, approved by the board of directors, executed at same time, and part of the official record of the financial institution, the agreement prevails under the D'Oench doctrine. Whether the written agreement will prevail to vindicate Defendants of the alleged debt from the promissory note is not an issue to be applied under the D'Oench Doctrine, nor appropriate for resolution on Plaintiff's motion for summary judgment.

This Court identifies the existence of a disputed material fact, and will proceed no further to address remaining issues of interpretation of documents, or whether the substitution of collateral constitutes release or relinquishment of any of Plaintiff's rights against Defendant, Bayles. Further, this Court will not address Defendant's contention that the substitution of collateral transaction can be characterized as diminishing the value of assets acquired by the FDIC.

III. COLLATERAL ESTOPPEL

*5 A right, question or fact distinctly put in issue and directly determined by a court of competent jurisdiction cannot be disputed in a subsequent suit. Bank of Heflin v. Miles, 621 F.2d 108, 112 (5th Cir.1980). Under collateral estoppel, once an issue is actually and necessarily determined by a court of competent jurisdiction, that determination is conclusive in subsequent suits based on a different cause of action involving a party to the prior litigation. State of Montana v. United States, 440 U.S. 147, 153, 99 S.Ct. 970, 973, 59 L.Ed.2d 210 (1979). Collateral estoppel bars relitigation when:

1) the issue at stake in the second suit is identical to one litigated in prior litigation;
2) the issue is actually litigated;
3) the determination of issue in prior litigation was critical and necessary to prior court's judgment; and
4) the party against whom earlier decisions is asserted had full and fair opportunity to litigate issue.

Fields v. Sarasota-Manatee Airport

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Authority, 755 F.Supp. 377, 380 (M.D.Fla.1991) (citing Fountain v. Metropolitan Atlanta Rapid Transit Authority, 849 F.2d 1412, 1414 (11th Cir.1988)), I.A. Durbin, Inc. v. Jefferson Nat'l Bank, 793 F.2d 1541, 1549 (11th Cir.1986).
The Supreme Court has held that the general doctrine of collateral estoppel is as applicable to the decision of criminal courts as to those of civil jurisdiction. Emich Motors Corp. v. General Motors Corp., 340 U.S. 558, 568, 71 S.Ct. 408, 414, 95 L.Ed.2d 534, (1951), quoted in, Wolfson v. Baker, 623 F.2d 1074, 1077 (5th Cir.1980). The proper inquiry for assessing whether the doctrine of collateral estoppel applies in a civil action is whether the issue for which estoppel is sought was distinctly put in issue and directly determined in a criminal action. Emich Motors, 340 U.S. at 569, 71, St. Ct. at 414. Where the criminal conviction was based on a jury verdict of guilty, "issues which were essential to the verdict must be regarded as having been determined by the judgment." Id.

Until recently collateral estoppel was limited by the doctrine of mutuality of parties. Under the mutuality doctrine, neither party could use a prior judgment as an estoppel against the other unless both parties were bound by the judgment. Blonder-Tongue Laboratories, Inc. v. University of Illinois Foundation, 402 U.S. 313, 328-29, 91 S.Ct. 1434, 1442-43, 28 L.Ed.2d 788 (1971). The mutuality doctrine has been abolished by the Supreme Court, which now allows a non-party to the first litigation to assert collateral estoppel offensively or defensively, though not a party to the original criminal proceedings. Parklane Hosiery Co. v. Shore, 439 U.S. 322, 326-33, 99 S.Ct. 648-52, 58 L.Ed.2d 552 (1979). However, nonmutual collateral estoppel is applied only where there was a "full and fair" opportunity in the first action to litigate the issue for which collateral estoppel is sought. Id. Nonmutual collateral estoppel will not be invoked if some overriding consideration dictates a different result in the circumstances of a particular case. Rachal v. Hill, 435 F.2d 59, 63 (5th Cir.1970), cert. denied, 403 U.S. 904, 91 S.Ct. 2203, 29 L.Ed.2d 680 (1971) (quoting Bruszewski v. United States, 181 F.2d 419, 421 (3d Cir.), cert. denied, 340 U.S. 865, 71 S.Ct. 87, 95 L.Ed. 632 (1950)).

A. Collateral Estoppel on Charge of Fraud

*6 This Court's review of the criminal litigation documents must determine whether Bayles' criminal trial and judgment of guilt disposed of all issues relevant to the proceeding of this case. Bayles was found guilty in a New Jersey trial of bank fraud in connection with the loans here involved. Exhibits indicate that after the jury was instructed on the elements of bank fraud; they established that Defendants made false or misleading representa-tion to the financial institution which constituted default. [FN2] Where the trial established the falsity of Bayles representations regarding the timeshare notes, he is estopped from denying the judgment.

