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THE SOURCE-OF-STRENGTH DOCTRINE: REVERED AND REVISITED — PART I

PAUL L. LEE

This two-part article revisits the premises of the source-of-strength doctrine and analyzes its application to the new contours of the financial regulatory system set by the Dodd-Frank Act. This first part begins with a brief history on the source-of-strength doctrine and proceeds to a discussion of the arguments traditionally mounted in support of or in opposition to the doctrine to illuminate themes that will arise in the application of the doctrine in expanded form under the Dodd-Frank Act. Part II, which will appear in the next issue of The Banking Law Journal, analyzes the new source-of-strength provision in the Dodd-Frank Act and the application and implications of the doctrine as a legal and policy matter for other types of depository holding companies and nonbank financial companies.

In the *summa theologica* of bank regulation there is no doctrine more hallowed or revered than that of the source of strength. As codified in regulation by the Board of Governors of the Federal Reserve System (the “Board”) in 1984, the doctrine simply, if indistinctly, provides that “[a] bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks.”¹ As further explicated by the Board in a policy statement in 1987, the doctrine envisions that “a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity.”² The devel-

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opment and application of the doctrine has over the years been marked by controversy. Commentators have sparred over the wisdom of the doctrine as a policy matter. Individual bank holding companies have challenged the application of the doctrine as a legal matter, leaving the validity of the doctrine, or perhaps more precisely the validity of the outer bounds of the doctrine, for a time in doubt. The Board has nonetheless consistently asserted the authority to require a bank holding company to serve as a source of strength to its subsidiary banks and has in recent years regularly incorporated a source-of-strength requirement into written agreements and cease and desist orders with bank holding companies.

The onset of the financial crisis in 2007 and 2008 brought a renewed focus on and a fresh perspective to the source-of-strength doctrine. Certain of the actions taken by the Board during the height of the crisis, such as the granting of waivers from the restrictions of Section 23A of the Federal Reserve Act to permit banks to supply liquidity to their affiliated mutual funds and other affiliated entities, seem to have inverted the doctrine — with the result that a bank subsidiary appeared to be serving as a source of strength to its holding company and other subsidiaries of the holding company.³ In a similar vein, during the height of the crisis the Board permitted (some say encouraged) certain large financial companies to convert to bank holding company status to acquire the imprimatur of Board supervision.⁴ Only the desperate tenor of the times can explain these apparent departures by the Board from its longstanding policy that a holding company should serve as “a source of financial and managerial strength for the banks in its system, rather than vice versa.”⁵

In the aftermath of the crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) sought to re-enshrine the source-of-strength doctrine and expand its application to other depository holding companies such as savings and loan holding companies and to certain structures involving systemically important nonbank financial companies designated under the Dodd-Frank Act.⁶ This article revisits the premises of the source-of-strength doctrine and analyzes its application to the new contours of the financial regulatory system set by the Dodd-Frank Act. Part I begins with a brief history on the source-of-strength doctrine. It then proceeds to a discussion of the arguments traditionally mounted in support of or in opposi-

tion to the doctrine to illuminate themes that will arise in the application of the doctrine in expanded form under the Dodd-Frank Act. Part II analyzes the new source-of-strength provision in the Dodd-Frank Act and the application and implications of the doctrine as a legal and policy matter for other types of depository holding companies and nonbank financial companies.

A BRIEF HISTORY OF THE SOURCE-OF-STRENGTH DOCTRINE

The principal underpinning of the source-of-strength doctrine is found in Section 3(c)(2) of the Bank Holding Company Act of 1956 (the “BHC Act”), which requires the Board to take into consideration “the financial and managerial resources and future prospects of the company or companies” involved in a proposed transaction requiring approval of the Board.⁷ In the early years of administering the BHC Act, the Board regularly addressed proposals to organize bank holding companies that involved significant incurrence of debt by the applicants.⁸ In considering these applications, the Board applied special attention to the effect that the incurrence of the debt would have on the financial resources and future prospects of the applicant. In what appears to be the earliest proximate articulation of the source-of-strength doctrine, the Board in a 1966 order, denying an application involving significant debt incurrence, stated that Section 3(c)(2) of the BHC Act required it to consider an applicant’s ability to “serve, when and as required, as a source of financial assistance to its subsidiary banks.”⁹ In following years, the Board relied on its assessment of the financial resources or prospective financial resources of an applicant to deny an application on some occasions without expressly invoking the source-of-strength phrasing.¹⁰ On other occasions, the Board expressly invoked the source-of-strength phrasing, saying that a bank holding company should provide a source of financial and managerial strength to its subsidiary banks.¹¹

In a provocative but ultimately inutile gesture, in 1976, a rejected bank holding company applicant, First Lincolnwood Corporation, challenged the Board’s invocation of the source-of-strength doctrine.¹² The application involved a proposal by shareholders of First National Bank of Lincolnwood to create a holding company for the bank.¹³ The Board order stated that as part of the proposal the holding company would incur acquisition debt of \$3.7

million.¹⁴ In fact, the proposal called for the holding company to assume the \$3.7 million in acquisition debt from the existing shareholders of the bank. The proposal also envisioned that additional capital would be raised for the bank in the future. The Board concluded that the incurrence of the acquisition debt would not provide the applicant holding company with the flexibility necessary to meet its debt service requirements and that the uncertainty surrounding the source of proposed new capital for the bank could prevent the applicant holding company from resolving “any unforeseen problems that may arise” at the bank.¹⁵ The Board concluded that it was not “in the public interest to approve the formation of a bank holding company with an initial debt structure that could result in the weakening of [b]ank’s overall financial condition.”¹⁶

The applicant petitioned the Seventh Circuit Court of Appeals for review of the Board’s action. The court of appeals held that Section 3(c) of the BHC Act did not permit the Board to withhold approval on the basis of financial or managerial deficiencies unless the deficiencies were caused or enhanced by the proposed transaction and that the Board could not use the advantages of holding company status as leverage to compel further financial enhancements from the applicant.¹⁷ Because the proposed transaction in the view of the Seventh Circuit simply reshuffled ownership interests in the bank, the Seventh Circuit concluded that the proposed transaction did not affect the existing financial situation of the bank. The Supreme Court reversed the Seventh Circuit and affirmed the Board’s decision, holding that the Board could use the advantages of holding company status “to induce applicants to improve their and their subsidiaries’ capital positions.”¹⁸ In support of its holding, the Supreme Court cited the fact that between 1970 and 1975 the Board had convinced 397 applicants to provide additional capital as part of the application process. The Supreme Court ruled that the Board could deny an application for bank holding company status “solely on grounds of financial or managerial unsoundness, regardless of whether the unsoundness was caused or exacerbated by the proposed transaction.”¹⁹ The *First Lincolnwood* decision provided support for a broad reading of the source-of-strength doctrine at least in the context of Board actions under Section 3(c) of the BHC Act.

An additional underpinning for the source-of-strength doctrine was added in 1984 when the Board adopted revisions to Regulation Y, the Board’s

regulation that generally implements the provisions of the BHC Act. As part of overall revisions to Regulation Y in 1984, the Board added a source-of-strength provision in Section 225.4(a)(1) of Regulation Y.²⁰ In the preamble to the proposed rule adopting the revisions, the Board said that the proposed source-of-strength provision:

codifies the policy of the Board that a bank holding company should serve as a source of strength for its bank subsidiaries, and conduct its bank and nonbank operations in accordance with sound banking policy and practice.²¹

In the preamble to the final rule adopting the revisions, the Board noted that it had received no substantive comments from the public on the proposed revisions being made in Section 225.4(a)(1).²² It may be that the public read the statement in the preamble to the proposed rule literally, *i.e.*, that the revisions to Regulation Y merely codified the existing source-of-strength policy, which had been applied up to that time only in the application context under Section 3 of the BHC Act. If so, the public failed to appreciate the significance of another statement made in the preamble, which pointed to a potentially expanded scope for the source-of-strength doctrine. In the preamble to the proposed rule, the Board stated that the source-of-strength provision in Regulation Y derived from Section 3(c) of the BHC Act, from Section 5(b) of the BHC Act (authorizing the Board to issue regulations) and, most significantly for future purposes, from the Board's authority under the Financial Institutions Supervisory Act ("FISA") to issue cease and desist orders to prevent unsafe and unsound banking practices.²³ With the invocation of authority to prevent unsafe and unsound banking practices, the Board vastly expanded the potential scope of application of the source-of-strength doctrine.²⁴

The implications of the 1984 revisions to Regulation Y were subsequently made clear by the Board. In February 1987, in a move that the banking industry press characterized as "unprecedented," the Board charged Hawkeye Bancorp, a multibank holding company, with an unsafe and unsound banking practice of refusing to contribute capital to a failing bank subsidiary.²⁵ The Board issued a cease and desist order to Hawkeye Bancorp only minutes after the state banking supervisor closed the bank subsidiary, which was

thereafter liquidated by the FDIC.²⁶ In light of the bank closure, the Board subsequently withdrew its cease and desist order against Hawkeye.²⁷ The stage was nonetheless set for the Board to proclaim more broadly its view of the expanded scope of the source-of-strength doctrine.

