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HEADLINE: TESTIMONY June 14, 1995 FRED GALVES ASSISTANT PROFESSOR OF LAW--MCGEORGE SCHOOL OF LAW UNIVERSITY OF THE PACIFIC SENATE BANKING FDIC CLAIMS

BODY:

TESTIMONY

OF

PROFESSOR FRED GALVES

ASSISTANT PROFESSOR OF LAW

McGEORGE SCHOOL OF LAW

UNIVERSITY OF THE PACIFIC

BEFORE

THE SENATE COMMITTEE ON

BANKING, HOUSING, AND URBAN

AFFAIRS

JUNE 14, 1995

Mr. Chairman, and distinguished members of this Committee, I appreciate this invitation to present testimony on how the D'Oench Duhme Doctrine, and its statutory analogue, 12 U.S.C. 1823(e), Currently operate in failed bank litigation and how they should be reformed to prevent injustice to thousands of innocent borrowers, creditors and service providers across the Country. I applaud your concern and your willingness to address this issue that has plagued so many individuals in the aftermath of the recent banking crisis and S&L debacle. Before criticizing the application of the D'Oench Doctrine and addressing the manner in which it should be reformed in order to trim the unnecessary and unfair power of federal bureaucracies over individuals, I briefly want to address the legal and financial framework in which it arises.

I. THE CONTEXT IN WHICH D'OENCH OPERATES

As You know, banks and S&Ls are regulated by several federal government agencies such as the OCC, the OTS, the FED, the FDIC and the RTC. These agencies oversee the chartering, operation, and management of financial

institutions, and even insure their deposits, all in an effort to help maintain the "safety and soundness" of, and tile public's confidence in, the U.S. banking industry. Despite these helpful oversight activities, banks and S&Ls still can and do fail, and we all witnessed how they did so in spectacular fashion during the late 1980s.

When a bank is declared insolvent by the regulators and fails, the FDIC takes over the bank as receiver or conservator. As such, it "steps into the slices" of the bank and assumes the responsibility for its assets, which notably consist of loans still owed to the bank. This includes any pending or potential lawsuits the bank may have against its debtors. The FDIC also undertakes the responsibility for the liabilities of the bank, which notably consist of the remaining deposits in tile customers' accounts, the general creditors of the bank, and any pending or potential lawsuits against the bank.

It is here, in the particular situations of a pending or potential lawsuit by the bank against a former debtor or a lawsuit by a creditor against the bank, where the application of the D'Oench Doctrine and 1823(e) arise. The crux of the problem is this: because of the application of the D'Oench Doctrine and 1823(e), many of the valid defenses and counterclaims a former debtor would otherwise have against the bank if the bank were still solvent, are barred once the bank fails and is taken over by the FDIC.

For example, a borrower who is completely unaware of a bank officer's fraud in procuring a loan, would not be able to raise the defense of fraudulent inducement in a lawsuit adjudicated after the bank falls and the FDIC takes control. This is only one of many such egregious examples of injustice about which I am sure we shall hear much today. However, in the zeal to reform the D'Oench Doctrine, one Should not lose sight of the fact that the D'Oench Doctrine, at its core, does serve some legitimate purposes as the FDIC and RTC representatives have underscored in their testimony. Although the D'Oench Doctrine and 1823(e) should not be completely abolished, the need for significant reform is critical to remove the unnecessary and unfair powers the government has against individuals in failed bank litigation.

II. THE ORIGINAL D'OENCH CASE AND ITS POLICY JUSTIFICATIONS

In 1942, the U.S. Supreme Court decided the D'Oench case. 1 Briefly Summarized, D'Oench, Duhme & Co., a Securities dealer, sold some bonds to Belleville Bank & Trust Co., but later defaulted. To remove these past due bonds from its books, D'Oench executed promissory notes to the bank, covering the value of the defaulted bonds. There was a secret agreement between D'Oench and the bank, however, that the promissory notes were never to be collected. The FDIC later obtained one of these notes as partial collateral for a $1,000,000 loan it made to the failing bank, but when the FDIC Sought to collect on the note, D'Oench claimed that the note was not enforceable. The Court rejected that defense and found that D'Oench was liable, since it had participated in making the bank appear more financially solid than it actually was. 1 D'Oench, Duhme Co. v. FDIC, 315 U.S. 447 (1942).

