12. Legal Aspects of Deposit Insurance

This section includes entries of a more legal nature, including but not limited to works dealing with national depositor preference, liability issues in bank-failure cases, case studies from bank-failure resolutions, and legislative histories.

Elam, Linda C. 1992. Financial Institutions Deposit Insurance—Directors' and Others' Liability Insurance Policies. *Tennessee Law Review* 59, no. 2:305ff.

> Many banks that failed during the 1980s held directors' and officers' liability insurance policies (D&O policies) that covered bank losses due to dishonest acts of employees. FDIC or FSLIC recovery under these policies recouped at least some of the losses of the bank and thereby lessened the expenditure necessary from deposit insurance funds. Insurers, however, began to reduce their liability exposure by adding limiting language to the D&O policies, such as the "regulatory exclusion." Regulatory agencies have repeatedly challenged these exclusions in courts, with mixed results. In 1990, in *FDIC v. Aetna Casualty and Survey,* the Court of Appeals for the Sixth Circuit found there was no clear manifestation of public-policy against regulatory exclusions and held them valid and enforceable. Later cases have upheld regulatory exclusion in the face of public-policy challenges, primarily by following that decision. However, the court's analysis was incomplete and misleading. Therefore, the issue has yet to be satisfactorily resolved.

Farmer, John S. 1996. Letting the "Sacred Cow" Run Loose. *Washington University Journal of Urban and Contemporary Law* (fall): 205ff.

> The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) provides a roadmap for the Federal Deposit Insurance Corporation. Congress enacted FIRREA to "restore the strength of the thrift industry." However, the author contends that giving the courts jurisdiction over claims against the FDIC and the power to grant an injunction may inhibit the FDIC from serving as an effective conservator or receiver and may impede the FDIC from responding in the first instance. The Third Circuit Court granted a preliminary injunction and the Resolution Trust Corporation (RTC) appealed, arguing that the court lacked subject-matter jurisdiction over those claims against the RTC in its receiver and conservator capacities. The Fifth Circuit Court found that "no court may take any action to restrain or affect the exercise of powers or functions of [the RTC] as a conservator or a receiver." The Fifth Circuit Court's decision is consistent with the Supreme Court's ruling favoring the right to judicial review in the absence of an alternative remedy.

Hirschhorn, Eric, and David Zervos. 1990. Policies to Change the Priority of Claimants: The Case of Depositor Preference Laws. *Journal of Financial Services Research* 4, no. 2:111–26.

> Depositor preference laws have been proposed to reduce the cost of bank failures to the deposit insurance agencies. This article shows how depositor preference

rules change the payoff functions for bank creditors, including the deposit insurer, depositors, and nondepositor claimants. The adoption of depositor preference laws would appear to make nondepositors worse off, but they can improve their standing by collateralizing their claims. If a large enough proportion of nondepositor claims becomes collateralized, depositor preference could increase the cost of bank failure to the deposit insurance agency. Empirical analysis indicates that depositor preference will induce a substantial increase in collateralization, eliminating a significant share of the savings envisioned for the deposit insurer. Depositor preference will also reduce interest rates on uninsured deposits.

Lobdell, David W., and John A. Darrow. 1991. Maximizing Federal Deposit Insurance Corporation's Insurance of Deposits. *Loyola Consumer Law Reporter* 3, no. 2:58–59.

This article reviews FDIC insurance coverage of deposits for individual accounts, joint accounts, trust accounts, and accounts of business entities. It also reviews documentation requirements. Finally, it describes the Treasury Department bank reform proposals and explains their effect on the amount of deposit insurance that an individual may receive.

Maloney, Thomas J. 1990. *Federal Deposit Insurance Corporation* v. *Texarkana National Bank*: When the Defense of Fraud Is No Defense against the FDIC. *Loyola Law Review* 35, no. 4:1440ff.