This pronouncement came in April 1987 when the Board issued a policy statement, “reaffirming” its longstanding policy that a bank holding company must serve as a source of strength to its subsidiary banks. In the preamble to the policy statement, the Board (clearly alluding to the Hawkeye experience) said that it had become “aware of situations where a bank has been threatened with failure notwithstanding the availability of resources to its parent holding company.”²⁸ The purpose of the policy statement was to confirm that the source-of-strength policy applied in failing bank situations. The cardinal point made by the Board in the policy statement was that:

in serving as a source of strength to its subsidiary banks, a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks in a manner consistent with the provisions of this policy statement.²⁹

The basis for the source-of-strength doctrine articulated in the policy statement was that a holding company derives “certain benefits” at the corporate level that result in part from the ownership of an institution that can issue federally insured deposits and has access to Federal Reserve credit.³⁰ The ultimate conclusion of the policy statement was that:

a bank holding company should not withhold financial support from a subsidiary bank in a weakened or failing condition when the holding company is in a position to provide the support. A bank holding company’s failure to assist a troubled or failing subsidiary bank under these circumstances would generally be viewed as an unsafe and unsound banking practice or a violation of Regulation Y or both.³¹

Shortly after the issuance of the policy statement, the expanded scope of the doctrine was put to the test. In October 1988 the Board issued an initial notice of charges and a temporary cease-and-desist order against MCorp, a Texas-based multibank holding company, alleging that MCorp was engaged in unsafe and unsound practices “likely to cause substantial dissipation of the assets of MCorp that could be used to allow MCorp to serve as a source of financial strength for its subsidiaries [b]anks.”³² Within a week of the initial charges, the Board issued an amended notice of charges, seeking to require MCorp to implement a capital plan that would ensure that “all of MCorp’s available assets are used to recapitalize the [s]ubsidiary [b]anks that are suffering capital deficiencies.”³³ In March 1989 creditors of MCorp commenced an involuntary bankruptcy proceeding against MCorp. A few days later the Office of the Comptroller of the Currency declared twenty of MCorp’s bank subsidiaries to be insolvent and appointed the Federal Deposit Insurance Corporation (“FDIC”) as receiver for these bank subsidiaries. MCorp itself thereafter filed a Chapter 11 bankruptcy petition. After MCorp filed its Chapter 11 petition, the Board issued a third notice of charges, alleging that MCorp was engaged in unsafe and unsound practices by failing to serve as a source of strength and in particular by refusing to make capital contributions to three of its remaining five bank subsidiaries. The Board also alleged that MCorp had caused its bank subsidiaries to violate Section 23A of the Federal Reserve Act.³⁴ In an adversary proceeding MCorp sought to enjoin the Board from further administrative proceedings, based either on the source-of-strength doctrine or Section 23A. In this adversary proceeding the Board argued that it had authority to issue the source-of-strength charges under its cease and desist power because MCorp (i) had violated a rule or regulation and (ii) was engaging in an unsafe and unsound practice.³⁵ A district court ruled in favor of MCorp in the adversary proceeding, enjoining the Board from pursuing either the source-of-strength charge or the Section 23A charge.³⁶

The Board appealed the district court order to the Fifth Circuit. The Fifth Circuit ruled that the Board was without authority under the BHC Act or the FISA to require MCorp to transfer its funds to a troubled subsidiary bank. It read the *First Lincolnwood* decision as limiting the Board’s use of the source-of-strength doctrine to the granting or denying of an application under Section 3(c).³⁷ It also concluded that the Board’s cease and desist author-

ity with respect to unsafe and unsound practices under FISA did not support the Board's action. It reasoned that requiring a bank holding company to transfer funds to a troubled bank subsidiary could hardly be considered to fall within "generally accepted standards of prudent operation," a standard that the Fifth Circuit retrieved from the legislative history of FISA.³⁸ In the view of the Fifth Circuit, such a transfer would require MCorp to disregard its own separate corporate status and would amount to a waste of corporate assets by MCorp in violation of its duty to shareholders.³⁹

Alas, there was to be no ultimate judicial determination of the breadth of the source-of-strength doctrine. On a *certiorari* review of the Fifth Circuit decision, the Supreme Court concluded that the district court lacked jurisdiction to enjoin any of the Board's regulatory proceedings and so did not reach the merits of MCorp's challenge to the Board's source-of-strength doctrine.⁴⁰ In the minds of many observers, this left the validity of the expanded source-of-strength doctrine unresolved as a legal matter.⁴¹ The Board itself was undeterred. On remand from the Supreme Court decision, the Board continued its administrative action against MCorp until June 1992 when it terminated the cease and desist order after finding that MCorp had contributed an additional \$17 million capital to its remaining subsidiary banks (four of which had already been sold) and had restored the capital level of its one remaining bank subsidiary.⁴² The termination order was also conditioned upon MCorp taking all action necessary to ensure that capital of its one remaining bank subsidiary met all capital requirements pending its anticipated sale.⁴³

COLLATERAL LEGISLATIVE ACTION

With the validity of the source-of-strength doctrine in question as the MCorp litigation proceeded, the federal regulators pursued other legislative strategies to expand their financial recourse against the holding companies and other affiliates of troubled banks. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") provided significant new authority to the FDIC in the form of the so-called "cross-guarantee" provision of the Federal Deposit Insurance Act (the "FDIA").⁴⁴ The cross-guarantee provision empowers the FDIC to claim against the capital of any commonly controlled insured depository institution for a loss incurred by

the FDIC resulting from the failure of another commonly controlled insured depository institution or from any assistance provided by the FDIC to another commonly controlled insured depository institution.⁴⁵ Under the cross-guarantee provision the FDIC has recourse against the capital of the solvent sister banks for the losses incurred with respect to the insolvent sister-bank or banks. The provision was characterized at the time by some commentators as a “weaker version” of the source-of-strength doctrine.⁴⁶ These commentators noted that the provision provided no claim against the capital of the parent company or other nonbank subsidiaries.⁴⁷ They also noted that it could be invoked only after a bank had failed or was so weakened that the FDIC had to provide open bank assistance.⁴⁸ Notwithstanding these critiques, one subsequent empirical analysis found that the cross-guarantee provision has had a significant effect on the behavior of multibank holding companies in prompting capital injections that otherwise might not have occurred.⁴⁹ The cross-guarantee provision provides an important tool to the FDIC for addressing concerns about the structure and behavior of multibank holding companies. Prior to the enactment of the cross-guarantee provision, as the *Hawkeye* and *MCorp* cases indicated, the treatment of failing banks and healthy banks within a multibank holding company structure presented troubling issues for the federal regulators.