The underlying policy supporting the D'Oench Doctrine is that bank examiners must be able to rely on as bank's written records regarding the existence of

side agreements that may impair or affect the value of any asset of the bank. Therefore, the application of the D'Oench Doctrine does not cause an injustice when the borrower, along with the bank, deceives bank examiners by not having their agreement written in the bank's official records for the examiners to review and record.

III. THE EXPANSION OF D'OENCH AND 1823(e)

Unfortunately for many borrowers in the last decade, that original limited application has been expanded beyond recognition. The Current broad scope of the application and interpretation of the D'Oench Doctrine and 1823(e) very often results in completely innocent former debtors, creditors, and others losing their otherwise legitimate claims and defenses.

The beginning of the expansion of the D'Oench Doctrine took place in 1950, when Congress enacted the Doctrine's statutory counterpart, 12 U.S. C. 1823 (e) to provide a means for a customer to enforce a legitimate side agreement with the financial institution in the event that the institution failed. In reality, the statute simply expanded the scope and power of the D'Oench Doctrine to defeat Such side agreements or bank representations by making it very difficult for an innocent customer to comply with the four requirements of the statute. The statute has been amended at various times in recent years but Currently, 12 U.S.C. 1823(e)(1) provides, in pertinent part, the following (and I am paraphrasing):

It bars nearly every conceivable claim or defense arising from any oral, and even many written, agreements with the lender that tends to diminish or defeat the interest of the FDIC, unless that agreement:

(A) is in writing; and

(B) was executed contemporaneously with the acquisition of the asset by both the lending institution and the borrower; and

(C) was approved by the lending institution's board of directors or its loan committee, and such approval is reflected in the minutes of the board or loan committee meetings; and,

(D) continuously has been an official record of the depository institution since the execution of the agreement.

The Supreme Court gave a very strict and literal interpretation of 1823(e), in the 1987 case of Langley v. FDIC 2 . There, the borrowers executed a promissory note to the bank in exchange for a large portion of land. The Langleys claimed that the bank orally misrepresented the actual size and value of tile land and, therefore, refused to pay the first installment due on the promissory note. When the bank sued to collect, the Langleys claimed they were fraudulently induced to sign the note. They asserted that they were not subject to 1823(e) because the oral misrepresentations of the bank were not "agreements."

Justice Scalia, writing for a unanimous Court, was not swayed by the plight of the Langleys, finding that the term "agreement" in 1823(e) must be read broadly. The Court then concluded that the truth of an express oral warranty by

the bank is to be construed as an "agreement" within the meaning of 1823(e), and therefore must be written. Finally, the Court ruled that fraud in the inducement cannot be used as a valid defense to 1823(e).

Langley thus expanded the D'Oench Doctrine by reinterpreting 1823(e) to include any agreement, not simply a "secret agreement" or participation in a "scheme that tends to deceive." Langley has subsequently allowed Courts to apply 1823(e) as a strict liability statute without the equitable underpinnings of D'Oench. In effect, Langley allows the FDIC to use the D'Oench Doctrine to prevent a borrower from brining forward a legitimate fraud claim against a bank, even though the borrower had not engaged in any Culpable conduct whatsoever. This requirement applies even when the FDIC clearly is aware of the side agreement. 3

In 1989, Congress enacted FIRREA, which, among many other things, expanded 1823(e) to apply to the FDIC in its receivership form as well as its corporate form. This greatly broadened the effect of the D'Oench Doctrine and 1823(e) because the FDIC and RTC 4 could use the doctrine and statute in many more instances. Unfortunately, FIRREA also implicitly acknowledged the expansion of D'Oench by and previous case law. 2 484 U.S. 86 (1987). 3 FDIC v. Gardner, 606 F.Supp. 1484, 1487 (S.D.M.S. 1992). 4 1823(e) has been deemed to apply to the RTC as well as the FDIC by subsequent case law.

