Board of Governors v. MCorp Financial, Inc.: Evaluating the Source-of-Strength Doctrine

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NOTE

BOARD OF GOVERNORS V. MCORP FINANCIAL, INC.: EVALUATING THE SOURCE-OF-STRENGTH DOCTRINE

INTRODUCTION

The Supreme Court of the United States in Board of Governors v. MCorp Financial, Inc. effectively reinstated the Federal Reserve Board's controversial "Source-of-Strength" doctrine by reversing the Fifth Circuit which had struck down the doctrine one year earlier. Although seldom litigated, the Source-of-Strength doctrine posed significant problems for managers of a bank holding company ("BHC") who were, after 1987, required to recapitalize ailing subsidiaries with parent corporation funds. Moreover, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and the Federal Deposit Insurance Corporation Improvement Act of 1991 both contain provisions increasing the BHC's responsibility for reviving an ailing subsidiary, as well as providing partial funding of Federal Deposit Insurance Corporation ("FDIC") liquidations.

Part I of this Note will discuss the Source-of-Strength doctrine, describing its history and current status. Part II will analyze the MCorp decision, and Part III will discuss the necessity of the Source-of-Strength doctrine in light of recently enacted legislation, the doctrine of corporate separateness, and the failure of regulatory oversight.

This Note will conclude that the Source-of-Strength doctrine is unnecessary beyond its original incarnation as a requirement of BHC formation and expansion.

I. THE SOURCE-OF-STRENGTH DOCTRINE

The Source-of-Strength doctrine is a Federal Reserve Board ("FRB"), self-proclaimed requirement that a BHC guarantee the capital adequacy of its subsidiaries.\(^5\) Initially, the doctrine was employed in the BHC application process\(^6\) but was later expanded to include capital infusions into subsidiaries when deemed necessary by the FRB.\(^7\)

A. Bank Holding Companies

The Bank Holding Company Act of 1956 ("BHCA") defines a BHC as "any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of this chapter."\(^8\) Traditionally, the BHC structure was used to avoid restrictive branching and interstate expansion regulations.\(^9\)

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6. See infra notes 38-71 and accompanying text.

7. See infra notes 91-109 and accompanying text.

(i) Ownership, control, or power to vote 25 percent or more of the outstanding shares of any class of voting securities of the bank or other company, directly or indirectly or acting through one or more other persons;
(ii) Control in any manner over the election of a majority of the directors, trustees, or general partners (or individuals exercising similar functions) of the bank or other company;
(iii) The power to exercise, directly or indirectly, a controlling influence over the management or policies of the bank or other company, as determined by the Board after notice and opportunity for hearing . . . ; or
(iv) Conditioning in any manner the transfer of 25 percent or more of the outstanding shares of any class of voting securities of a bank or other company upon the transfer of 25 percent or more of the outstanding shares of any class of voting securities of another bank or other company.

enactment of the BHCA acknowledged two primary problems with BHCs: (1) the danger of concentration of commercial banking resources through unit acquisitions, and (2) the combination, under a single corporate entity, of banking and non-banking enterprises. The BHC structure is particularly attractive in states such as Texas which prohibit branching.

The BHC structure is much like the standard holding company, except the BHC’s bank ownership justifies regulation. Unlike non-banking holding companies, significant social costs result from BHC failures, especially depletion of federal deposit insurance funds.

William R. Keeton, a senior economist at the Federal Reserve Bank of Kansas City, argues that BHCs adversely affect their subsidiary banks’ safety and soundness in three fundamental ways. First, a BHC’s benefits from diversification are inferior to those achieved by unrestricted branching because the presence of limited liability gives the parent an incentive to allow a subsidiary to fail. This occurs because the FDIC will insure the subsidiary’s losses while the parent appears financially sound. Second, the BHC structure encourages a parent company to engage in improper transactions with its affiliates. While successful transactions promise high profits, failures pose little threat of loss because the FDIC will insure the losses if the bank fails. Improper transactions may take the form of below-market loans to bank officers or subsidiaries, mispriced business deals, or book value purchases of non-performing assets. Finally, the BHC

10. S. REP. No. 91-1084, 91st Cong., 2d Sess. (1970), reprinted in 1970 U.S.C.A.N. 5519, 5520.; see also MACEY & MILLER, supra note 9, at 293-95 (noting inter alia that additional reasons for regulating BHCs include compromise of subsidiary bank integrity through improper transactions and financial favoritism regarding loans).