Another source of potential recourse against a holding company was added to the FDIA by the Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”).⁵⁰ FDICIA added the so-called prompt corrective action provisions in Section 38 of the FDIA.⁵¹ Under the prompt corrective action regime created by Section 38, an undercapitalized insured depository institution must submit an acceptable capital restoration plan to its federal banking agency. For a plan to be deemed acceptable, each company having control of the insured institution must guarantee that the insured institution will comply with the plan until the institution returns to an adequately capitalized level for four consecutive calendar quarters and must provide “appropriate assurances of performance” of the guarantee.⁵² Commentators noted various limitations in the guarantee provision of Section 38 that would potentially reduce its effectiveness.⁵³ First, Section 38 does not require a controlling company to guarantee the capital restoration plan. It merely makes the guarantee a condition precedent to a finding by the federal regulator that

the plan is otherwise acceptable. Thus, a controlling company may decline to provide the guarantee if it is prepared to accept the other regulatory consequences of that action.⁵⁴ Second, Section 38 relies on a traditional stated capital analysis as the predicate for the capital restoration plan requirement and the concomitant guarantee. Regulatory experience over recent decades suggests that a stated capital analysis is not a particularly timely or even accurate metric for judging the failure risk of a depository institution.⁵⁵ Finally, even if invoked, the guarantee of a capital restoration plan is limited to an amount equal to the lesser of (1) an amount equal to five percent of the insured institution's assets at the time it became undercapitalized and (2) the amount necessary to bring the institution into compliance with all capital standards. Observers questioned whether the guarantee provision of Section 38 would prove effective in harnessing the resources of holding companies and concluded that the federal regulators would want to continue to pursue the source-of-strength doctrine as a tool.⁵⁶

In addition to the amendments to the FDIA discussed above, there was at the same time a regulatory interest in clarifying the treatment of capital commitments given by a holding company in the event of the bankruptcy of the holding company. This question was of particular concern to the Office of Thrift Supervision (the "OTS"), the regulator of savings and loan holding companies and savings associations, because it or its predecessor agency, the Federal Home Loan Bank Board, had obtained net worth maintenance agreements or stipulations from holding company applicants in connection with approval of various applications under the Home Owners' Loan Act.⁵⁷ The enforceability of such agreements had been called into question as the thrift crisis worsened in the late 1980s and various savings and loan holding companies sought bankruptcy protection. In 1990 Congress enacted two amendments to the Bankruptcy Code intended to address the treatment of a commitment given to a federal banking agency to maintain the capital of an insured depository institution. Section 365(o), which is part of the section of the Bankruptcy Code dealing with executory contracts, was enacted to read in relevant part as follows:

In a case under chapter 11 of this title, the trustee shall be deemed to have assumed (consistent with the debtor's other obligations under section

507), and shall immediately cure any deficit under, any commitment by the debtor to a [f]ederal depository institutions regulatory agency (or predecessor to such agency) to maintain the capital of an insured depository institution, and any claim for a subsequent breach of the obligations thereunder shall be entitled to priority under section 507.⁵⁸

A companion provision was added to Section 507 of the Bankruptcy Code, which deals with priorities of payment. Section 507(a)(9) provides a ninth priority for:

allowed unsecured claims based upon any commitment by the debtor to a [f]ederal depository institutions regulatory agency (or predecessor to such agency) to maintain the capital of an insured depository institution.⁵⁹

The legislative history of these changes to the Bankruptcy Code indicates that they were intended to prevent parties affiliated with federally insured depository institutions from “using bankruptcy to evade commitments to maintain capital reserve requirements of a [f]ederally insured depository institution.”⁶⁰

The clarity of treatment intended by these amendments was not the immediate result. Instead, the OTS and the FDIC have been required to litigate with Chapter 11 debtors the meaning of such terms as “commitment” and “[f]ederal depository institutions regulatory agency.” The courts have generally held that the net worth maintenance conditions, agreements or stipulations used by the OTS and its predecessors constitute a “commitment” within the meaning of Section 365(o).⁶¹ A bankruptcy court decision in 2010 relating to Colonial BancGroup, a bank holding company and Chapter 11 debtor, however, demonstrates the difficulties that may lie ahead with respect to the enforcement of the source-of-strength doctrine in bankruptcy cases.⁶² Among the issues before the bankruptcy court was whether a Board consent order with Colonial BancGroup containing a source-of-strength provision constituted a “commitment” to maintain the capital of its bank subsidiary for purposes of Section 365(o). The bankruptcy court found it did not.⁶³ The FDIC has appealed the decision of the bankruptcy court, and the appeal is still pending. The issues presented under the source-of-strength doctrine in bankruptcy proceedings are of critical importance to the future implementation of the source-of-strength doctrine and are discussed at greater length in Part II of this article.

THE POLICY DEBATE

The *MCorp* case prompted a flurry of legal commentary.⁶⁴ In the midst of the MCorp litigation, William Keeton, a senior economist from the Federal Reserve Bank of Kansas City, proffered in a short paper a broad thesis for the source-of-strength doctrine.⁶⁵ His thesis was that a holding company structure could inherently pose risks to the safety and soundness of its bank subsidiaries. He cited three principal risks posed by a holding company structure: (1) geographic and product diversification might not significantly reduce the rate of bank failures if profits and losses are not “pooled” in the bank holding company; (2) a holding company might encourage its bank subsidiaries to engage in transactions among themselves or with affiliates that would boost the holding company’s profits at the expense of a particular bank subsidiary; and (3) a bank holding company might rely too heavily on debt as a source of funds.⁶⁶ In his view behavior arising from each of these risks could be seen as a “rational” response to the deposit insurance system, which places the burden of bank failure on the FDIC. In respect of the first risk, Keeton posited that a bank holding company that had diversified either by geography (through multiple bank subsidiaries) or by product line (through nonbank subsidiaries) would have a strong incentive to let an individual bank subsidiary fail.⁶⁷ In respect of the second risk, he hypothesized that a troubled bank might charge too low a rate on loans to healthy sister banks or might purchase loans from healthy sister banks at book value rather than at market price.⁶⁸

Keeton concluded that the source-of-strength doctrine was needed because existing regulatory measures were insufficient to address these risks. He noted that while Section 23A and Section 23B place restrictions on affiliate transactions, Section 23A contains a significant exemption for sister-bank extensions of credit.⁶⁹ He also voiced concern that the affiliate rules were difficult to enforce and could in any event be breached by a desperate holding company.⁷⁰ (In this respect it should be noted that the MCorp case involved claims of violations of the affiliate transaction rules.) He acknowledged that these concerns, at least as to sister-bank dealings, had been mitigated by the addition of the cross-guarantee provision in FIRREA. But he expressed concern that the cross-guarantee provision did not address incentives to prefer or protect nonbank subsidiaries of a holding company.⁷¹ (In this respect it should be noted that the *MCorp* case involved claims that the holding com-

pany had refused to contribute the proceeds from the sale of two nonbank subsidiaries to its undercapitalized bank subsidiaries.)

The thesis posited by Keeton would have benefited from a more extended exposition than Keeton provided in his own paper. Coincidentally, another commentator writing at the time provided the more extended exposition in a paper discussing the general risks to the banking system presented by diversification.⁷² Although this paper did not focus on the source-of-strength doctrine, it provided a detailed analysis of the risks that diversification might present to the banking subsidiaries of bank holding companies, paralleling many of the points made more generally by Keeton. This commentator identified a broad range of risks that would be presented by diversification, including not just the risk of specific conflicts of interest or opportunistic behavior, but also general problems of organization, structure and management.⁷³ She provided, for example, a detailed discussion of the incentives that would lead management to permit transfers from bank subsidiaries to weaker nonbank subsidiaries and to resist transfers from nonbanking operations to weaker bank subsidiaries. She concluded generally that diversification would lead to greater risk in the banking system with two results: (1) there would be more bank failures, and (2) (of particular interest today) future bank failures would be much more complex and difficult to resolve.

Other commentators writing at this time identified many of these same risks. In some cases they disagreed over the degree of risk. In other cases they disagreed over the appropriate means of addressing the risk.⁷⁴ Commentators supporting the source-of-strength doctrine focused on the general moral hazard risk associated with insurance coverage for bank subsidiaries. A basic policy proposition in their minds was that it is more equitable for bank holding companies and their shareholders to bear the loss from bank risk than the FDIC and federal taxpayers.⁷⁵ Other commentators suggested that a holding company and its management are in a better position to monitor the affairs of their regulated subsidiaries than federal examiners and so should be held responsible for the affairs of these subsidiaries through a call on the capital of the holding company.⁷⁶ These commentators also focused on the specific risk that a holding company would not use the assets of nonbank subsidiaries to support a failing bank subsidiary.⁷⁷ These commentators like Keeton concluded that the cross-guarantee provision was an inadequate solution for

this problem because it did not provide a claim on the capital of the nonbank subsidiaries.⁷⁸ At the time these commentators were writing, the prospect of further deregulation and diversification of activities of bank holding companies was already on the horizon. These commentators noted that the principal argument for permitting a broader range of financial activities to bank holding companies was that it would enhance the earnings, competitiveness, and ultimately the safety and soundness of bank holding companies. These commentators noted the paradox that diversification into nonbank activities might at the same time lessen the incentive for a bank holding company to support a failing bank subsidiary.