It is beyond dispute that Bayles had a full and fair opportunity to litigate the issue of whether he made false or misleading representation to the financial institution which constituted an event of default on the loans. However, the New Jersey District Court jury verdict does not indicate full consideration of the issue of whether the substitution of the Marco Island property as collateral, and subsequent sale of said property relieves Defendants of any portion of the indebtedness. Bayles, in a petition for a new trial based on additional evidence, asserted that the substitution of collateral satisfied the notes to Pascagoula Mississippi property. It can not reasonably be considered, where the evidence was not adduced by a trier of fact and was not litigated, that the New Jersey District Court's refusal to grant a new trial disposed of the issue for which Defendant Bayles currently asserts as a defense.

Further, in the bankruptcy proceeding, Judge Calloway entered summary judgment in favor of plaintiff, FDIC, holding that "any sums due and owing on them [debt guaranteed by Bayles] after all credits have been given is

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determined to be non-dischargeable subject to any valid defense in which the debtor, defendant Fred. M. Bayles may raise if the FSLIC [FDIC now receiver] desires to pursue civil collection of obligations elsewhere." Mr. Gertwitz, appearing as counsel on behalf of FDIC stipulated for the purpose of the bankruptcy proceedings that "not only was collateral substituted subsequent to the funding of the loans but that the substitution of collateral was agreed to and evidenced by the books, record and documents that these loans are represented by." Therefore, Defendants are not estopped from raising the substitution of collateral issue as a defense to Plaintiff's claim on the original promissory notes and guarantee. The viability of this defense in this litigation represents an unsettled material issue of fact as to whether or not the substitution of collateral documents are equivalent to a release or relinquishment of any of Plaintiff's rights against Defendant, Bayles.

B. Collateral Estoppel as to RICO Charges

FDIC seeks summary judgment for treble damages against Defendants for alleged violations of the Racketeering Influence and Corrupt Organization Act (RICO), 18 U.S.C. §§ 1961-1964. FDIC maintains that Defendants were engaged in a "pattern of racketeering activity" through use of the mail and wire services in a scheme to defraud financial institutions, as predicate acts associated with loans of July, August and November of 1982. FDIC contends that Defendants are collaterally estopped from denying they devised a scheme to defraud, after a jury trial determined that beyond a reasonable doubt that Bayles knowingly and willfully made false statements, overvalued property and timeshare notes to influence its predecessor, First Federal's decision to make the loans.

*7 FDIC further lists other activities to demonstrate that Defendants were engaged in a "pattern of racketeering": 1) 1982 criminal judgment charging Bayles with a violation of 18 U.S.C. § 656 for knowingly and wilfully misapplying funds entrusted to his care as director of the Singing River Bank of Moss Point, Mississippi; and 2) 1987 indictment for submittal in 1982 of false and fraudulent loan application to Center Savings and Loan Association, Clifton, New Jersey.

Defendant Bayles, in response proffers that the "racketeering activity" which is alleged forms the basis of FDIC's claim, involved actions for which Bayles was indicted under 18 U.S.C. § 656 and § 1014. Defendant Bayles recounting the definition of racketeering activities delineated within the RICO § 1961 definition provision asserts the position that as a matter of law FDIC's reliance on these statutory sections to allege RICO violations is improper.

In seeking to satisfy and establish that a pattern of racketeering activity exists the Plaintiff emphasizes Defendant Bayles' criminal conviction by the United States District Court for the District of New Jersey for bank fraud in violation of 18 U.S.C. § 1014. Plaintiff also includes the following recent indictments or guilty pleas: Bayles pled guilty in 1985 in the United States District Court for the Southern District of Mississippi to a criminal information charging him with violation of 18 U.S.C. § 656 for knowingly and willfully misapplying funds entrusted to his care as a director of the Singing River Bank of Moss Point, Mississippi on January 29, 1982; and, an indictment of Bayles for defrauding Center Savings and Loan Association, Clifton, New Jersey for submitting a false and fraudulent loan application (specific statutory violation unspecified).

Once a plaintiff alleges a violation of RICO it triggers massive amounts of caselaw for application to the facts. Initially adopted as a broad range legislation, RICO was to serve the purpose of assisting in the elimination of the infiltration by organized crime and racketeering into legitimate organizations affecting interstate commerce. Organized Crime and Control Act of 1969, Report Committee on the Judiciary, S.Rep. No. 617, 91st Cong., 1st Sess. 76 (1969). RICO statutes under Title 18 civil racketeering provisions

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are structured around three main sections: § 1961 provides for the definition, § 1962 describes prohibited conduct, and § 1964 details the remedies.

