TESTIMONY OF

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ON

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

BEFORE THE

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

WEDNESDAY, JUNE 14, 1995
ROOM 534, DIRKSEN SENATE OFFICE BUILDING

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

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

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

What is commonly referred to as the "D'Oench doctrine" is essentially an estoppel doctrine applied by the courts to bar enforcement of secret agreements against the receiver of a failed financial institution. In effect, the doctrine bars reliance upon any secret agreement or arrangement that may tend to mislead financial institution examiners. The D'Oench doctrine arises from a 1942 United States Supreme Court decision, D'Oench Duhme & Co. v. FDIC, 315 U.S. 447 (1942), in which a borrower signed promissory notes to a bank with a secret side agreement that the notes would never have to be repaid. The Court held that the debtor was estopped from asserting the oral side agreement as a defense. It stated that the FDIC must be able to rely on the institution's books and records to determine the institution's true condition and that allowing the debtor to avoid liability based on an agreement outside the books and records would tend to deceive the regulators.

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

In essence, the D'Oench doctrine and section 1823(e) serve to ensure that all agreements or arrangements affecting the depository institution's financial condition must be recorded and available for review by regulators and receivers so that they can accurately assess the true financial condition of the institution. This public policy lies at the center of the ability of the FDIC and other regulators to supervise open institutions and to resolve failing ones. The ability to rely upon the records of an institution in order to evaluate its assets and liabilities supports key public policy goals and related statutory requirements such as prompt corrective action, the "least cost" test, and the protection of the deposit insurance funds.

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

EFFORTS BY THE FDIC TO ENSURE FAIRNESS

Although the D'Oench doctrine and section 1823(e) promote critical public policy goals, the FDIC recognizes that the application of these legal principles requires a balancing of those goals with the public interest that individuals be treated fairly. This balancing of interests has been the subject of debate since the earliest days of the D'Oench doctrine and section 1823(e). Attachment A summarizes the debate surrounding the passage of section 1823(e) in 1950.

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

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

As a result of the working group's efforts, new guidelines were implemented during November 1994. All FDIC staff, outside law firms, and asset servicing contractors are now subject to the guidelines in all cases involving D'Oench and section 1823(e). Since adoption of the guidelines, the FDIC has conducted intensive training in their application for its staff across the country. This training has been conducted nationally as well as regionally to ensure that the guidelines are understood and followed.

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

The seven categories include, among other things: claims by pre-closing vendors; claims or defenses asserted where an authorized bank officer signed the agreement, but it was not included in the bank records; claims or defenses based on the bank's violation of some part of a written agreement; and claims where there is no loan transaction involved in the dispute. In these and the other categories of cases, D'Oench or section 1823(e) cannot be asserted without specific prior approval from FDIC headquarters in Washington. Thus, the guidelines are designed to ensure the consistent and appropriate application of D'Oench and section 1823(e). A copy of the guidelines is attached to this testimony as Attachment B.

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

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

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

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

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

There are three public policy goals accomplished by the D'Oench doctrine and section 1823(e). First, the D'Oench doctrine ensures that regulators can rely on a financial institution's records for supervisory purposes and in order to protect the deposit insurance funds they administer. This goal encompasses the supervision of open institutions, the determination of the least cost resolution of failing institutions, and the efficient disposition of assets and payment of creditors of failed institutions. Second, the D'Oench doctrine promotes careful consideration of lending practices, assures proper recordation of various financial activities and protects against collusive or erroneous structuring or restructuring of terms, especially just before the institution fails. Third, the D'Oench doctrine protects the innocent depositors and creditors of a failed institution, including the FDIC, from absorbing the losses resulting from agreements that do not appear in the records and books of the institution and helps to facilitate the quick return of a failed institution's assets to the community.

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

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

The failure of a financial institution can be very harmful to a community, especially a small community that does not have other significant financial resources. Therefore, the efficient resolution of a failed institution and the prompt availability of deposits and advance dividends can be vitally important in a community that otherwise would be devastated by the closure of its primary financial institution. As a result of the FDIC's ability to rely on the financial institution's records, depositors typically have access to their money on the following business day after an institution fails. The FDIC also often advances funds, known as advance dividends, to uninsured depositors or creditors based on its historical experience regarding the recovery it can anticipate from the liquidation of the institution's assets. Without the ability to rely on the failed institution's books to value the assets, it would be considerably more difficult for the FDIC to achieve prompt resolutions or to pay advance dividends.