For their part, opponents of the source-of-strength doctrine acknowledged at least in theory the risks outlined above, but they concluded that the negative consequences of the doctrine outweighed its benefits. The principal legal argument made by the opponents was that the source-of-strength doctrine was in direct contravention of traditional corporate law principles that recognize the limited liability of shareholders and thus amounted to a mandatory piercing of the corporate veil.⁷⁹ A related principle of corporate law implicated in the source-of-strength debate is the fiduciary duty owed by a board of directors of a company to its shareholders. The Fifth Circuit decision in *MCorp* appeared to put significant weight on the issue when it observed that the transfer of funds by MCorp to its troubled bank subsidiaries at the time would have amounted to corporate waste in violation of MCorp's duties to its shareholders. Opponents of the doctrine further asserted that the doctrine would in effect usurp the business judgment of the board.⁸⁰

The policy arguments mounted by the opponents related to the prospective negative effects of the doctrine on the banking system. Opponents maintained that the doctrine would negatively affect the ability of bank holding companies to raise equity and debt in the markets, particularly because of the uncapped nature of the call on the holding company.⁸¹ In support of this concern the commentators noted that representatives from both the FDIC and the Securities and Exchange Commission had expressed concerns about the effect of the doctrine on the market for bank holding company equity and debt.⁸² The proponents of the doctrine would presumably respond that the higher cost of equity and debt issuance by bank holding companies would reflect the higher overall risk to the industry resulting from the diversification process.

In the end, it was a differing judgment as to the effects of diversification that appears to have separated the proponents and opponents most fundamentally. As noted above, the proponents of the doctrine concluded that diversification would increase risks to the banking system as a whole and to bank subsidiaries of bank holding companies in particular.⁸³ The opponents of the doctrine believed that diversification would reduce risks to the banking system as a whole and (presumably, if handled appropriately) to individual bank holding companies.⁸⁴ In fact, the opponents argued that the source-of-strength doctrine would impede the product-line and geographic diversification that was occurring as statutory and regulatory constraints were being loosened. To these policy arguments the opponents added a practical observation: there were already strong regulatory and market incentives for a bank holding company to support its bank subsidiaries.⁸⁵

WHERE'S THE DATA?

As the debate raged over the wisdom of the source-of-strength doctrine in the 1990s, commentators were able to stake out positions, largely unburdened by empirical data. As written, Keeton's piece would have been characterized by his economist colleagues at the Federal Reserve Bank as one based on "intuition" (although his supervisory colleagues at the Bank might have been more accommodating in characterizing it as based on supervisory observations). In fact, there was only limited empirical research available at the time to frame the debate over the expanded source-of-strength doctrine. One study published in 1991 sought to determine whether capital injections into troubled bank subsidiaries of bank holding companies were larger than the capital injections into independent banks.⁸⁶ The author of this study posited the thesis that multibank holding companies would have stronger incentives to maintain a favorable reputation in the markets and with the regulators than independent banks or one-bank holding companies. The study, surveying the experience during the period from 1985 through 1988 in 20 states that permitted multibank holding companies, found that multibank holding companies made larger capital injections into their troubled bank subsidiaries than the owners of independent banks, but only when the multibank holding companies have total assets ranging from at least 10 to 50 times the size of their troubled bank subsidiaries.⁸⁷

There are obvious limits to the results of this study. Besides the limited nature of the sample of institutions covered, a majority of the sample was composed of banks that encountered trouble before the Board's 1987 announcement of the expanded source-of-strength doctrine.⁸⁸ The results nonetheless suggest that even before the 1987 announcement of the expanded source-of-strength doctrine, multibank holding companies had strong incentives to maintain the health of their bank subsidiaries.⁸⁹

Another study published in 1995 sought to assess the effect of the issuance of the 1987 policy statement on the market for bank holding company shares.⁹⁰ This study excluded one-bank holding companies from its scope because the authors of the study concluded that one-bank holding companies were not really capable of serving as a source of strength to their bank subsidiaries. The study analyzed the effect of the announcement of the Board's cease and desist order against Hawkeye on the market for publicly-traded multibank holding companies.⁹¹ The results of the study indicated that the sample of bank holding companies with troubled bank subsidiaries had a significant negative price reaction to the Board's announcement while the sample of the bank holding companies with healthy bank subsidiaries had no significant price reaction. The results of the study also showed that the subsequent announcement of the policy statement in April 1987 had no significant price effect on the market in general, presumably because the market had already absorbed the effect of the policy statement through the earlier announcement of the Hawkeye enforcement action. The conclusion of the authors of the study was that, contrary to the concerns expressed by some in the banking community at the time, the pronouncement of the expanded source-of-strength policy did not have a negative effect on the attractiveness of all bank holding companies as an equity investment; instead the effect was limited primarily to those with troubled bank subsidiaries.⁹² Both the 1995 study and the 1991 study were not comprehensive and hence do not provide a basis for assessing the overall effects of the source-of-strength doctrine.

The only comprehensive empirical study of the source-of-strength doctrine was initially published in 2004 and re-published in revised form in 2008 by a research officer of the Federal Reserve Bank of New York.⁹³ Like the 1991 study discussed above, this study principally compared the experience of multibank holding companies with the experience of standalone banks and

one-bank holding companies, but unlike the 1991 study this study covered all insured commercial banks and any affiliated bank holding companies. This study also covered a much longer time frame — from 1984 through 2004. Among the findings of the study was that multibank holding company affiliation was associated with greater efforts to salvage a distressed bank subsidiary than in a standalone case or a one-bank holding company case.⁹⁴ Another finding was that multibank holding company affiliation has an important beneficial impact on the probability of future distress for the bank subsidiaries of that holding company compared to the case of a one-bank holding company.⁹⁵

One of the purposes of this study was to analyze the behavior of bank holding companies during the period after the enactment of the cross-guarantee authority in FIRREA. The relevant finding of the study is that while bank subsidiaries of multibank holding companies were less likely to be distressed than a bank subsidiary of a one-bank holding company, the relative difference became much greater after 1989.⁹⁶ The study suggests that the cross-guarantee authority had a significant effect on the behavior of multibank holding companies. Perhaps of even greater significance for future analysis, the study suggests that the legislative changes in both 1989 and 1991 have had an effect on how the resources in nonbank affiliates are used to assist troubled bank subsidiaries.⁹⁷

BOARD ENFORCEMENT PRACTICE AFTER MCorp

The Board publishes its formal enforcement actions, *i.e.*, written agreements, cease and desist orders, and civil money penalty assessments.⁹⁸ A review of these formal enforcement actions (available on the Board's website commencing with the year 1997) provides some insight into the use by the Board of the source-of-strength doctrine in enforcement actions in recent years.

Between 1997 and 2003, the Board issued 19 written agreements that required a bank holding company to submit an acceptable written plan to achieve and maintain an adequate capital position for its bank subsidiary. The relevant provision in the written agreement required the capital plan to “address” among other points the current and future capital requirements of the bank and the source and timing of additional funds needed to fulfill all

current and future capital needs of the bank. This provision may be read as an implicit invocation of the source-of-strength requirement since it requires a plan from the holding company to address the capital requirements of the bank subsidiary. The capital plan provision in three of the 19 written agreements also expressly required the capital plan to address “the requirements of section 225.4(a) of the Regulation Y of the Board of Governors that [the bank holding company] serve as a source of strength to the [b]ank.” This provision first appeared in a written agreement in 2002.