In order to support a claim for violation of RICO a plaintiff must allege each of the following: 1) conduct, 2) of an enterprise; 3) through a pattern of; 4) racketeering activity. Sedima S.P.R.L. v. Imrex Co., 473 U.S. 479, 497, 105 S.Ct. 3275, 3285 87 L.Ed.2d 346 (1985). An act of racketeering commonly referred to as a "predicate act" is defined to include, inter alia, acts of mail and wire fraud, and financial institution fraud. 18 U.S.C. § 1961(1) (1988 & Supp.1991). To establish a pattern of racketeering there must be at least two distinct but related predicate acts of racketeering activity. Sedima, 105 S.Ct. at 3285, § 1961(5). Predicate acts are related if they "have the same or similar purposes, results, participants, victims, or methods of commission, or otherwise are interrelated by distinguishing characteristics and are not isolated events." Sedima, 473 U.S. at 496 n. 14, 105 S.Ct. at 3285 n. 14 (quoting 18 U.S.C. § 3575(e) (1988).

*8 Although two predicate acts are a prerequisite to establishing a pattern of racketeering activity, they are not by themselves sufficient. Sedima, 105 S.Ct. at 3285 n. 14. In interpreting the Sedima language the Eleventh Circuit has held that to establish a pattern there must be a showing of more than one racketeering activity and the threat of continuing activity. Durham v. Business Management Associates, 847 F.2d 1505, 1511 (11th Cir.1988) (quoting, Bank of America Nat'l Trust & Sav. Ass'n v. Touche Ross & Co., 782 F.2d 966, 971 (11th Cir.1986)). The Supreme Court suggested that lower courts focus on the concept of "continuity plus relationship" in developing standards for evaluating existence of a "pattern of racketeering activity". Aldridge v. Lily-Tulip, Inc., 953 F.2d 587, 593 (11th Cir.1992) (citing, Sedima, 473 U.S. at 496, 105 S.Ct. at 3285)).

(1). Elements of Fraud (Mail, Wire, Financial Institution)

The elements of mail and wire fraud are identical predicate acts. Carpenter v. United States, 484 U.S. 19, 25 n. 6, 108 S.Ct. 316, 320 n. 6, 98 L.Ed.2d 275 (1987). Unlike criminal RICO prosecutions civil RICO plaintiffs must allege and prove reliance in cases using the mail and wire fraud statutes. Pelletier v. Zwiefel, 921 F.2d 1465, 1499 (11th Cir.1991), O'Malley v. O'Neill, 887 F.2d 1557, 1563 (11th Cir.1989). The essential element of mail or wire fraud violations are (1) intentional participation in a scheme to defraud another of money or property, and (2) use of the United States mails or interstate wire facilities in furtherance of that scheme. United States v. Downs, 870 F.2d 613, 615 (11th Cir.1989), See e.g., United States v. Pereira, 347 U.S. 1, 74 S.Ct. 358, 98 L.Ed. 435 (1953).

For purposes of financial institution fraud, terms "scheme" and "artifice" are defined to include any plan, pattern or cause of action, including false and fraudulent pretenses and misrepresentation, intended to deceive others in order to obtain something of value, such as money, from the targeted institution. U.S. v. Goldblatt, 813 F.2d 619, 624 (3d Cir.1987). In contrast to mail and wire fraud which expressly punish separate acts in furtherance, or execution of the scheme, financial institution fraud only imposes punishment for each execution of the scheme and not each act in furtherance, thereof. U.S. v. Lemons, 941 F.2d 309 (5th Cir.1991).

The government must show, not only that the defendant's actions could have deceived a reasonable prudent person, but also that the defendant must have "had a conscious knowing intent to defraud." Blu-J, Inc. v. Kemper C.P.A. Group, 916 F.2d 637 (11th Cir.1990). Mere dishonesty or corruption will not suffice, the defendant must intend to use the mail, wire [or financial institution] fraud for an economic motive. McNally v. United States, 483 U.S. 350, 107 S.Ct. 2875, 97 L.Ed.2d 292 (1987).