12. Keeton defined a holding company as a company “that owns or controls other companies and operates those companies as separately incorporated subsidiaries. An important feature of all holding companies is that they enjoy limited liability against the claims of private creditors on their subsidiaries.” Id. at 55.

13. Id.

14. See id. at 56. The BHC will have a strong incentive to allow its subsidiary to fail, even though it will lose its investment in the subsidiary in situations where the subsidiary has experienced heavy losses and is unlikely to return to profitability. In this case the BHC has the advantage of being able to shift its loss onto the FDIC in exchange for foregoing unlikely future profits. Id.

15. See id. at 56-57.

16. See id. (discussing improper transactions and regulatory controls on same, and also noting that an important drawback relates to the likelihood of civil or criminal enforcement
structure encourages undercapitalization of the parent company. The BHC's incentive to engage in risky transactions may result in high leveraging of the parent, thus encouraging the parent to engage in further high-risk activities in order to recover previous losses or to pay down debt. Once again, if the transactions are unsuccessful and the bank fails, federal deposit insurance will cover the losses.

Various solutions have been proposed in response to these issues. One of the most controversial solutions in current practice is the FRB's Source-of-Strength doctrine.

B. Bases of the Source-of-Strength Doctrine

1. The Bank Holding Company Act

The Source-of-Strength doctrine was first used in the context of applications for BHC formation and expansion. Formation of BHCs is governed by section 3 of the BHCA under which the potential BHC must receive FRB permission. Expansion of BHCs is also governed by section 3. BHCs desiring to acquire additional units must also apply for FRB permission which is dependent upon an FRB determination that the acquisition or merger would not result in a

after the damage has been done). Keeton also observes that similar incentives exist for BHC transactions with their non-bank affiliates and that §§ 23A and 23B of the Federal Reserve Act do not necessarily provide full coverage in this area. See also STAFF OF HOUSE SUBCOMM. ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE OF THE COMM. ON BANKING, FINANCE AND URBAN AFFAIRS, 102D CONG., 2D SESS., MCORP: A REGULATORY CASE STUDY 18 (Comm. Print 1992) [hereinafter MCORP STUDY] (discussing below-market loans made by MCorp to certain insiders which allowed the borrowers to pay a 6% interest rate while being able to reinvest the funds in risk-free government securities at over 8.5%; the FRB allowed MCorp to implement this program despite its emerging financial instability).

17. Keeton, supra note 11, at 57.

18. Although the FDIC may be forced to bail out a BHC's subsidiary, the entire organization does not necessarily fail. Id. See generally MCORP STUDY, supra note 16 (discussing the federal bailout of MCorp).

19. Keeton suggests reduction of deposit insurance and permission to branch freely in addition to the Source-of-Strength doctrine and Cross-Bank Guarantees discussed. Keeton, supra note 11, at 57-58; see also MACEY & MILLER, supra note 9, at 264-88 (discussing policy issues in deposit insurance and suggestions for risk reduction).


21. See 12 U.S.C. § 1842(a) (1988) (stating that "[i]t shall be unlawful, except with the prior approval of the Board, (1) for any action to be taken that causes any company to become a bank holding company").
monopoly, and would not substantially lessen competition.\textsuperscript{22} In all cases, the FRB will look to "the financial and managerial resources and future prospects of the company or companies and the banks concerned, and the convenience and needs of the community to be served."\textsuperscript{23} Further, the FRB will take into consideration ease of regulatory supervision and the presence of certain bank stock loans.\textsuperscript{24} The FRB may reject a BHC's application solely on the basis of its findings relating to the BHC's financial and managerial resources.\textsuperscript{25} Expansion into non-banking activities is generally governed by the exceptions to section 4(a).\textsuperscript{26}

The Source-of-Strength doctrine emerged from this statutory framework, specifically based upon section 3's language empowering the FRB to consider the applicant's financial and managerial resources as well as its future prospects.\textsuperscript{27}