In 2004 the Board issued three written agreements and two consent cease and desist orders with a capital plan requirement. Four of the five capital plan provisions included the express source-of-strength language quoted above. In 2005 the Board issued two written agreements with capital plan requirements. One included the express source-of-strength provision; one did not. In 2006 the Board issued five consent cease and desist orders with a capital plan requirement. All included the express source-of-strength requirement. In 2007 the Board issued four written agreements with a capital plan requirement. None of them included the express source-of-strength requirement. The pattern of inclusion of the express source-of-strength provision in a capital plan requirement was thus inconsistent in the years between 2002 and 2007.

In 2008 the Board issued ten written agreements or consent orders with a capital plan requirement. All ten included the express source-of-strength provision in the capital plan section. For the first time, the Board also added a separate source-of-strength section in addition to the source-of-strength provision in the capital plan section. The separate source-of-strength section in one written agreement provided that the bank holding company:

shall take appropriate steps to fully utilize its financial and managerial resources to assist the [b]ank in functioning in a safe and sound manner pursuant to Regulation Y...(12 C.F.R. § 225.4).

One consent order also contained a separate source-of-strength section that provided that the bank holding company:

shall serve as a source of financial strength to the Banks pursuant to section 225.4(a) of Regulation Y of the Board of Governors (12 C.F.R.

§ 225.4(a)), including but not limited to, by providing and complying with any guarantee required by the OCC under section 38 of the FDI Act (12 U.S.C. § 1831o).

In 2009 the Board issued fourteen written agreements or consent orders containing a capital plan requirement. Following the pattern set in 2008, the capital plan section in each of the agreements or orders included the express source-of-strength provision. In addition, two of the consent orders had a separate source-of-strength section that was linked to a cease and desist order issued to the bank subsidiary by that institution's primary federal banking regulator. One of these consent orders was issued to Colonial BancGroup and is the subject of the litigation discussed above. The separate source-of-strength section in the Colonial BancGroup consent order read as follows:

The board of directors of BancGroup shall take appropriate steps to ensure that the Bank complies with the Order to Cease and Desist entered into with the Federal Deposit Insurance Corporation...and the Superintendent effective as of June 15, 2009, and any other supervisory action taken by the Bank's federal or state regulators.

The other consent order with Irwin Financial Corporation and Irwin Union Bank and Trust Company contained a separate source-of-strength section that read as follows:

Irwin shall take appropriate steps to fully utilize its financial and managerial resources to assist the Bank in functioning in a safe and sound manner pursuant to Regulation Y of the Board of Governors (12 C.F.R. § 225.4) and to ensure that Irwin Union Bank, F.S.B....complies with the Order to Cease and Desist entered into with the Office of Thrift Supervision...effective as of July 24, 2009.

In 2010 the Board issued 81 written agreements or consent orders containing a capital plan requirement. The capital plan requirement in 77 of the agreements or orders included the express source-of-strength provision. In addition, 65 of the agreements or orders included a separate source-of-strength section. By 2010 the separate source-of-strength provision became

fairly formulaic with two standard versions of language. The first version provided as follows:

The board of directors of [the bank holding company] shall take appropriate steps to fully utilize [the bank holding company's] financial and managerial resources, pursuant to section 225.4 of Regulation Y ... to serve as a source of strength to the [b]ank including, but not limited to, taking steps to ensure that the [b]ank complies with this Agreement, and any other supervisory action taken by the [b]ank's federal or state regulator.

When another enforcement order was outstanding against the bank subsidiary from its primary federal regulator, the language in the separate source-of-strength section provided as follows:

The board of directors of [the bank holding company] shall take appropriate steps to fully utilize [the bank holding company's] financial and managerial resources, pursuant to section 225.4 of Regulation Y ... to serve as a source of strength to the [b]ank including, but not limited to, taking steps to ensure that the [b]ank complies with the Consent Order entered into with the [primary federal bank regulator] on [date], and any other supervisory action taken by the Bank's federal or state regulator.

In 2011 the Board issued 39 written agreements or consent orders containing a capital plan requirement. The capital plan section in all but one of the agreements or orders included the express source-of-strength provision. In addition all of the agreements or orders that contained a capital plan section also included a separate source-of-strength section following one of the two versions that had become standardized in 2010. In the second half of 2011, the Board expanded the language of the separate source-of-strength section and the source-of-strength provision in the capital plan section to include a reference not only to Section 225.4 of Regulation Y, but also Section 38A of the FDIA (the source-of-strength provision added by the Dodd-Frank Act which came into effect on July 21, 2011). Thus, by 2011 the Board's approach at least as to language with respect to the source-of-strength provision had become largely uniform and standardized. It is not clear, however, that

any of these generic formulations will satisfy the requirements for priority treatment in the event of the bankruptcy of a bank holding company.⁹⁹

CONCLUSION

This brief reprise of the history of the source-of-strength doctrine and of the arguments and practices surrounding the doctrine suggests a set of issues that the federal banking agencies will confront as they seek to implement the new source-of-strength provision in the Dodd-Frank Act.¹⁰⁰ The original source-of-strength doctrine, derived as it was from Section 3(c)(2) of the BHC Act, was self-bounded. It was no more extensive as to time or scope than the application process itself. The expanded source-of-strength doctrine as reflected in Section 225.4(a) of Regulation Y and the 1987 policy statement provides indeterminate bounds as to the time and duration of application and as to scope and depth of application. The indeterminate nature of the bounds of the doctrine may serve the Board's purposes in negotiating concessions or other ameliorative actions from bank holding companies in the regulatory and supervisory process, but it will likely weaken the Board's position if the Board must resort to legal action to enforce the doctrine in a particular case.

The legislative responses reflected in the cross-guarantee provision of FIRREA and the capital restoration plan guarantee provision of FDICIA may be seen as efforts to provide both clearer bounds for the regulated entities and easier enforcement for the regulators of sub-elements of the source-of-strength doctrine. The guarantee provision in Section 38 of the FDIA in particular may be seen as designed to provide holding companies with greater clarity as to when an obligation to guarantee the capital position of a bank or thrift subsidiary might arise and with greater comfort as to the extent of their obligation (i.e., by capping the obligation at the lesser of five percent of the total assets of the subsidiary and the amount necessary to bring the subsidiary into compliance with capital standards).¹⁰¹ The cap in Section 38 presumably eases the case for the directors giving the guarantee against the claim that they might otherwise be in breach of their duties to the shareholders of the holding company. The bank regulators for their part get a guarantee with greater enforcement value and ease. They also get a commitment more likely

to satisfy the requirements of Section 365(o) and Section 507(a)(9) of the Bankruptcy Code.¹⁰²

The cross-guarantee provision of the FDIA also provides a clearer avenue for recovery by the FDIC in cases involving multibank holding companies than reliance on a source-of-strength doctrine. The apparent trade-off is that the recovery base is limited to the capital of sister banks and does not extend to the capital of the holding company or other subsidiaries of the holding company. The FDIC may have acquiesced to this limitation for its own reason, namely, a concern that a measure making all nonbank affiliates subject to a cross-guarantee liability would discourage capital investment in holding companies.¹⁰³ In any event, at the time of the passage of the cross-guarantee provision in 1989, the FDIC's immediate concern was dealing with the more prominent fact pattern of multibank holding companies and the admixture of healthy and failing bank subsidiaries in holding company structures. The cross-guarantee provision in FIRREA handily addressed that concern.