(2) Damages

For plaintiffs able to prove elements of a substantial claim under § 1962, § 1964 details

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civil remedy available, and provides that a person injured in business or property may sue for treble damages, cost of suit, and attorney fees. To sustain a claim for treble damages plaintiff in a RICO action must prove RICO violation, injury to business or property, and that the violation caused the injury. Avirgan v. Hull, 932 F.2d 1572, 1579 (11th Cir.1991), Sedima 473 U.S. at 495, 105 S.Ct. 3284. The existence of a prior criminal conviction as a predicate act is not required to sustain a RICO claim for treble damages for a RICO violation. Sedima, 473 U.S. at 491, 105 S.Ct 3282. However, in a civil RICO action private plaintiffs must prove that criminal conduct in violation of RICO directly or indirectly injured plaintiff's business or property, Avirgan, 932 F.2d at 1579, or prove that plaintiff sustained loss as a result of RICO violation. Taffett v. Southern Co., 930 F.2d 847 (11th Cir.1991). Section 1964(c), as interpreted, established that injury must flow from the commission of predicate acts which means that the plaintiff who wants recovery under civil RICO must show some injury flowing from one or more predicate acts, as proximate cause requirement. Pelletier v. Zweifel, 921 F.2d 1465, 1499 (11th Cir.1991). The Eleventh Circuit has taken the view that a plaintiff has standing to sue under section 1964(c) only if his injury directly flowed from the commission of the predicate acts. Morast v. Lance, 807 F.2d 926, 933 (11th Cir.1987). This means that the plaintiff must have been the target of the scheme to defraud and must have relied to his detriment on misrepresentations made in furtherance of that scheme. See O'Malley, 887 F.2d at 1563 & n. 9 (11th Cir.1989), cited in, Pelletier, 921 F.2d at 1400-501.

(3) Application of Estoppel Principles

*9 If a final judgment is rendered in favor of the United States, § 1964(d) estops the defendant from denying essential allegations of the criminal offense in any subsequent criminal proceeding brought by the United States. Offensive use of collateral estoppel differs from defensive use situations and does not promote judicial economy in the same way defensive use does. Parklane Hosiery Co. v. Shore, 439 U.S. 322, 329, 99 S.Ct. 645, 59 L.Ed.2d 552, 561 (1979). Therefore, trial courts are granted broad discretion to determine when offensive collateral estoppel applies. Parklane, 439 U.S. at 331, 59 L.Ed.2d at 562.

It is not disputed that a party subject to criminal prosecution that may result in imprisonment and fine has a great incentive in that litigation to vigorously defend the action. However, in a prior criminal case the jury must have been charged with finding that a specific person was defrauded of money or property and that there was in fact a scheme to defraud. McNally v. United States, 483 U.S. 350, 107 S.Ct. 2875, 2882, 97 L.Ed.2d 292 (1987). Defendant Bayles' previous charges and indictments do not provide an indication that the issues at stake in this litigation are identical to those of prior criminal actions, such that application of collateral estoppel principles are proper. In addition, the nature of a civil proceeding affords additional opportunities for parties to complete discovery, and raise defenses not available in criminal proceedings. While Plaintiffs have provided a history of activities that may formulate the requisite proof of two or more predicate acts to establish a pattern of racketeering, when viewing the evidence above in the light most favorable to the nonmoving party, the Court finds that the Plaintiff has failed to establish the relationship of the predicate acts to each other, that the acts threaten to be continuous, that the acts constitute a nexus which forms the basis for an alleged scheme, that the provisions of 18 U.S.C. § 656, misapplying funds and § 1014 bank, not identified in § 1961(1) can be used as predicate activities to establish a pattern of racketeering which might inure to an award of treble damages, or that Defendant Bayles' convictions or indictment in any way provided an opportunity for litigation of RICO issues. All RICO issues identified by FDIC are more appropriately determined by a jury.

C. Summary Judgment as to Defendants' Affirmative Defenses/Counterclaims

FDIC requests summary judgment as to Defendants' counterclaims or affirmative

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defenses. Defendants allege that:

Count I--FDIC was overpaid by approximately four million dollars as a result of sale of substituted collateral property.

Count II--The substituted collateral was significant to satisfy indebtedness to FDIC, i.e. accord and satisfaction of the original timeshare notes in the substitution of collateral.

Count III--duress

Count IV--fraudulent inducement into completing development of project used as substituted collateral