That is why I suggest that in addition to reforming the D'Oench Doctrine, the D'Oench Duhme Reform Act should explicitly overrule Langley to the extent that it Is inconsistent with the findings and purposes of the Act. It is against that general backdrop, and the Supreme Court's very strict interpretation of 1823(e) in Langley, that the four requirements of 1823(e)(1) Should be reformed. 5 5 See suggested statutory language, infra.

A. 1823(e)(1)(A)'s Writing Requirement

The first and most elemental requirement of 1823(e)'s "categorical recording scheme," is a writing requirement for side agreements. In keeping with the purposes of 1823(e) as stated in Langley, a writing requirement is an historically and legally sound means for record keeping and prudent loan consideration. No commentator or policy maker has proposed dismissing this particular requirement and simply relying on the word of the parties. Therefore, this requirement should be maintained.

However, I also suggest that borrowers should expressly be made aware of the possible application of 1823(e) and its requirements whenever they obtain a loan. Such could be accomplished with a simple disclosure requirement and special filing system, the advantages of which I will discuss in more detail later. In short, the system would inform borrowers that they must put in writing any side agreement or relied upon bank representation regarding the loan and file it directly with the regulators.

B. 1823(e)(1)(B)'s Contemporaneous Requirement

The second requirement of 1823(e)(1) is that the agreement must have been executed contemporaneously with the acquisition of the loan by the bank. The purpose of this contemporaneous requirement is to ensure sound lending practices and to prevent fraudulent schemes such as the one in the D'Oench case. Specifically, this requirement prevents the fraudulent insertion of new terms,

with the collusion of bank employees, when a bank appears headed for failure. Unfortunately, this requirement also has left borrowers with the substantial risk that a modification of their loan agreements would not be enforced.

For example, the Court in Cardente v. Fleet Bank of Maine 6 refused to accept the plaintiff's contention that several loan documents, going into effect at the same time, constituted a single closing binder and thus were executed "contemporaneously." The Court Supported its decision citing an extensive string of cases implying that nothing short of same day execution would satisfy this requirement. 7 Again, the strict application of the language of 1823(e) often makes the courts reach absurd and unjust results, all the while thinking they are doing justice because they are simply applying the statute. 6 796 F.Supp. 603 (Me. 1992). 7 Id. at 611. Under Section 1823(e)(1)(B), an agreement not executed by the bank "contemporaneously with the acquisition of the asset of the asset" by that bank cannot serve to defeat the FDIC's interest in that asset. See FDIC v. P.L.M. International Inc., 834 F.2d 248, 253 (1st Cir. 1987)(release agreement dated April 17, 1983, was not executed contemporaneously with the letter of guaranty dated December 31, 1981); FDIC v. Cremona Co., 832 F.2d 959, 962 (6th Cir. 1987)(Partnership Agreement dates April 12, 1974, was not executed contemporaneously with the acquisition of any of the notes buy the bank, and presented to and signed by the defendant at the same time as one of the notes), cert. dismissed, 485 U.S. 1017 (1988); FDIC v. La Rambla Shopping Center, 791 F.2d 215, 220 (1st Cir. 1986)(the 1968 lease that is the subject of Defendant's counterclaim was not executed contemporaneously with the note that evidences the 1970 loan; Fleet Bank of Maine v. Steeves, 785 F. Supp. 209, 215 (D. Me 1992)("The Agreement was executed approximately nine months before the First note and more than two years before the Equity Line Agreement. It therefore fails to met the second requirement under Section 1823(e)(2)."); FDIC v. Friedland, 758 F. Supp. 941, 943 (S.D.N.Y. 1991)(investment agreement dates May 10 1984, was not executed contemporaneously with acquisition on the same date of a promissory note by the bank and, therefore, said agreement was not binding on FDIC under 1823(e).

In response to this troubling interpretation, many borrowers have attempted to invoke equitable arguments to satisfy the contemporaneous requirement with mixed results. For instance, in RTC v. Midwest Fed. Sav. Bank Minot, 8 the commitment letter was executed more than two months prior to the final loan documents. In a victory for common sense, the Minot court held that in the nature of a large real estate loan, "contemporaneous" may mean within several months. This court's finding, however, serves to demonstrate that a Court must hedge on the interpretation of 1823(c) in order to do justice and essentially ignore the overwhelming case law abiding by the letter of Langley. Reforming 1823(e) will ensure that future judges will not have to perform such intellectual and definitional contortions simply to apply 1823(e) in a commercially reasonable and just way. 8 4 F.3d, 1490, 1500 (9th Cir. 1993)(commitment letter executed more than two months prior to the final loan documents satisfied contemporaneous requirement of 1823(e); but see RTC v. Crow, 763 F. Supp. 887 (N.D. TX. 1991)(alleged commitment letters given months after asset acquired by bank did not satisfy 1823(e)).