Dissatisfied with these legislative initiatives that were designed to complement the source-of-strength doctrine, certain academic observers responded with proposals of their own that were characterized by increasing eccentricity (at least from the perspective of a traditional corporate law analysis). One academic observer proposed an approach that would allow the substantive consolidation of all insured subsidiaries of a multibank holding company upon a finding that the subsidiaries did not have separate economic identities.¹⁰⁴ Another academic observer went further, suggesting a notion of "family liability" for holding companies of insured subsidiaries.¹⁰⁵ Under this notion of "family liability," the FDIC would be able to assert a claim against the holding company and any or all of its subsidiaries on a joint and several basis for losses incurred by the FDIC. The "family liability" proposal would include no cap or "artificial" limit on the family liability.¹⁰⁶

Other academic observers offered variations on this theme. One observer proposed an approach similar to the family liability approach, but suggested a cap on the liability (at least for subsidiaries) at a percentage of the subsidiary's total liabilities or capital requirements.¹⁰⁷ Still another academic observer proposed a middle ground approach, seeking to mediate between the concern for an open-ended piercing of the corporate veil (as suggested by the expanded source-of-strength doctrine) and the policy desire to provide

recourse against a holding company when it mismanages the affairs of its insured subsidiary.¹⁰⁸ This observer proposed a test for holding company liability based on, and only applicable to, situations where the insured subsidiary's directors owed a duty to a non-shareholder (including the subsidiary itself) and failed to discharge that duty properly.¹⁰⁹ This test involves a significant degree of imprecision. In all events, the policy considerations relating to holding company liability for the capital deficiency or failure of an insured institution were widely discussed and remained open to a wide range of views.

The patterns that the federal banking agencies will face in implementing the new source-of-strength provision differ significantly from those that existed when the source-of-strength doctrine was developed in the 1980s and early 1990s. The extensive network of sister banks that once characterized the multibank holding company structure has contracted, making the cross-guarantee provision less of a substitute for the source-of-strength doctrine. At the same time, the percentage of nonbank subsidiary assets in the bank holding company sector has risen sharply, particularly among the largest bank holding companies. This fact pattern presents a policy anomaly. On the one hand, the greater the percentage of nonbank assets in a holding company structure, the greater the resources available to the holding company *ceteris paribus* to support its bank subsidiary. On the other hand, the systemic consequences of a failure of a large nonbank subsidiary of a holding company may suggest that the holding company must also be prepared to marshal its assets to support the nonbank subsidiary. The source-of-strength provision added by the Dodd-Frank Act speaks only of a bank holding company or savings and loan holding company acting as a source of financial strength for its insured depository institution subsidiary.

Will the Board as the supervisor of a systemically important financial holding company find its interest in the capital and financial strength of the holding company veering in a direction that is not exclusively responsive to the future needs of the insured depository subsidiary? Will the Board as supervisor of savings and loan holding companies apply the same calculus to these entities as it would to bank holding companies with large bank subsidiaries? Presumably, the FDIC and the OCC as the appropriate federal banking agency with respect to any company that controls an insured depository institution that is not a subsidiary of a bank holding company or a

savings and loan holding company will have a strong incentive to implement the new source-of-strength authority with an exclusive focus on the insured depository institution since the FDIC and the OCC will have no supervisory responsibility for the controlling company. Finally, in all cases, the appropriate federal banking agency should have an interest in devising a regime that provides for effective enforcement and presumably appropriate recognition, if necessary, in the event of a bankruptcy proceeding for the holding company. These issues will be explored in greater depth in Part II of this article.

NOTES

¹ 12 C.F.R. § 225.4(a) (2011).

² Policy Statement on the Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks, 52 Fed. Reg. 15707 (Apr. 30, 1987).

³ For a comprehensive discussion of the Board's use of the waiver authority under Section 23A, see Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C.L. REV. 1683 (2011). The author traces the extensive use of waiver authority by the Board prior to and during the financial crisis under the heading "Banks to the Rescue." *Id.* at 1725. The author also discusses the changes made by the Dodd-Frank Act to the provisions of Section 23A, including the waiver authority, that were intended to address some of the concerns identified with the application of Section 23A during the financial crisis. *Id.* at 1757-1761.

⁴ See, e.g., Morgan Stanley, 94 FED. RES. BULL. C103 (2008); Goldman Sachs Group, 94 FED. RES. BULL. C101 (2008); American Express Company, 95 FED. RES. BULL. B20 (2009). The "conversion" in these cases actually occurred at the depository institution subsidiary level where an entity such as an industrial loan company that is exempt from the definition of "bank" in § 2(c)(2)(H) of the BHC Act converted into a national bank or state chartered bank. The conversion of the depository institution subsidiary required the holding company to qualify and register as a bank holding company. At least one of these conversions proved to be a deathbed conversion. CIT Group was approved to convert to bank holding company status in December 2008. See CIT Group, 95 FED. RES. BULL. B26 (2009). It filed a prepackaged Chapter 11 petition in November 2009. (The more evangelically-minded may question the deathbed analogy, preferring to see in a Chapter 11 filing the hope of a reorganization and resurrection. CIT Group did in fact emerge from bankruptcy in thirty-eight days.) Another *converso*, GMAC (now Ally Financial),

appears to have been enveloped on virtually all sides by the Chapter 11 proceedings of its former parent, General Motors Corporation, its former subsidiary, GMAC Commercial Holdings (renamed Capmark Financial Group after its sale by GMAC), and its existing subsidiary, Residential Capital, LLC.

⁵ First Southwest Bancorporation, 58 FED. RES. BULL. 301, 302 (1972). *See also* NCNB Corporation, 58 FED. RES. BULL. 844, 846 (1972) (“it is essential that bank holding companies and their nonbank subsidiaries be soundly financed so that they will, if anything, be in a position to add to the strength of their affiliated banks and in no way dilute or ‘trade on’ that banking strength”).

⁶ Pub. L. No. 111-203, § 616(d), 12 Stat. 1376, 1616 (codified at 12 U.S.C. § 1831o-1).

⁷ 12 U.S.C. § 1842(c)(2).

⁸ *See, e.g.*, Clayton Bancshares Corporation, 50 FED. RES. BULL. 1261 (1964) (denying an application to become a bank holding company on the grounds that the incurrence of debt would render the applicant’s prospective financial condition less than satisfactory).

⁹ Mid-Continent Bancorporation, 52 FED. RES. BULL. 198, 200 (1966) (the applicant’s proposed debt to equity ratio exceeded by far the ratio presented in any proposal that the Board had theretofore considered).

¹⁰ *See, e.g.*, Midwest Bancorporation, 56 FED. RES. BULL. 948, 950 (1970) (acquisition debt “would hinder [Applicant’s] ability to meet emergency capital needs of its subsidiary banks should such need arise”); Seilon, 58 FED. RES. BULL. 729, 730 (1972) (acquisition would have positioned the applicant “to improve its [weak] financial condition at the expense of [the one-bank holding company proposed to be acquired] through liberal or excessive dividends or management fees drawn from [bank]”); Bankshares of Hawley, 62 FED. RES. BULL. 610, 611 (1976) (“servicing of Applicant’s substantial acquisition debt over a 12-year period through Bank’s dividends can be expected to further weaken Bank’s capital position”).

¹¹ *See, e.g.*, First Southwest Bancorporation, 58 FED. RES. BULL. 301, 302 (1972) (“[t]he Board believes that a holding company should be a source of financial and managerial strength for the banks in its system, rather than vice versa”); Downs Bancshares, 61 FED. RES. BULL. 673 (1975) (“[t]he Board has indicated on previous occasions that it believes that a holding company should provide a source of financial and managerial strength to its subsidiary bank(s)”).

¹² *Board of Governors v. First Lincolnwood Corp.*, 439 U.S. 234 (1978), *reversing First Lincolnwood Corp. v. Board of Governors*, 560 F.2d 258 (7th Cir. 1977).

¹³ First Lincolnwood Corp., 62 FED. RES. BULL. 153 (1976).

¹⁴ *See First Lincolnwood Corp. v. Board of Governors*, 546 F.2d 718, 720 (1976). The proposal for the creation of the holding company was designed to permit the filing of

a consolidated tax return, which would allow the interest deduction for the debt to be taken against the earnings of the bank, resulting in increased net after-tax earnings for the bank.

¹⁵ 62 FED. RES. BULL. at 154.

¹⁶ *Id.*

¹⁷ *First Lincolnwood Corp. v. Board of Governors*, 560 F.2d 258, 262 (7th Cir. 1977). The crux of the analysis of the Seventh Circuit is encapsulated in the following statement:

Here the concern of the Board is the amount of indebtedness to be assumed by the corporate owner of the Bank. Yet the individual present owners are obliged in the same amount.... The proposed transaction will not create nor increase the debt, nor increase any danger it poses to the soundness of the Bank. The only changes identified as resulting from the proposed transaction are a tax advantage which will make it possible to speed the reduction of the debt, and a proposed addition to Bank capital which will alleviate the other concerns. Both changes are favorable to the public interest, although they do not guarantee as much of an improvement as the Board would like. The Board assumes the stance that the tax advantage of bank holding company status is a reward which it may withhold until the applicant's financial status fulfills the Board's standard of desirability. We do not find this power or breadth of discretion in the statute.