*10 Count V--Prima Facie Tort

Counterclaims and proposed affirmative defenses include disputed facts regarding material issues for Counts I-IV. Under Florida tort provisions economic duress is not recognized as an actionable tort. Reidel v. NCNB Bank of Florida, Inc, 591 So.2d 1038, 1040 (Fla. 1st DCA 1991), NN Investors Life Ins. Co. v. The Professional Group, Inc., 468 So.2d 532, 533 (Fla. ed DCA 1985). However, duress is recognized as a defense or remedy in contractual context, City of Miami v. Kory, 394 So.2d 494 (Fla.3d DCA), rev. denied, 407 So.2d 1104 (Fla.1981), and as an affirmative defense for release of underlying claim. Associated Hous. Corp. v. Keller Bldg. Products of Jacksonville, Inc., 335 So.2d 362 (Fla. 1st DCA 1976, Deleo v. Spero, 560 So.2d 426 (Fla. 4th DCA 1990). The factual dispute as to the duress issue, the significance of substitution of collateral, the satisfaction of debt, and overpayment, if any, preclude summary judgment on behalf of FDIC. Further where counterclaims or affirmative defenses are raised by a pro se litigant, as in this case additional leeway is granted in review of issue classification. Defendant's counterclaim of "prima facie tort" is not recognized as an actionable tort and may not be raised as a defense or counterclaim.

Although defendants BCA and Sectra have failed to submit memoranda in opposition to FDIC's request for summary judgment, the Court will exercise its discretion and withhold issuance of summary judgment against these defendants where: 1) defendant interest and defenses are akin to those enunciated by Defendant Bayles; and 2) where Defendant Bayles, as guarantor of obligations for BCA and Sectra, will be the party to which ultimate liability in judgment would lie.

IV. CONCLUSION

Therefore, the Court finds that material issue of facts exist which preclude a finding of summary judgment on behalf of Plaintiff, FDIC. Accordingly it is

ORDERED that plaintiff's the motion for summary judgment on the basis of the D'Oench Doctrine and Collateral Estoppel for Counts I, II, III, IV and VII; request for oral argument; and plaintiff's motion for summary judgment on defendants counterclaims or affirmatives defenses be DENIED; and further ORDERED defendant's counterclaim of "Prima Facie Tort" is Striken.

DONE and ORDERED in Chambers In Tampa, Florida on this 30th day of June 1992.

FN1. FDIC identifies the existence of written minutes related to a transaction completed by the Board of Directors of Directors on 4/28/83 & 5/24/83. Plaintiff Motion for Summary Judgment. p. 5 n. 3 (Dec. 13, 1991). While Defendants allege in their response, p. 3, that the underlying indebtedness of the notes were satisfied, new loans and substitution of collateral was made, FDIC alleges the board meeting only indicates a substitution of collateral.

FN2. The following elements of bank fraud were proven beyond a reasonable doubt: 1) Bayles made or caused to be made false a false statement or report in applying to a bank for a loan; 2) Bayles knowingly made or caused such false statement to be made; 3) Bayles made such knowing and willfully materially false statements for the purpose of influencing the action of the financial institution; 4) that the false statements were made in connection with the loan application to a bank, the deposits of which were then insured by the FDIC.

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MIDDLE DISTRICT OF FLORIDA
TAMPA.FLORIDA

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF FLORIDA
TAMPA DIVISION

FEDERAL DEPOSIT INSURANCE CORP.	:	CIVIL ACTION
v.	:	
BAYLES & COMPANY OF AMERICA, et al.	:	NO. 87-1468-CIV-T-17B

Newcomer, J. September 25, 1993.

MEMORANDUM

Presently before the Court are several motions by Plaintiff FDIC and Counterdefendant RTC. Plaintiff's Joint Motion to Amend or Vacate Judgment and Substitute Final Judgment and the Joint Motion for Judgment as a Matter of Law will be denied. However, plaintiff and counterdefendant's Joint Motion for a New Trial will be granted.

I. Factual Background.

In 1982, defendant Bayles ~~&~~ Company of America ("BCA") executed three promissory notes in favor of First Federal Savings and Loan Association of Hammonton, New Jersey ("Hammonton") in the amount of $9,194,907. These notes were personally guaranteed by Defendants BCA and Fred M. Bayles. In 1987, Hammonton brought suit to recover over $7.7 million due on the notes.[1] The Complaint contains four counts for money damages against the

1. The FDIC sought $7.7 million due on the Notes as of October, 1987, together with interest through the date of judgment. By the time of the trial, the amount the FDIC sought had risen to $11.1 million as a result of the accumulation of interest.

defendants: (1) an action on the Notes against BCA; (2) an action on the Notes against Sectra, the successor to BCA; (3) an action on the Guarantees against Bayles; and (4) an action for fraud against Bayles. The defendants asserted a counterclaim against Hammonton which contained four affirmative claims: (1) overpayment of the Notes in the amount of $4,471,618; (2) negligence; (3) duress; and (4) fraud.