Appellant, FDIC, receiver of failed Guaranty Bond State Bank (GBSB), brought suit against appellee, Texarkana National Bank (TNB), for breach of contract. The FDIC alleged that TNB failed to pay monies due GBSB under certificates of deposit and loan participation agreements. TNB asserted that it was entitled to set off those liabilities against liabilities owed it by GBSB, including fraudulent and legitimate loans made by GBSB in which TNB participated, and subordinated debentures held by TNB. This case is significant because it follows a long line of cases in which the courts have found that the federal policy of protecting the FDIC and public funds is paramount to the interest of innocent individuals and financial institutions.

Marino, James A., and Rosalind L. Bennett. 1999. The Consequences of National Depositor Preference. *FDIC Banking Review* 12, no. 2:19–38.

The authors examine the history of depositor preference laws and the potential costs and benefits of the national depositor preference legislation that was enacted in 1993. They study six large banks that failed between 1984 and 1992, to see how liabilities shifted just before failure. Finally, they discuss the potential effects of the combination of FDICIA and national depositor preference on the cost savings to the FDIC. The study suggests that even though national depositor preference may produce cost savings for the FDIC, it may also induce bank creditors and depositors to act in ways that significantly reduce the cost savings. In addition, the effect of national depositor preference on foreign depositors may induce foreign governments to act in such a way that the FDIC loses some control of the resolution process.

Massachusetts Continuing Legal Education (MCLE). 1991. *FDIC/RTC Crash Course*. MCLE.

This book is a collection of papers published by Massachusetts Continuing Legal Education, Inc. Authors and paper topics include "FDIC/RTC Superpowers," by Robert J. Stillman; "Some Procedural Issues under FIRREA," by Allen N. David; "Guidelines of the FDIC/RTC with Respect to Conflicts of Interest and Confidentiality and General Policies of Waiver Favored by the Outside Counsel Conflicts Committee," by Judith H. Thomsen; "Practical Concerns in Dealing with the RTC," by Peter C. Jacobs; "Directors' and Officers' Liability," by Mark I. Rosen and John V. Thomas; and "Potential Conflicts between Chapter 11 and 12 of the United States Code," by Sheryl Serreze.

Metzger, Thomas M. L. 1993. FDIC Capital Directive Procedures: The Unacceptable Risk of Bias. *Banking Law Journal* 110, no. 3:237–59.

The author maintains that procedural due process protections against bias are not present when the Federal Deposit Insurance Corporation issues a capital directive. A bank is deprived not only of a neutral decisionmaker but also of oral argument; cross-examination of FDIC decisionmakers; intra-agency review of the examiner's decision; and judicial review of the merits of the agency's decision. Even the one protection afforded the bank—written response to the intent to issue a directive—provides no protection against bias, since the response is considered only by the official who wrote the intent to issue the capital directive. Contrary to the Fifth Circuit Court's decision in *FDIC* v. *Bank of Coushatta*, which held that the FDIC's capital directive procedures are constitutionally sound and not subject to judicial review under the Administrative Procedure Act, a procedure that threatens a substantial property interest but affords no protection against potential bias of the decisionmaker is not constitutionally sound.

Murphy, M. Maureen. 1990. Federal Bank Regulators' Positions on 1980 Deposit Insurance Increase to $100,000. Report for Congress (September 12). Congressional Research Service.

This report briefly describes the legislative history of the 1980 increase in deposit insurance and identifies documents that shed light on the position of the following regulatory agencies: the Comptroller of the Currency (national banks), the Board of Governors of the Federal Reserve System (state member banks), the Federal Deposit Insurance Corporation (federally insured state-chartered banks), the Federal Home Loan Bank Board (federally chartered and federally insured thrifts), and the National Credit Union Administration (federally chartered and federally insured credit unions).

Nussbaum, Andrew J. 1992. Like Money in the Bank? An Economic Analysis of Fiduciary Duties to Protect the S&L Deposit Insurance Fund. *Administrative Law Review* 44, no. 2:355–401.