¹⁸ 439 U.S. at 251.

¹⁹ 439 U.S. at 252 (footnote omitted).

²⁰ 49 Fed. Reg. 794 (1984).

²¹ 48 Fed. Reg. 23520, 23523 (1983).

²² 49 Fed. Reg. at 800.

²³ 48 Fed. Reg. at 23523.

²⁴ At least one observer at the time noted the significance of the codification of the doctrine. See, e.g., Julius L. Loeser, *Bank Holding Company Regulation: The Federal Reserve Board's Recent Revision of Regulation Y*, 101 BANKING L.J. 525, 546 (1984).

²⁵ See *Fed Disciplines Financially Strapped BHC for Failure to Bail Out Ailing Subsidiary*, 48 BANKING REP. (BNA) 297 (Feb. 16, 1987).

²⁶ *Id.* The press story also reported that representatives of Hawkeye met with officials from the FDIC and the state banking supervisor who advised Hawkeye *not* to contribute additional capital to the bank subsidiary because "doing so would only cause the bank to linger and become a more costly problem in the long run." *Id.* If true, there must be some irony in the fact that the Board commenced its first source-of-strength enforcement proceeding in a case where the primary federal and state regulatory agencies requested the bank holding company not to make any further

capital contributions to the bank.

²⁷ See Lisabeth Weiner, *Fed Drops Case Against Hawkeye*, AM. BANKER, May 1, 1987, at 11.

²⁸ 52 Fed. Reg. at 15707.

²⁹ *Id.*

³⁰ *Id.* The policy statement also referenced the critical fiduciary responsibilities of depository institutions “as custodians of depositors’ funds” and their strategic role in the economy as operators of the payments system and providers of credit. *Id.*

³¹ *Id.* at 15708. The Board subsequently incorporated the text of the policy statement into its bank holding company supervision manual. See BANK HOLDING COMPANY SUPERVISION MANUAL § 2010.0.1 (Dec. 1992).

³² *MCorp Financial v. Board of Governors*, 900 F.2d 852 (5th Cir. 1990), *aff’d in part, rev’d in part*, 502 U.S. 32 (1991). At the time of the issuance of the initial notice of charges, MCorp owned 25 bank subsidiaries. 900 F.2d at 854.

³³ 900 F.2d at 853. The source-of-strength charges related to MCorp’s refusal to use \$400 million of cash (acquired from the sale of two nonbank subsidiaries) to recapitalize its bank subsidiaries. See Steve Klinkerman, *Regulators, MCorp Wrestle Over Bailout: Fed Acts to Seize Assets; Firm Hints at Bankruptcy*, AM. BANKER, Oct. 25, 1988, at 1.

³⁴ 900 F.2d at 854. The alleged violations of Section 23A related to certain extensions of credit by two MCorp bank subsidiaries to an MCorp nonbank subsidiary. 900 F.2d at 854 & 858.

³⁵ 900 F.2d at 859.

³⁶ *In re MCorp*, 101 B. R. 483 (S.D. Tex. 1989).

³⁷ 900 F.2d at 861-862.

³⁸ 900 F.2d at 863.

³⁹ *Id.*

⁴⁰ 502 U.S. 32, 34.

⁴¹ See, e.g., Lissa L. Broome, *Redistributing Bank Insolvency Risks: Challenges to Limited Liability in the Bank Holding Company Structure*, 26 U.C. DAVIS L. REV. 936, 964 (1992-1993); Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 507, 538-539 (1994).

⁴² *In the Matter of MCorp*, Board of Gov. of Fed. Res. Sys., Docket No. 88-062-B-A2-HC; 88-062-C1-HC; 88-062-C2-HC; and 88-062-C3-HC (June 15, 1992). See Leonard Bierman & Donald R. Fraser, *The “Source of Strength” Doctrine: Formulating The Future of America’s Financial Markets*, 12 ANN. REV. BANKING L. 269, 278 (1993).

⁴³ *Id.* The Board also took every opportunity to remind the rest of its regulatory audience of the importance of the source-of-strength doctrine. See, e.g., Banc One Corp., 78 FED. RES. BULL. 159, 161 (1992) (declining to relieve Banc One of its

responsibility to serve as a source of strength to the distressed bank proposed to be acquired in a stake-out investment); Deutsche Bank AG, 79 FED. RES. BULL. 133, 137 (1993) (confirming that the source-of-strength doctrine applies to foreign bank holding companies).

⁴⁴ Pub. L. No. 101-73, 103 Stat. 183 (1989).

⁴⁵ 12 U.S.C. § 1815(e)(1)(A). For purposes of the cross-guarantee provision, depository institutions are commonly controlled if the institutions are controlled by the same company or if one depository institution is controlled by another depository institution. 12 U.S.C. 1815(e)(8).

⁴⁶ See, e.g., R. Alton Gilbert, *Do Bank Holding Companies Act as "Sources of Strength" for Their Banking Subsidiaries?*, REV. FED. RES. BANK ST. LOUIS, Jan.-Feb. 1991, 3, 4.

⁴⁷ See, e.g., Gilbert, *supra* note 46, at 4; Broome, *supra* note 41, at 993; Jackson, *supra* note 41, at 537.

⁴⁸ See *id.*

⁴⁹ See Adam B. Ashcraft, *Are Bank Holding Companies a Source of Strength to Their Banking Subsidiaries?*, FED. RES. BANK OF NY STAFF REPORT No. 189 (June 2004).

⁵⁰ Pub. L. No. 102-242, 105 Stat. 2236 (1991).

⁵¹ 12 U.S.C. § 1831o.

⁵² 12 U.S.C. § 1831o(e)(2)(C)(ii).

⁵³ See, e.g., Broome, *supra* note 41, at 993-994; Jackson, *supra* note 41, at 538-539.

⁵⁴ The failure to submit an acceptable capital plan including the guarantee exposes the insured institution to extensive operating restrictions. 12 U.S.C. § 1830(f). A controlling company will presumably carefully weigh the financial and reputational consequences of declining to provide a guarantee of a capital plan against the risk the capital plan may not be fulfilled with resulting recourse to the controlling company and likely loss of any residual value in the insured institution.

⁵⁵ See, e.g., Jackson, *supra* note 41, at 538-539.

⁵⁶ *Id.* at 539 n.105.

⁵⁷ For a discussion of the use of net worth maintenance agreements and stipulations by the OTS and its predecessor agency, see Jackson, *supra* note 41, at 517-528. See also Cassandra Jones Havard, *Back to the Parent: Holding Company Liability for Subsidiary Banks — A Discussion of the Net Worth Maintenance Agreement, the Source of Strength Doctrine, and the Prompt Corrective Action Provision*, 16 CARD. L. REV. 2353, 2370-2381 (1995).

⁵⁸ 11 U.S.C. § 365(o).

⁵⁹ 11 U.S.C. § 507(a)(9).

⁶⁰ H.R. Rep. No. 681(I), 101st Cong., 2d Sess. 179 (1990), *reprinted in* 1990 U.S.C.C.A.N. 6472, 6585.

⁶¹ See *Wolkowitz v. Fed. Deposit Ins. Corp.*, 537 F.3d 959, 973 (9th Cir. 2008); *Office of*

Thrift Supervision v. Overland Park Fin. Corp., 236 F.3d 1246, 1252 (10th Cir. 2001); *Resolution Trust Corp. v. Firstcorp, Inc.* 973 F.2d 243 (4th Cir. 1992); *Franklin Savings Corp. v. Office of Thrift Supervision*, 303 B.R. 488, 491 (D. Kan 2004).

⁶² *In re Colonial BancGroup*, 436 B.R. 713 (Bankr. M.D. Ala.2010).

⁶³ The bankruptcy court distinguished the Board's consent order based on its language and its circumstances from the net worth maintenance agreements and stipulations that had been found by the courts cited in note 61 *supra* to constitute a commitment to maintain capital within the meaning of § 365(o). 436 B.R. at 730-735.