Without reform, this contemporaneous requirement will remain an arbitrary barrier to fair defenses and claims by borrowers. If the otherwise legitimate agreement was not executed on the same day as the underlying, loan, the FDIC can escape responsibility for that agreement when it steps into the shoes of the

failed bank. Collection on the loan then becomes an easy windfall instead of a difficult and perhaps unsuccessful collection lawsuit. Such is not a sound policy reason for denying otherwise legitimate claims and defenses of borrowers. The dismissal of all claims and defenses comes at the expense of making the borrower pay the cost of bank failures rather than the FDIC's insurance fund. For these reasons, this requirement Should be stripped from 1823(e). The D'Oench Duhme Reform Act does this and I urge that it should remain a part of any reform.

C. 1823(e)(1)(C)'s Requirement

to Obtain the Approval of the Bank Board or Loan Committee

The third requirement of 1823(e)(1) provides that the bank must consider, approve, and record the loan transaction. Accordingly, the Courts are directed to Consult the minutes of either the Board of Directors' or the Loan Committee to (1) assure the prudent consideration of a loan by senior bank officials before a loan is made and (2) protect against collusive reconstruction of loan terms by certain lower level bank officials and borrowers. Perhaps the most problematic aspect about this requirement is that often the borrower is not sophisticated enough to know that even though a high level officer like a bank director approves the loan, the loan still must be documented in the appropriate official minutes for the agreement to have any enforceability against the FDIC or RTC, should the institution fail.

For example, in RTC v. Wilson 9 thrift officials convinced Wilson to consolidate his partnership's prior loans with an additional loan into one single loan in Wilson's name only. Thrift officials assured Wilson, both orally and in a letter from tile Executive Vice President of the thrift, that he Would be responsible for only 50% of tile loan. This letter, representing a side agreement, never made it to the meeting minutes of tile loan committee or the board of directors. Applying the strict language of 1823(e), tile Court held for tile RTC.

As if the gauntlet of 1823(e) were not difficult already, getting a written agreement into the official minutes may not be enough to satisfy the requirements, regardless of any other considerations. One Court found that the draft minutes of a board meeting did not satisfy the requirement since the final, "official" board minutes did not reflect the agreement. 10

This demonstrates that the authorization requirement, like tile other 1823(e) requirements, is strictly interpreted. Nevertheless, it still leaves many questions unanswered. What about a standing resolution of the board? It is likely that a Court, strictly applying 1823(e), would rule that such did not meet the statutory requirement because it is not referred to specifically in the statute. Similarly, what about the vote of an executive committee or other committee of the board? Recall, I 823(e) merely states Board or loan committee minutes; thus, a strict interpretation of the statute would again result in a finding that the requirement Would not have been satisfied. Also, what level of detail must be incorporated into the minutes; do the minutes need to spell out each and every specific term of the agreement or merely the fact that an agreement exists? This requirement should be eliminated. Even tile FDIC and the RTC agree that this requirement is too burdensome for borrowers. 11 9 RTC v,. Wilson, 851 F.Supp. 141 (D. N.J. 1994). 10 RTC v. Ruggiero, 977 F.2d 309, 316

(7th Cir. 1992). 11 The FDIC/RTC guidlines suggest that although agreement must be kept continuously in the bank's official records, usage of the D'Oench Doctrine or 1823(e) in these situations is subject to a case- by-case headquarter's review. In any event, the decision is ultimately left to the agency's discretion. See Reed, Kenneth C., Use of D'Oech Duhme to Ease Up, FDIC Says, THE BANKING ATTORNEY, vol., 5, no. 7, p.1, February 20, 1995.