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

As the receiver for the failed financial institution, the FDIC has a legal obligation to the other creditors to protect the receivership estate for the benefit of the institution's creditors. If the FDIC as receiver pays unsubstantiated claims, other claimants and creditors of the receivership estate, such as vendors who provided services to the institution before it failed, will receive less. Creditors will also receive less if the FDIC cannot enforce valid obligations owed to the failed institution. There is a limited pool of assets in each receivership of a failed institution and anything that reduces the value of the assets or increases the number of claimants will reduce the recoveries for creditors.

COMMENTS ON THE PROPOSED _D'OENCH DUHME_ REFORM ACT

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

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

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

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

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

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

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

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

The Cohen substitute also includes an exception for "alleged intentional torts or alleged violation of State or Federal law." While the FDIC has no desire to perpetuate or benefit from inappropriate actions by the failed institution or its employees, the exception as currently drafted could overwhelm the general rule requiring a written agreement.

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

The Cohen substitute applies retroactively to "administrative claims brought or pending, and any litigation filed, in progress or on appeal on or after the date of enactment." By applying to all administrative claims at any stage in the review process and to all litigation pending on or after the stated date, the retroactive application of the Cohen substitute raises issues of implementation and cost to the deposit insurance funds.

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

Using the FDIC's case tracking system, we have identified approximately 750 cases involving D'Oench and section 1823(e) issues that could be affected by the retroactive application of the Cohen substitute. Because we received the new language of the Cohen substitute only within the last several days, we are still attempting to determine the extent of additional exposure to the deposit insurance funds and additional litigation costs. We will forward this information to the Committee as soon as it is available.

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

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

CONCLUSION

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

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

Attachment A

BRIEF SUMMARY OF THE 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 an 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 terms different from those reflected in the loan file or deferred completely, or that the bank would provide some additional services or "sweetener" not contained in the loan documents. If enforceable, this secret agreement could render an apparently valuable asset worthless or create hidden liabilities that would mislead regulators and the receiver in their efforts 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 facilitated creation of a transaction that could mislead the banking authorities. The Court refused to require intent to defraud by the borrower or claimant because the public policy purpose of requiring records in the bank's files would not be served by limiting the doctrine only to those cases.

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.

The Congressional debates leading to the enactment of section 1823(e) mirror many of the concerns expressed in the current debate. 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.

The issue of whether the D'Oench doctrine and section 1823(e) should be limited solely to cases of fraudulent schemes 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.

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.

As finally enacted, 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 and when collecting on obligations owing to a failed bank.

Attachment B

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429

Division of Depositor and Asset Services

To: Regional Directors
Regional Counsel
Associate Director - COMB

From: John F. Bovenzi
Director
Division of Depositor and Asset Services

Thomas A. Rose
Deputy General Counsel

Subject: Guidelines for Use of D'Oench and Section 1823(e)

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1. Purpose. To set forth guidelines for the use of the D'Oench doctrine and 12 U.S.C. § 1823(e).

2. Scope. This directive applies to all Service Centers and Consolidated Offices, to all future Servicers and, to the extent feasible, to all current Servicers.

3. Responsibility. It is the responsibility of the Regional Directors, Associate Director - COMB, and Regional Counsel to ensure compliance with this Directive by all personnel in their respective service centers.

4. Background.

a. D'Oench Doctrine

In an effort to protect the federal deposit insurance funds and the innocent depositors and creditors of insured financial institutions, the Supreme Court in the case of D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447 (1942) adopted what is commonly known as the D'Oench doctrine. This legal doctrine provides that a party who lends himself or herself to a scheme or arrangement that would tend to mislead the banking authorities cannot assert defenses and/or claims based on that scheme or arrangement.

b. Section 1823(e)

In 1950, Congress supplemented the D'Oench doctrine with 12 U.S.C. § 1823(e) which bars any agreement which "tends to diminish or defeat the interest of the [FDIC] in any asset" unless the agreement satisfies all four of the following requirements: (1) it is in writing; (2) it was executed by the depository institution and any person claiming an adverse interest under the agreement contemporaneously with the acquisition of the asset; (3) it was approved by the board of directors of the institution or its loan committee as reflected in the minutes of the board or committee; and (4) it has been continuously an official record of the institution.