In 1988, Hammonton became insolvent and it was merged into Hansen Savings in an FSLIC-assisted merger. The FSLIC became entitled to the proceeds of the notes in exchange for its continuing financial assistance. The FDIC acquired the notes when the FDIC succeeded the FSLIC. As a result, in November, 1991, the FDIC was substituted as plaintiff in this action. In January, 1992, Hansen Savings was declared insolvent and the RTC was named as receiver. The RTC assigned the assets of Hansen Savings to a new entity that it created called Hansen Federal Savings Association. The RTC now acts as conservator for Hansen Federal.

At the conclusion of the trial, the jury returned a verdict for the defendant-counterplaintiff in the amount of $1,756,985. The instant motions followed.

II. Joint Motion to Amend or Vacate Judgment and Substitute Final Judgment.

Because the court will grant the motion for a new trial, the motion to amend or vacate judgment and substitute final judgment will be denied.

III. Joint Motion for Judgment as a Matter of Law after Trial.

The basis of the jury award to the defendants/ counterplaintiffs is unclear from the jury verdict. The jury answered yes to the interrogatory which stated: "Except for their fraud claim, do you find in favor of the defendants with respect to any of their other counterclaims against plaintiff?" Thus, the jury could have found for the defendants on their overpayment, negligence, or duress claims. As will be discussed, defendants' evidence in support of the overpayment claim and one negligence claim was improperly admitted. However, the determination that this evidence was improperly admitted does not warrant reversal of the trial outcome because a jury could still have found for the defendants on either the duress[2] or the impairment of collateral claims. As a result, it is impossible to determine either liability or damages as a matter of law. Instead, the plaintiff's motion for a new trial will be granted.

IV. Joint Motion for a New Trial.

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2. Plaintiffs argue that "the defense of . . . duress cannot be used against the FDIC unless Defendant can show in writing from the Board of Directors or Loan Committee minutes evidence which supports the validity of these defenses." FDIC v. Gettysburg Corporation, 760 F. Supp. 115, 117 (S.D. Tex. 1990). However, the 11th Circuit has seemed to suggest that section 1823(e) may allow debtors to assert the real defense of duress. FDIC v. Morley, 867 F.2d 1381, 1385 n.5 (11th Cir. 1989). Plaintiff also argues that it is entitled to judgment as a matter of law because the alternative of litigation was available to the defendant. City of Miami v. Kory, 394 So.2d 494, 499 (Fla. Dist. Ct. App. 1981) ("Threatened action cannot constitute duress, when there are adequate legal remedies available with which to challenge it"). However, whether an alternative to Hammonton's offer was available to Bayles is a question for the jury.

"In few, if any, situations is the discretion of a trial judge broader than in granting a new trial. A district judge may grant a new trial if he thinks he has committed error; and he may grant one (and he alone can) because he thinks the verdict is wrong, though supported by some evidence." Willit v. Purvis, 276 F.2d 129, 132 (5th Cir. 1960). Further, if the court admitted irrelevant and prejudicial evidence, it is under a duty to grant a new trial. Id. Plaintiff requests a new trial on three grounds: evidence which should have been excluded was admitted, improper closing arguments were made, and the verdict was contrary to the weight of the evidence.

A. Evidence Which Should Have Been Excluded.

As stated, the court must grant a new trial if it finds improper evidence was admitted which prejudiced the jury in arriving at its verdict.

1. Evidence barred by the D'Oench Duhme doctrine.

In D'Oench, Duhme & Co., Inc. v. FDIC, 315 U.S. 447, 459 (1942), the Supreme Court held ~~that~~ a bank customer was estopped from asserting an alleged unrecorded agreement as a defense to an action maintained by the FDIC to collect on a note contained in the files of an insolvent bank. The statutory counterpart to this doctrine is enacted at 12 U.S.C. § 1823(e):

> (e) Agreements Against Interest of Corporation.
> No Agreement which tends to diminish or defeat the interest of the Corporation [FDIC and RTC] in any asset acquired by it under this section or section 11, either as security for a loan or by purchase or as receiver of any insured depository institution, shall be valid against the Corporation unless such agreement --
> (1) is in writing;

(2) was executed by the depository institution and any person claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the depository institution;

(3) was approved by the Board of Directors of the depository institution or its loan committee, which approval shall be reflected in the minutes of said board or committee; and

(4) has been continuously, from the time of its execution, an official record of the depository institution.

The doctrine has most recently been formulated as follows by the 11th Circuit: "The rationale behind D'Oench has been extended far beyond the factual setting in D'Oench itself, and now applies to virtually all cases where a federal depository institution regulatory agency is confronted with an agreement not documented in the institution's records." Baumann v. Savers Federal Savings & Loan Association, 934 F.2d 1506, 1510 (11th Cir. 1991). In a suit concerning the "enforcement of an agreement originally executed between an insured depository institution and a private party, a private party may not enforce against a federal depository insurer any obligation not specifically memorialized in a written document such that the agency would be aware of the obligation when conducting an examination of the institution's records." Id. at 1515 (citations omitted). Further, "the D'Oench doctrine applies even where the customer is completely innocent of any bad faith, recklessness, or negligence." Id.