The D'Oench Duhme Reform Act replaces this authorization requirement with general language about agreements executed in the "ordinary course of business" by employees with authority." This language is clearly all improvement, but it leaves the courts, once again, with the difficult task of determining the threshold for bank authorization. These new terms are ripe with ambiguity and will no doubt lead to litigation which I shall discuss shortly.

These difficulties would be greatly alleviated with a disclosure and filing system. The borrower would be informed about the requirements of 1823(e) by having to Submit all 1823(e) filing form directly with the regulators instead of just the financial institution (assuming they choose to protect the enforceability of any agreement). Although the disclosure system I propose may not by itself ensure that each and every unsophisticated borrower will fully understand all of the intricacies of 1823(e), it would be a dramatic improvement when compared to the status quo.

D. 1823(e)(1)(D)'s Continuous and Official Recordation

Requirement

The final and perhaps most egregious requirement of' 1823(e)(1) is that a valid side agreement Must have been "continuously, from the time of its execution, an official record of the bank." The main problem here is that the borrower has no control over this requirement: whether tile agreement was in the official records and whether it was Continuously kept there is under the unilateral control of the institution. Since banks do not allow private individuals to inspect bank files, there is no way a borrower call protect himself against the unilateral control of the bank. Consequently, the borrower often ends up at the mercy of the institution or its officers.

For example, suppose a hypothetical bank is to be examined for, among other things, portfolio weaknesses in the bank's loan files. Naturally the bank employees want for the bank's loan portfolio to appear as strong as possible with no continent liabilities evidenced by 1823(e) side agreements or possible misrepresentation claims. A dishonest hypothetical bank officer, however, might simply physically remove the side agreement from tile bank's official files in order to hide the contingent weakness of the loan(s) from the examiners. Moreover, the document might simply be misfiled or get lost as all honest mistake. In any event, the bank's federal examiner charged with checking the bank's books for general "safety and soundness," would never see the memorialized side agreements during an annual or semiannual examination of the bank and therefore would not record or acknowledge the side agreement. Thus, if that hypothetical bank were to fail, the FDIC, pursuant to tile D'Oench Doctrine and 1823(e), could later successfully claim that the particular side agreement entered into between the bank and the borrower would be unenforceable because the side agreement would not have been "continuously all official bank record" notwithstanding the hypothetical bank officer's unethical and objectionable actions, or the occurrence of an honest misfiling mistake.

Under Langley, the Courts have applied this requirement very strictly leading to extremely harsh results. For example, the Court in RTC v. McCrory 12 held that the requirement prohibited any claims and defenses based on a letter agreement that was not filed in the thrift's files. The letter agreement in this case had been fully executed, but was kept in the files of the thrift's attorney, who had offices on the same floor of the same building as the thrift. The agreement, however, had been referenced in other documents kept in the thrift's files. Still, the Court declined to define what would satisfy this requirement, reasoning that strict adherence to 1823(e) was needed so that the RTC could make an overnight evaluation. 12 951 F.2d 68 (5th Cir. 1992),

In addition to unjust results, there are many questions left unanswered by the case law in this area. For example, what exactly should "continuous" mean? Presumably bank officers might remove the agreement during a bank examination, Such that it is never seen or recorded by the examiners during an on-site examination and audit of the bank's files. The officer could then place the agreement back into the "official" files. Technically, however, it is no longer a "continuous record" in the official files as its continuity obviously would have been interrupted. Similarly, we have seen that it is difficult to ascertain what is an "official" bank record.

D'Oench Duhme Reform Act recognizes the inequity of this recording requirement and eliminates it. However, if it is not extinguished, then there must be some reform or guideline that truly gives the borrower protection from the nefarious acts of bank officials. The disclosure and filing system I propose would effectively address this particular problem because the agreement would be filed directly with the regulators and thus would not be subject to any manipulation of the agreement by bank employees nor would the borrower be at the mercy of the bank's unilateral action regarding the physical location of the agreement.

The preceding issues are perhaps the most glaring problems with 1823(e) as it currently stands. Although the D'Oench Duhme Reform Act clearly addresses these problems, and should be enacted, there are certain ambiguities as the bill now is written that might be changed.