> This article argues that the Office of Thrift Supervision's theory of fiduciary duty owed to the federal insurance fund lacks a legal basis and controverts economic theory. Such a duty, if it focused on limiting the risk to the S&Ls' assets in order to protect the fund, would exacerbate a principal cause of the continued instability of S&Ls: the lack of adequate capital investment. The article examines the triangular relationship involving the federal government as insurer, S&L management, and S&L shareholders (who are the traditional recipients of a fiduciary duty). The article concludes that the OTS's theory is fundamentally economically unsound.

Osterberg, William P. 1996. The Impact of Depositor Preference Laws. Federal Reserve Bank of Cleveland *Economic Review* 32, no. 3:2–11.

> The 1993 amendment to the Federal Deposit Insurance Corporation Act made depositors' claims on failed banks superior to those of general creditors. The legislation's stated purpose was to reduce the cost to the FDIC of resolving bank failures, but how effective is it likely to be? This paper examines the impact of states' depositor preference laws from 1984 through 1992 and finds that although resolution costs were lower, creditors' responses may have partially offset the legislation's benefit to the FDIC. (©1999 EconLit)

Osterberg, William, and James B. Thomson. 1994. Depositor Preference and the Cost of Capital for Insured Depository Institutions. Working Paper Series, no. 9404. Federal Reserve Bank of Cleveland.

> Depositor preference laws provide depositors with a claim on a failed depository institution's assets that is senior to unsecured general-creditor claims. Therefore, the author claims that depositor preference is correctly viewed as changing the capital structure of banks and thrifts, and these laws will affect the cost of capital for depositories. However, depositor preference will not affect the total value of banks and thrifts unless deposit insurance is mispriced.

Osterberg, William P., and James B. Thomson. 1999. Depositor-Preference Laws and the Cost of Debt Capital. Federal Reserve Bank of Cleveland *Economic Review* 35, no. 3:10–20.

> Under depositor preference laws, depositors' claims on the assets of failed depository institutions are senior to unsecured general-creditor claims. As a result, the authors believe depositor preference changes the capital structure of banks and thrifts, thereby affecting the cost of capital for depositories. This article analyzes the effect of depositor preference laws on banks' cost of debt capital and on the value of FDIC deposit guarantees, and it does so by extending the single-period-cash-flow version of the capital-asset-pricing model to include depositor preference. The results indicate that under depositor preference laws, all general creditors would see the value of their claims reduced to the benefit of

the FDIC and uninsured depositors. Depositor preference laws may have another effect, however. In its most extreme form, structural arbitrage by general creditors can in fact render depositor and FDIC claims junior to those of general creditors.

Pulles, Gregory, Robert Whitlock, and James Hogg. 1991. *FIRREA: A Legislative History and Section-by-Section Analysis*. 3 vols. West Group.

This three-volume collection provides general information about FIRREA, including legislative reports.

Silverberg, Stanley C. 1994. A Report on Depositor Preference, Insurance Costs, and the Cost of Supervision. *The Golembe Reports* 1994-2.

This report addresses the cost of supervision, the likely effect of depositor preference on banking, and the effect of actions both actual and potential on the federal budget. The first section focuses on the cost of supervision and deposit insurance and the effect of both on the federal budget. The remainder of the report focuses on depositor preference: what it is, how its importance has been affected by the way the FDIC has handled bank failures, and how it is likely to affect the cost of future failures and the operations of banks.

Thomson, James B. 1994. The National Depositor Preference Law. Federal Reserve Bank of Cleveland *Economic Commentary* (February 15).

The author takes a critical look at depositor preference. The first section outlines the legislation and its implementation by the FDIC, and the second section examines the way in which depositor preference restructures a bank's liabilities. Then the author examines the possible reactions of nondeposit creditors to this restructuring, and discusses the policy implications.