In FIRREA Congress extended the coverage of section 1823(e) to claims against the receiver or the Corporation. 12 U.S.C. § 1821(d)(9)(A).

c. **Policy Considerations**

The *D'Oench* doctrine and section 1823(e) embody a public policy designed to protect 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 requirement that any arrangement or agreement with a failed bank must be in writing allows banking regulators to conduct effective evaluations of open banks and the FDIC to accurately and quickly complete resolution transactions for failed banks. This requirement also places the burden of any losses from an undocumented or "secret" arrangement or agreement on the parties to the transaction, who are in the best position to prevent any loss.

Although the *D'Oench* doctrine and section 1823(e) generally promote essential public policy goals, overly aggressive application of the specific requirements of these legal doctrines could lead to inequitable and inconsistent results in particular cases. In order to ameliorate this possibility, the FDIC has undertaken development of these guidelines and procedures to promote the exercise of sound discretion in the application of *D'Oench* and section 1823(e).

5. Guidelines.

These guidelines are intended to aid in the review of matters where the assertion of *D'Oench* and/or section 1823(e) is being considered. **The examples given are intended to give clear direction as to when *D'Oench* and section 1823(e) issues must be referred to Washington pursuant to the procedures discussed below in Section 6. In particular, if the use of *D'Oench* or 1823(e) is proposed in a DAS - Operations matter within the categories set forth below, the matter and recommendation must be referred to the Associate Director - Operations for approval through the procedures contained in Section 6.**

In the great majority of cases, however, it is anticipated that no resort to Washington should be necessary. It is only in the categories of cases highlighted in the guidelines that

Washington approval must be obtained.

a. <u>Pre-closing Vendors</u>

<u>D'Oench</u> and section 1823(e) **shall <u>not</u>** be used as a defense against claims by vendors who have supplied goods and/or services to the failed institution pre-closing when there is clear evidence that the goods/services were received. In such cases, <u>D'Oench</u> and section 1823(e) shall not be asserted whether or not there are written records in the bank's files confirming a contract for the goods and/or services.

This does not mean that <u>D'Oench</u> and section 1823(e) may never be asserted against a vendor, but only that each claim must be examined carefully on its facts. When there is no evidence that goods or services were received by the failed bank or in other appropriate circumstances, **the defenses may be asserted after approval by Washington.**

Examples Requiring Washington Approval:

1. Landscaping service filed claim for planting trees around the institution's parking lot. There is no contract for planting trees in the books and records of the institution, but there are trees around the parking lot and no record of any payment. **In this example, Washington approval must be obtained before asserting <u>D'Oench</u> or section 1823(e).**

2. A contingency fee attorney is unable to produce any contingency fee agreement, but there is evidence in the files that this attorney has been paid for his collection work for the past 20 years and his name appears on the court records for collection matters for which he has not been paid. **In this example also, Washington approval must be obtained before asserting <u>D'Oench</u> or section 1823(e).**

3. Contractor had construction contract with bank to renovate an ORE property. At the time the bank failed, the contractor had completed 90% of the contract and was owed about 50% of the contract price. The Construction company filed a claim which was denied on the ground that the contract was not enforceable against the FDIC because it had not been approved by the bank's board of directors or loan committee. **Here too, Washington approval must be obtained before asserting <u>D'Oench</u> or section 1823(e).**

b. Diligent Party

D'Oench and section 1823(e) may not be asserted without Washington approval where the borrower or claimant took all reasonable steps to document and record the agreement or understanding with the bank and there is no evidence that the borrower or claimant participated in some activity that could likely result in deception of banking regulators, examiners, or the FDIC regarding the assets or liabilities of the bank. In particular, Washington approval is required before D'Oench or section 1823(e) may be asserted where the agreement is not contained in the bank's records, but where the borrower or claimant can 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. Cases involving "insiders" of the depository institution require particularly careful review because of the greater opportunities of such parties to manipulate the inclusion of "agreements" within the bank's records.