⁶⁴ See, e.g., James F. Groth, Comment, *Can Regulators Force Bank Holding Companies to Bail Out Their Failing Subsidiaries? An Analysis of the Federal Reserve Board's Source-of-Strength Doctrine*, 86 NW. U.L. REV. 112 (1991-1992); Craig L. Brown, Note, *Board of Governors v. MCorp Financial, Inc.: Evaluating the Source-of-Strength Doctrine*, 21 HOFSTRA L. REV. 235 (1992-1993); Kieran J. Fallon, Note, *Source of Strength or Source of Weakness? A Critique of the "Source-of-Strength" Doctrine in Banking Reform*, 66 N.Y.U.L. REV. 1344 (1991); and Leonard Bierman & Donald R. Fraser, *The "Source-of-Strength" Doctrine: Formulating the Future of America's Financial Markets*, 12 Ann. Rev. Banking L. 269 (1993).

⁶⁵ William R. Keeton, *Bank Holding Companies, Cross-Bank Guarantees, and Source of Strength*, FED. RES. BANK OF KAN. CITY ECON. REV., May/June 1990, 54.

⁶⁶ *Id.*

⁶⁷ *Id.* at 56.

⁶⁸ *Id.*

⁶⁹ *Id.* at 57. Among the rationales for the sister-bank exemption in Section 23A was that a bank would be in a better position to rescue a financially troubled sister bank within a holding company system. See Veryl Victoria Miles, *Banking Affiliate Regulation Under Section 23A of the Federal Reserve Act*, 105 BANKING L.J. 476, 486 (1988).

⁷⁰ Keeton, *supra* note 65, at 57 See also Helen A. Garten, *Subtle Hazards, Financial Risks, and Diversified Banks: An Essay on the Perils of Regulatory Reform*, 49 MD. L. REV. 314, 353 (1990) (discussing the risk that banks will divert funds to troubled nonbank affiliates in contravention of affiliate transaction rules).

⁷¹ Keeton, *supra* note 65, at 60-62. It might also be observed that the cross-guarantee provision applies only after a bank subsidiary has failed whereas the source-of-strength doctrine would apply before a failure and if successfully invoked might forestall the failure.

⁷² Garten, *supra* note 70.

⁷³ Garten, *supra* note 70, at 317-318. Although Garten expansively catalogued the risks of diversification to the banking system, she appears to have concluded that the source-of-strength doctrine was not an appropriate approach for dealing with these

risks. *Id.* at 384.

⁷⁴ Both proponents and opponents of the source-of-strength doctrine appeared to acknowledge at times in strikingly similar language that the doctrine contravened traditional corporate law principles. *See, e.g.*, Michael Schinski & Donald Mullineaux, *The Impact of the Federal Reserve's Source of Strength Policy on Bank Holding Companies*, 35 QUARTERLY REV. OF ECONOMICS & FINANCE 483 (1995) (“[i]n contradiction to traditional corporate law, the source of strength policy has mandated a ‘piercing of the corporate veil’ in the case of [bank holding companies]”); Bierman & Fraser, *supra* note 64, at 269 (“in clear contradiction to traditional corporate law, the Federal Reserve has mandated a ‘piercing of the corporate veil’ in the banking industry”) (footnote omitted).

⁷⁵ *See, e.g.*, Broome, *supra* note 41, at 939.

⁷⁶ Jackson, *supra* note 41, at 570.

⁷⁷ *See, e.g.*, Groth, *supra* note 64, at 140-141;

⁷⁸ *See, e.g.*, Gilbert, *supra* note 46, at 4; Groth, *supra* note 64, at 134.

⁷⁹ *See, e.g.*, Fallon, *supra* note 64, at 1393; Brown, *supra* note 64, at 255; Bierman & Fraser, *supra* note 64, at 269.

⁸⁰ *See, e.g.*, Fallon, *supra* note 64, at 1395; Bierman & Fraser, *supra* note 64, at 307.

⁸¹ *See, e.g.*, Fallon, *supra* note 64, at 1394-1398; Bierman & Fraser, *supra* note 64, at 302-303.

⁸² *See id.*

⁸³ *See, e.g.*, Keeton, *supra* note 65; Groth, *supra* note 64.

⁸⁴ *See, e.g.*, Fallon, *supra* note 64, at 1398-1401; Bierman & Fraser, *supra* note 64, at 304-306.

⁸⁵ *See, e.g.*, Fallon, *supra* note 64, at 1384-1390; Garten, *supra* note 70, at 538. *See also* discussion accompanying note 86 *infra*.

⁸⁶ Gilbert, *supra* note 46.

⁸⁷ *Id.* at 13.

⁸⁸ *See* Jackson, *supra* note 41, at 576 n. 247.

⁸⁹ Gilbert, *supra* note 46, at 5. Another study of savings and loan associations in California, Arizona and Nevada covering the period from 1986 to 1990 compared the performance of associations owned by substantial holding companies with the performance of associations owned by individuals or by “shell” holding companies. *See* Howell E. Jackson, *The Superior Performance of Savings and Loan Associations With Substantial Holding Companies*, 22 J. OF LEGAL STUD. 405 (1993). This study concluded that the existence of net worth maintenance agreements lead substantial holding companies to monitor the performance of their savings associations more carefully, resulting in better operational performance, fewer failures, and less cost to the FDIC in the case of a failure. *Id.* *See also* Jackson, *supra* note 41, at 577-578.

⁹⁰ Schinski & Mullineaux, *supra* note 74.

⁹¹ *Id.* at 492.

⁹² *Id.* at 494.

⁹³ Adam B. Ashcraft, *Are Bank Holding Companies a Source of Strength to Their Banking Subsidiaries?*, J. OF MONEY, CREDIT & BANKING 273 (2008). *See also supra* note 49.

⁹⁴ *Id.* at 285.

⁹⁵ *Id.*

⁹⁶ *Id.* at 290.

⁹⁷ *Id.* at 293.

⁹⁸ The Board also uses informal enforcement mechanisms such as a memorandum of understanding, which the Board does not publicly disclose. The Board also uses so-called Section 4(m) agreements (from Section 4(m) of the BHC Act), which are formal agreements but are confidential and are not publicly disclosed.

⁹⁹ *See supra* text accompanying notes 61 and 62.

¹⁰⁰ *See* Joe Adler, “Bank Parents About to Receive a Big ‘Wake-Up Call’,” AM. BANKER, Aug. 20, 2012, at 1.

¹⁰¹ Eric J. Gouvin, *Of Hungry Wolves and Horizontal Conflicts: Rethinking the Justifications for Bank Holding Company Liability*, U. ILL. L. REV. 949, 984 (1999).

¹⁰² In adopting rules to implement the guarantee provision in § 38 of the FDIA, the federal banking agencies stated that the FDIC would have a priority claim in any bankruptcy proceeding of a holding company that had guaranteed an institution’s compliance with a capital restoration plan. *See* 57 Fed. Reg. 44866, 44880 (1992).

¹⁰³ *See* Gouvin, *supra* note 101, at 985.

¹⁰⁴ *See* Havard, *supra* note 57, at 2407-2412. This functional consolidation would be triggered in a fashion similar to that under the prompt corrective action provision of § 38 of the FDIA. The capital restoration plan for the undercapitalized institution would “call for the consolidation of economic resources” of the other insured subsidiaries that are functioning as an economic unit. *Id.* at 2408. The author does not describe the details of how such a consolidation of economic resources would be accomplished.

¹⁰⁵ *See* Broome, *supra* note 41, at 991-1004.

¹⁰⁶ *Id.* at 1000. This observer proposed, however, that the uncapped liability would not enjoy any priority of payment in the bankruptcy of the holding company. *Id.* at 1002 n.254.

¹⁰⁷ *See* Jackson, *supra* note 41, at 616. This proposal envisioned that the liability would be accorded priority in the bankruptcy of a holding company. *Id.* at 619.

¹⁰⁸ *See* Gouvin, *supra* note 101, at 985-999.

¹⁰⁹ *Id.* at 1013.