IV. S. 648 -- THE "D'OENCH DUHME REFORM ACT"

Section 2 (a)(3) -- lines 10-15 -- of the "Findings and Purposes of the Act," should be understood as a complete repeal and amendment of the current 1823(e) to underscore the strong break with the Current overly broad interpretation of 1823(e) by some state and federal courts. Such also would emphasize and demonstrate Congress' clear legislative intent to have the amended 1823(e) interpreted far more narrowly and thus consistent with the original limited scope of the D'Oench Doctrine and the original 1823(e). I also recommend the that the section explicitly refer to the Langley case and in section 2(b)(2) curtail the broad interpretation of the term "agreement" in Langley so that it does not include non-promissory statements or failures to make statements.

Next, Subsection 3 (e)(1) -- lines 5-9 -- requires that any enforceable agreement against the FDIC must be in writing and "executed in the ordinary course of business by . . . an officer or other employee or representative of

the bank having the authority to execute such an agreement on behalf of the institution."

Each of these phrases may be breeding grounds for interpretations which could eviscerate the goals of the Act. The FDIC might argue, for example, that tile particular side agreement was "unique" or posed "special circumstances" that place the agreement "outside the ordinary course of business." Similarly, the FDIC may be able to escape the enforceability of the agreement if it can argue that tile bank officer or employee upon whom the innocent borrower relied in reaching tile agreement did not have actual authority to bind the financial institution within the meaning of the statute.

Subsection 3 (e)(2) presents similar interpretive problems. Subsection (e)(2)(A) -- lines 15-18 -- allows a borrower to advance a "claim or defense that does not relate to an agreement affecting an asset acquired from the insured depository institution by the FDIC ." The qualifying phrase "does not relate" is open to a wide range of interpretation. Conceivably, a court might decide that the nexus in relatedness does not have to be tightly drawn and therefore certain claims and defenses may be deemed "related" to affecting some asset acquired from the institution, such that the lack of a written agreement might still bar the claim or defense. The degree of relatedness should be clarified in the legislative history so that courts would be given some guidance in interpreting this phrase. Perhaps also the term "substantially" into the language, so it reads "...an agreement substantially affecting an asset . . ." will help courts to understand that only agreements that substantially affect the asset are related to it and therefore must be written to satisfy 1823(e).

Also, Subsection (c)(2)(B) -- Lines 19-22 -- makes an exception for the requirement of a writing for any claim or defense that does not relate to transactions that, in tile normal Course of business, would not be reflected in tile transaction records of the institution. But who is to decide what is "in the normal course of business"? Again, depending upon how narrowly or broadly the court defines this phrase, the borrower may or may not be able to use the claim or defense.

Moreover, is the "normal course of business" going to be an objective uniform standard throughout the country for big and small banks alike, or will there be subjective, geographical determinations of the phrase "In the normal course of business," and will such subjective standards further be manipulable depending upon whether the institution is a large, urban bank or a smaller, rural bank'? Finally, what is the difference between "ordinary" course of business and "normal" course of business'? Here, too, legislative history should provide the courts with some guidance on these issues. I concur with Professor Swire's suggestion that the subjectivity allowed by the phrase "in the ordinary course of business" might be eliminated by using a more objective standard, such as the phrase "which conform to industry standards."

Subsection (e)(2)(C) -- lines 23-25; 1-2 -- provides that a "claim or defense filed in a judicial proceeding more than 90 days before the FDIC is appointed as receiver or conservator " will not be subject to 1823(c)(1). Individuals and borrowers often have a good sense that their bank is in financial trouble. Thus, the 90 day exception is necessary because, without it, the consequence could be the hastening of the failure of a bank already in financial trouble. As a result, there may be something akin to a "bank run,"

where individuals, fearful that their institution may fail, file claims to "save" those claims from any application of 1823(e).

When a bank is failing, it needs customer confidence, not a rush of lawsuits against it to save claims. A disclosure and filing requirement, however, would obviate this particular problem as all borrowers would have been made aware of the 1823(e) requirements about putting any side agreement in writing and filing it with the appropriate regulators long before the bank would have begin to fail. Ninety days appears to be enough time.