Further, where it is clear that a borrower or claimant has been diligent in insisting on a written document in an apparently arms-length transaction, and had no control over the section 1823(e) requirement that the transaction be reflected in the Board of Directors' or Loan Committee minutes, assertion of a section 1823(e) defense solely because the transaction is not reflected in those minutes may not be appropriate. In such cases, **Washington approval must be obtained before asserting D'Oench or section 1823(e).**

Examples Requiring Washington Approval:

1. Plaintiff sold a large parcel of land to the borrower of the failed bank and the property description in the failed bank's Deed of Trust mistakenly included both the parcel intended to be sold and a parcel of property not included in the sale. Prior to the appointment of the receiver, the bank agreed orally to amend the Deed of Trust, and indeed sent a letter to the title company asking for the amendment. However, there was nothing in the books and records of the institution to indicate the mistake. The bank failed and the Deed of Trust had never been amended. The borrower defaulted and the FDIC attempted to foreclose on both parcels. **In this example, Washington approval must be obtained before asserting D'Oench or section 1823(e).**

2. A limited partnership applied for refinancing. A commitment letter was issued by the bank to fund a non-recourse permanent loan which required additional security of $ 1 million from a non-partner. The Board

of Directors minutes reflect that approval was for a nonrecourse loan, however, the final loan documents, including the note, did not contain the nonrecourse provisions. The bank failed, the partnership defaulted and it was determined that the collateral plus the additional collateral was approximately $ 3 million less than the balance of the loan. **In a suit by the FDIC for the deficiency, Washington approval must be obtained before asserting D'Oench or section 1823(e).**

3. A borrower completes payment on a loan, and he has cancelled checks evidencing that his loan has been paid off. The bank's records, however, do not document that the final payment has been tendered. The bank fails and the FDIC seeks to enforce the note. **Washington approval must be obtained before asserting D'Oench or section 1823(e).**

However, if it is clear that the borrower or claimant participated in some fraudulent or other activity which could have resulted in deception of banking regulators or examiners, then D'Oench and/or section 1823(e) may be asserted without prior approval from Washington.

Examples Not Requiring Washington Approval:

1. Borrower signed a note with several blanks including the amount of the loan. Bank officer filled in the amount of the loan as $ 40,000. Bank failed, loan was in default, the FDIC sued to collect $ 40,000 and the borrower claimed that he only borrowed $ 20,000. There was nothing in the bank's books and records to indicate the $ 20,000 amount, and, in fact, the bank's books and records evidenced disbursement of $40,000. D'Oench and section 1823(e) may be asserted.

2. Guarantor, an officer of the borrower corporation, signed a guaranty for the entire amount of a loan to the corporation. At the time of the bank's failure, the loan was in default and the corporation was in Chapter 7 bankruptcy. FDIC filed suit against the guarantor for the entire amount of the loan. The guarantor claimed that he had an agreement with the bank that he was only liable for the first $ 25,000. There was no record in the bank's files of such an agreement. Again, D'Oench and section 1823(e) may be asserted.

Where the specific facts of a case raise any question as to whether D'Oench or section 1823(e) should be asserted, Washington approval must be obtained before asserting D'Oench or section 1823(e).

c. <u>Integral Document</u>

If there are documents in the books and records of the institution which indicate an agreement under the terms asserted by the claimant or borrower, the use of <u>D'Oench</u> and section 1823(e) must be carefully evaluated. Particular care must be taken before challenging a claim or defense solely because it fails to comply with the 1823(e) requirement that the agreement be reflected in the minutes of the Board of Directors or Loan Committee. While any number of cases have held that the terms of the agreement must be ascertainable on the face of the document, in some circumstances it may be appropriate to consider all of the failed bank's books and records in determining the agreement, not just an individual document. **Where the records of the Bank provide satisfactory evidence of an agreement, Washington approval must be obtained before asserting <u>D'Oench</u> or section 1823(e).**

Examples Requiring Washington Approval:

1. Note in failed bank's file was for one year term on its face. However, the loan application, which was in the loan file, was for five years renewable at one year intervals. The borrower also produced a letter from a bank officer confirming that the loan would be renewed on a sixty month basis with a series of one year notes. **In this example, Washington approval must be obtained before asserting <u>D'Oench</u> or section 1823(e).**

2. Debtor executed two notes with the proviso that there would be no personal liability to the debtor beyond the collateral pledged. When the notes became due they were rolled over and consolidated into one note which recited that it was a renewal and extension of the original notes but did not contain the express disclaimer of personal liability. All three notes were contained together in one loan file. Here, all of the notes should be considered as part of the bank's records. **In this example also, Washington approval must be obtained before asserting <u>D'Oench</u> or section 1823(e).**

d. **<u>No Asset/Transactions Not Recorded in Ordinary Course of Business</u>**

The use of <u>D'Oench</u> and section 1823(e) should be limited in most circumstances to loan transactions and other similar financial transactions, to matters involving specific current or former assets, or to transactions designed to acquire or create an asset. The application of <u>D'Oench</u> should be carefully considered before it is asserted in opposition to a tort claim, such as negligence, misrepresentation or tortious interference with business relationships, where the claim is unrelated to a loan or similar transaction or to a transaction creating or designed to create an asset. **Washington approval must be obtained before asserting D'Oench or section 1823(e) in such cases.**