Plaintiff argues that evidence admitted at trial on four issues does not comply with the D'Oench doctrine as codified in section 1823(e). First, defendants argued at trial that it assigned a $4,000,000 note to the plaintiffs, which plaintiff

agreed to credit against the $9.1 million loan. This agreement tends to diminish the interest of the FDIC in an asset acquired by it as receiver of an insured depository institution. As a result, it must comply with section 1823(e). However, defendants' only supporting evidence of this agreement was neither executed by Hammonton contemporaneously with the acquisition of the $9.1 million loan, approved by Hammonton's Board of Director's as reflected in its minutes, nor maintained as an official Hammonton record. Thus, this evidence was improperly admitted during trial.

Second, defendants argued that Hammonton had agreed to substitute the Marco Island Project as collateral for the Timeshare paper which was the original collateral (see Tr., Vol. II at 36-43). Again, because this alleged agreement may diminish the FDIC's interest in the $9.1 million loan, evidence introduced on the issue must comply with section 1823(e). Because the evidence introduced did not comply with that section, the evidence was improperly admitted.

Third, defendants argued that they paid Hammonton a $70,000 commitment fee for a loan Hammonton never made to defendants. Defendants therefore argue that they are due a $70,000 credit against the $9.1 million loan. Again, this agreement would diminish the asset received by the FDIC and therefore must comply with D'Oench. However, defendants' only documentation of this credit is Plaintiff's Exhibit 54. This documentation does not comply with section 1823(e) because it

states that a payment of $30,000, not $70,000, was received, that the fee is non-refundable, but says nothing about crediting the amount to the $9.1 million loan.

Fourth, defendants also allege that Hammonton financed a construction project for G.S. of Marco, a company Hammonton allegedly controlled through a voting trust. At the same time, Hammonton allegedly hired defendant Bayles to supervise the construction. Defendants argue that Hammonton's negligent decisions on behalf of G.S. of Marco caused the construction project to fail, which in turn prevented G.S. of Marco from paying Bayles money it owed him for supervision services rendered. As a result, Bayles was unable to pay off the $9.1 million loan. In Baumann, the debtor similarly argued that the bank had agreed to be its partner. Baumann, 934 F.2d at 1516. The court excluded testimony concerning this oral argument because the agreement went "beyond the scope of the written loan documents." Id. Likewise here, documents that comply with section 1823(e) do not establish the contractual duty the defendants allege. Nor does Florida law recognize a duty in tort to pay damages for negligence unaccompanied by physical property damage or bodily injury. Sandarac Association, Inc. v. Frizzell Architects, Inc., 609 So.2d 1349, 1352 (Fla. Dist. Ct. App., 1992).

Thus, evidence of the $4,000,000 note, the substitution of collateral, the $70,000 commitment fee, and Hammonton's negligence in connection with the Marco Island project was

erroneously admitted during trial. In order to grant a new trial, the court must also find that the jury considered this evidence in reaching its verdict. As discussed earlier, it is unclear whether the jury found for the defendants on their overpayment, negligence or duress claims. However, plaintiff asserted a $4,000,000 credit was not due to Bayles, while Bayles asserted it was. This difference alone made the difference between Bayles' assertion that he had overpaid the loan and the FDIC's assertion that he had defaulted on the loan. (Tr. at Vol. II at 75). In addition, except for the $4,000,000 credit, the $70,000 commitment fee/credit and the $1.6 million timeshare mortgage credit, the defendants' figures were materially the same as the plaintiff's. Thus, the jury must have relied on some of the evidence that should have been excluded in order to reach the verdict they reached.

2. Evidence of lost Timeshare paper.

Plaintiff argues that evidence concerning impairment of collateral through loss of timeshare paper should not have been admitted for two reasons. First, the allegedly lost timeshare mortgages were not lost but were recorded in the official records of Jackson County, Mississippi. However, defendant Bayles testified that plaintiff refused to make available the necessary documentation to foreclose on the lost mortgages. (Tr. Vol. II at 108). From this testimony, the jury could have found that defendant Bayles was due an offset for the lost paper. Second, defendant argues that D'Oench requires that an agreement by

Hammonton to maintain or protect the collateral timeshare paper must be in writing. This court disagrees. Florida law reads:

> If the obligation of a party is secured by an interest in collateral not provided by an accommodation party and a person entitled to enforce the instrument impairs the value of the interest in collateral, the obligation of any party who is jointly and severally liable with respect to the secured obligation is discharged to the extent the impairment causes the party asserting discharge to pay more than that party would have been obliged to pay, . . . if impairment had not occurred.