Finally, Subsection (e)(2)(D), as it is written, might be understood to exclude a very important class of cases. The provision states that the requirement of a writing will not be necessary for "intentional torts." A general tort exception is important because it ensures that the D'Oench Doctrine and 1823(e) will not be used against an individual who, for example, slips and falls in the bank lobby, then attempts to claim against the FDIC as receiver when the bank fails. Such an individual should be able to pursue a tort claim without having it barred by 1823(e) for failure to obtain a writing. The problem, however, is that the term "intentional" tort limits the scope of such actions to intentional battery or assault (i.e. , where a bank officer walks up and punches a customer in the nose). To alleviate this, the term "Intentional" Should be clarified so that it does not stop an innocent victim of the bank's negligence from suing or defending against the bank should the bank fail and be taken over by the FDIC.

Technically, Subsection (e)(2)(A) does include negligence torts, as they would not be "related to an agreement affecting an asset acquired from the depository institution." But the legislative history Should be clear oil the point that both intelligence and intentional torts are excepted from the application of 1823(e).

V. ADDITIONAL DISCLOSURE AND REPORTING PROPOSAL

As previously mentioned, I urge the addition of a simple disclosure requirement. One of the major problems with the D'Oench Doctrine is that borrowers and other innocent "victims" are unaware of the D'Oench Doctrine and 1823(e) "until It is too late. " A disclosure system, however, Would make all borrowers aware of 1823(e) and its requirements. Bankers would be required to inform all potential borrowers that if tile borrower does not reduce to a writing any side agreement with the bank, or any verbal representation made by the bank regarding the loan, then that agreement or representation will not be recognized if the bank fails and is taken over by the FDIC. In this system, the bank Would be required to provide a simple filing form for the borrower to file the side agreement or verbal representation directly with the federal regulators, instead of films, it only with the bank.

My proposed disclosure system would benefit all relevant parties concerned, while remaining consistent with tile goals of the "D'Oench Duhme Reform Act." First, borrowers would benefit by being made aware that they, in effect, are allowed to obtain "enforcement insurance" for any legitimate side agreements, should their institutions fail. As a result, they would be able to enforce their legitimate side agreements with the institution, and/or relied upon representations made by the institution, both against the institution (in the event the institution does not fail) and against the FDIC (in the event the

institution does fail).

The financial institutions also would benefit because if they do not fail, they would be able to argue that a borrower should not be able to rely upon any alleged oral side agreements or verbal representations in order to escape repayment of the loan. This is due to the fact that, under this proposal, a borrower relying on such an alleged agreement or representation by the institution would have had full knowledge of the 1823(e) written agreement requirements (because of the 1823(e) disclosure requirements) and therefore would have had every incentive to reduce such oral side agreements or verbal representations to a protected, enforceable writing.

Even the regulators would benefit because they would receive important and direct information about the status of the financial institution's loans (e.g. , the extent to which a bank may be making too many 1823(e) side agreements with borrowers and thereby compromising the repayment strength and/or future collectability of the loans). Perhaps most importantly, this requirement would begin to reduce the exposure of U.S. taxpayers, who, after all, ultimately must fund the FDIC, to pay for the bailout of failed financial institutions.

Thank you once again for allowing me this opportunity to comment on the D'Oench Duhme Reform Act. I applaud the goals of the Act and I command this Committee for taking up this issue on behalf of the American people to correct the problem and maintain the integrity of the banking industry.

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UNITED STATES SENATE

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Wednesday, June 14, 1995, 10:00 AM; 538 Dirksen Senate Office Building

Honorable William Cohen

United States Senator; Maine

PANEL ONE

Sharon Powers Sivertsen

Assistant General Counsel - Closed Bank Litigation and Policy

Federal Deposit Insurance Corporation

Washington, DC

Mark P. Hileman

Assistant General Counsel - Litigation

Resolution Trust Corporation

Washington, DC

PANEL TWO

Dr. David S. Hess

President, Citizens and Business for D'Oench Duhme Reform

Great Falls, VA

James H. Harvey, Jr.

President, T & J Heating and Air Conditioning, Inc.
Bellingham, MA

PANEL THREE

Fred Galves

Associate Professor

McGeorge School of Law

Sacramento, CA

Peter P. Swire

Associate Professor

University of Virginia School of Law

Charlottesville, VA

LANGUAGE: ENGLISH

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