Examples Requiring Washington Approval:

1. Three years before failure the bank sold one of its subsidiaries. The bank warranted that the subsidiary had been in "continuous and uninterrupted status of good standing" through the date of sale. The buyer in turn attempted to sell the subsidiary and discovered that the subsidiary's charter had been briefly forfeited. The prospective buyer refused to go through with the sale and the original buyer sued the institution for breach of warranty. FDIC is appointed receiver. This transaction does not involve a lending or other banking financial relationship between the bank and the buyer. In addition, the subsidiary was not an asset or on the books of the institution at the time of the receivership. **In this example, Washington approval must be obtained before asserting D'Oench or section 1823(e).**

2. In the case described above in the diligent party section, where the property description in the failed bank's Deed of Trust mistakenly included a parcel not included in the sale, the parcel at issue was not an actual asset of the failed bank and the assertion of D'Oench would not be appropriate. **Here too, Washington approval must be obtained before asserting D'Oench or section 1823(e).**

However, if a claim arises out of an asset which was involved in a normal banking transaction, such as a loan, D'Oench and section 1823(e) would be properly asserted against such a claim despite the fact that the asset no longer exists. For example, collection on the asset does not preclude the use of D'Oench and section 1823(e) in response to claims by the former debtor related to the transaction creating the asset.

Example Not Requiring Washington Approval:

1. A borrower obtained a loan from a bank, secured by inventory and with an agreement that allowed the bank to audit the business. The business failed, the bank sold the remaining inventory, and applied the proceeds of the sale to the business's debt. Borrower sued the bank for breach of oral agreements, breach of fiduciary

duty, and negligence in performance of audits of the business. Borrower then paid off remaining amount of loan and continued the lawsuit. The bank subsequently failed. Despite borrower's argument that there was no asset involved since the debt had been paid, assertion of D'Oench would be appropriate.

To permit the borrower to proceed with the litigation after the loan is repaid, where that litigation would have been barred by D'Oench prior to the payoff, would be contrary to the public policy permitting regulators to ignore unknown and unrecorded agreements.

e. Bilateral Obligations

The facts must be examined closely in matters where the agreement which the FDIC is attempting to enforce contains obligations on both the borrower or claimant and the failed bank and the borrower or claimant is asserting that the bank breached the agreement. **If the failed bank's obligation is clear on the face of the agreement and there are documents supporting the claimed breach which are outside the books and records of the institution, Washington approval must be obtained before asserting D'Oench or section 1823(e).**

f. Statutory Defenses

The appropriateness of using D'Oench and section 1823(e) to counter statutory defenses should be evaluated on a case by case basis. Although many such defenses may be based on an agreement that is not fully reflected in the books and records of the institution, a careful analysis should be made before asserting D'Oench or section 1823(e). In such cases, **Washington approval must be obtained before asserting D'Oench or section 1823(e).**

The clearest examples of situations where assertion of D'Oench or section 1823(e) may be appropriate occur where the opposing party is relying on a statutory defense based upon some misrepresentation or omission by the failed bank. Examples of this type of statute are unfair trade practice statutes.

On the other hand, application of D'Oench or section 1823(e) may not be appropriate to oppose claims based on mechanics lien statutes or statutes granting other recorded property rights. The fact that all elements of those liens may not be reflected in the books and records of the institution should not control the application of D'Oench or section 1823(e).

In analyzing the propriety of asserting the D'Oench doctrine or section 1823(e), at least the following two general factors should be considered in preparation for seeking approval from Washington:

* To what extent is the purpose of the statute regulatory, rather than remedial? If the statute simply imposes regulatory or mandatory requirements for a transaction, such as a filing requirement or maximum fee for services, assertion of D'Oench and/or section 1823(e) is unlikely to be successful.

* To what extent is the application of the statute premised upon facts that are not reflected in the books and records of the bank? If the state statute requires the existence and/or maintenance of certain facts, but those facts are not recorded in the bank's records, then D'Oench and/or section 1823(e) may be applicable.