Fla. Stat. ch. 673.606 (West 1992). The purpose of D'Oench is to protect taxpayers from secret side agreements which decrease the value of an asset held by a federal regulatory agency. D'Oench, Duhme, 315 U.S. at 457. Because the obligation to maintain the collateral is an obligation asserted by statute on the bank rather than by secret agreement between the bank and the defendant, the FDIC should have been aware of this defense when it acquired the note. As a result, the defendant is not estopped from asserting it.

B. Verdict Contrary to the Weight of the Evidence.

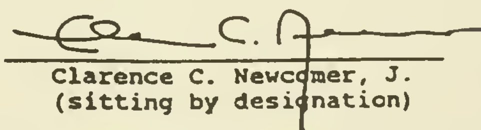
Because the court will grant a new trial, the court need not consider whether the verdict was contrary to the weight of the evidence.

V. Conclusion.

Factors this court has previously considered in reviewing a district court's alternative grant of a new trial include, among others, the simplicity or complexity of the issues, the degree to which the evidence presented was in dispute, and whether any undesirable or pernicious element

occurred or was introduced into the trial. Spurlin v. General Motors Corporation, 528 F.2d 612, 620 (5th Cir. 1976). Here, the issues were made complex by the many reorganizations of the original plaintiff and the various assets and liabilities these reorganizations created in the FDIC and the RTC. It was also made complex by the introduction of testimony concerning G.S. of Marco, a company which allegedly had connections with both Hammonton and Bayles. The evidence presented was in dispute to a large degree. For instance, plaintiff asserted a $4,000,000 credit was not due to Bayles, while Bayles asserted it was. This difference alone made the difference between Bayles' assertion that he had overpaid the loan and the FDIC's assertion that he had defaulted on the loan. (Tr. at Vol. II, 75). Finally, two undesirable or pernicious elements occurred at trial. Testimony that should have been excluded for failure to comply with the requirements of 12 U.S.C. § 1823(e) was admitted and defendant Bayles and defense counsel appealed to passion and prejudice during their closing arguments. Thus, a new trial is warranted in this case.

An appropriate Order follows.



Clarence C. Newcomer, J.
(sitting by designation)

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF FLORIDA
TAMPA DIVISION

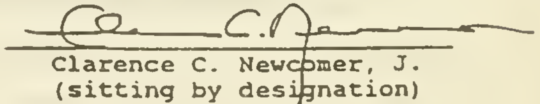
FEDERAL DEPOSIT INSURANCE CORP.	:	CIVIL ACTION
v.	:	
BAYLES & COMPANY OF AMERICA, et al.	:	NO. 87-1468-CIV-T-17B

ORDER

AND NOW, this 25th day of September, 1993, upon consideration of Plaintiff FDIC's and Counterdefendant RTC's Joint Motion for a New Trial, and the response thereto, and consistent with the foregoing Memorandum Opinion, it is hereby ORDERED that said motion is GRANTED.

IT IS FURTHER ORDERED that Plaintiff FDIC and Counterdefendant RTC's Joint Motion to Amend or Vacate Judgment and Substitute Final Judgment and their Joint Motion for Judgment as a Matter of Law after Trial is DENIED.

AND IT IS SO ORDERED.



Clarence C. Newcomer, J.
(sitting by designation)

AO 450 (Rev. 5/85) Judgment in a Civil Case

United States District Court

MIDDLE DISTRICT OF FLORIDA

FEDERAL DEPOSIT INSURANCE CORP.

V.

BAYLES & COMPANY OF AMERICA, INC.,
SECTRA, INC., and FRED BAYLES

JUDGMENT IN A CIVIL CASE

CASE NUMBER: 87-1468-Civ-T-17B

☒ Jury Verdict. This action came before the Court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

☐ Decision by Court. This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

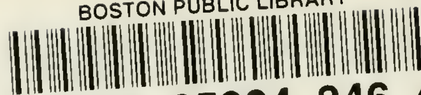
IT IS ORDERED AND ADJUDGED

that the Plaintiff, Federal Deposit Insurance Corporation recover of the Defendant, Bayles & Company of America, Inc., Sectra, Inc., and Fred Bayles the sum of $11,901,160.09, with interest thereon at the rate as provided by law, and his costs of action.

March 31, 1994
Date

DAVID L. EDWARDS
Clerk

(By) Deputy Clerk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