* To what extent do the facts involve circumstances where the opposing party failed to take reasonable steps to document some necessary requirement or participated in some scheme or arrangement that would tend to mislead the banking authorities.

Examples Requiring Washington Approval:

1. A priority dispute arose involving a mechanic's lien against property on which the FDIC was attempting to foreclose. An attempt to persuade a court that the mechanic's lien was a form of secret agreement under D'Oench, which, if given priority over the interests of the FDIC, would tend to diminish or defeat the value of the asset may not be appropriate. **In this example, Washington approval must be obtained before asserting D'Oench or section 1823(e).**

2. State law required insurance companies doing business in the state to deposit funds with the Commissioner of Insurance. Further, the law provided that the deposit could not be levied upon by creditors or claimants of the insurance company. An insurance company purchased a certificate of deposit from a bank and assigned it to the Commissioner. At the same time a document was executed entitled "Requisition to the Bank" which stated that the bank would not release the CD funds without authorization of the Commissioner. Subsequently the insurance company borrowed money from the bank. When the loan went into default, the bank did not roll the CD over, but rather credited the proceeds to the loan account. The bank then failed and the Commissioner filed a proof of claim with the FDIC seeking payment on the CD. The FDIC may not defend the suit by claiming that the assignment

documents did not meet the requirements of section 1823(e). **In this example, Washington approval must be obtained before asserting D'Oench or section 1823(e).**

3. The FDIC is attempting to collect on a note which the failed bank acquired from a mortgage broker. The note is at a 15% interest rate and the mortgage broker charged six and one half points. State law provides that interest shall be no more than 13% and that no more than one point may be charged. The FDIC may not defend the borrower's counterclaim of a usurious loan by asserting D'Oench or 1823(e). **Here too, Washington approval must be obtained before asserting D'Oench or section 1823(e).**

g. Section 1823(e) Contemporaneous Requirement

This requirement of section 1823(e) may not be asserted to invalidate a good faith workout or loan modification agreement where the sole issue is whether the contemporaneous requirement of section 1823(e) is met. Where there is an agreement which otherwise satisfies the remaining requirements of the statute, but was not executed contemporaneously with the acquisition of the asset, in most circumstances section 1823(e) should not be asserted. This applies only to workouts or loan modifications done by the failed bank prior to receivership. The assertion of the section 1823(e) contemporaneous requirement should be considered principally where the facts demonstrate that the workout or restructure was entered into in bad faith and in anticipation of bank failure.

Washington approval must be obtained before asserting D'Oench or section 1823(e) in these cases.

6. Procedures To Obtain Washington Approval.

DAS Operations: When facts involving the possible assertion of D'Oench and section 1823(e) arise, Legal should be consulted. When the assertion of D'Oench or section 1823(e) requires Washington approval, as outlined above, prior approval must be received from the Associate Director - Operations in Washington in all such cases. Such approval must be obtained by preparation of a memorandum identifying the facts of the case forwarded through Legal Division procedures to the Associate Director - Operations.

DAS Asset Disposition: When facts involving the possible assertion of D'Oench and section 1823(e) arise, Legal should be consulted. When the assertion of D'Oench or section

1823(e) requires Washington approval, as outlined above, Legal Division procedures should be followed for referral to Washington. Washington Legal will consult with Washington DAS where appropriate.

DAS COMB: When facts involving the possible assertion of D'Oench and section 1823(e) arise, Legal should be consulted. When the assertion of D'Oench or section 1823(e) requires Washington approval, as outlined above, Legal Division procedures should be followed for referral to Washington. Washington Legal will consult with the Managing Director - COMB.

Legal: Each attorney must carefully review the facts of each instance where the assertion of D'Oench or section 1823(e) is being considered under revised Litigation Procedure 3 ("LP 3"). All cases requiring consultation or approval within these Guidelines and/or LP3 must be referred to Washington pursuant to LP3 procedures.

These Guidelines are intended only to improve the FDIC's review and management of utilization of D'Oench and section 1823(e). The Guidelines do not create any right or benefit, substantive or procedural, that is enforceable at law, in equity, or otherwise by any party against the FDIC, its officers, employees, or agents, or any other person. The Guidelines shall not be construed to create any right to judicial review, settlement, or any other right involving compliance with its terms.