2. The Financial Institutions Supervisory Act of 1966

The FRB's cease and desist authority under the Financial Institutions Supervisory Act of 1966 ("FISA")\textsuperscript{28} has been argued to be a source of statutory authority for the Source-of-Strength doctrine as well.\textsuperscript{29} Section 1818(b)(1) allows an appropriate Federal banking agency [which is of the opinion that]

\footnotesize{\begin{enumerate}
\item \textsuperscript{22} 12 U.S.C. § 1842(c)(1) (Supp. III 1991). However, an acquisition, consolidation or merger may be approved notwithstanding anticompetitive effects where the FRB finds that "the anticompetitive effects of the proposed transaction are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served." \textit{Id.} § 1842(c)(1)(B).
\item \textsuperscript{23} \textit{Id.} § 1842(c)(2); \textit{see also id.} § 1842(c)(5) (stating that "[c]onsideration of the managerial resources of a company or bank \ldots shall include consideration of the competence, experience and integrity of the officers, directors, and principal shareholders of the company or bank").
\item \textsuperscript{24} 12 U.S.C. § 1842(c)(2). The FRB may condition approval on the BHC's "adequate assurances" that it will provide appropriate information to aid the FRB in enforcement. \textit{See id.} § 1842(c)(3)(A). The BHC must first submit its application to its "local Federal Reserve bank, \ldots after the local Federal Reserve bank has reviewed the application and made recommendations, it forwards the application to the Board for a final determination." \textit{Fallon, supra} note 2, at 1353 n.49 (describing the application and approval process).
\item \textsuperscript{25} \textit{See Fallon, supra} note 2, at 1353 n.54. Fallon further notes that § 210 of the FDICIA provides similarly.
\item \textsuperscript{26} 12 U.S.C. § 1843(a); \textit{see also Fallon, supra} note 2, at 1354.
\item \textsuperscript{27} \textit{See generally 12 U.S.C. § 1841(c); Clayton Bancshares Corp., 50 Fed. Res. BULL. 1261 (denying application because of financial and managerial deficiencies).
\item \textsuperscript{29} \textit{See generally Groth, supra} note 20, at 126.}
any insured depository institution . . . or any institution-affiliated party is engaging or has engaged, or the agency has reasonable cause to believe that the depository institution is about to engage, in an unsafe or unsound practice [to issue a cease and desist order or an order to take affirmative action].

Further, § 1818(b)(3) provides that the FRB’s cease and desist authority applies to BHCs.

FISA has been justified as statutory authority for the Source-of-Strength doctrine under the common law and its legislative history arguing that the “unsafe or unsound” provisions were intended as a broad delegation of authority in deference to the FRB’s regulatory expertise. Moreover, in 1984 the Supreme Court held in Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc. that “if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency’s answer is based on a permissible construction of the statute.” The agency’s interpretation is reviewed on an arbitrary, capricious, or contrary-to-the-statute standard.

However, as Groth notes, using this language to require a BHC to recapitalize an ailing subsidiary under the rubric of “unsafe or unsound practices” through capital infusions is not necessarily an optimal policy choice. For example, Groth argues that a recapitalization using BHC funds is complicated by the many interests affected. Groth further argues that on balance, the risks inherent in recapitalization, as is typical of banking regulation in general, may be deemed to be assumed by the relevant parties because of the perva-

31. Id. § 1818(b)(3).
32. See Groth, supra note 20, at 126-32 (justifying FISA as a source of statutory authority for the Source-of-Strength doctrine). Groth includes numerous cases supporting FISA as statutory authority for banking regulators’ broad-based interpretive authority. See, e.g., Groos Nat’l Bank v. Comptroller of Currency, 573 F.2d 889, 897 (5th Cir. 1978) (holding that “[t]he phrase ‘unsafe or unsound banking practice’ is widely used in the regulatory statutes and in case law, and one of the purposes of the banking acts is clearly to commit the progressive definition and eradication of such practices to the expertise of the appropriate regulatory agencies”).
34. Id. at 843.
35. Id. at 844; see also Groth, supra note 20, at 129 (discussing the observation in Investment Co. Inst. v. FDIC, 815 F.2d 1540, 1550 (D.C. Cir. 1987), that “Congress intended to delegate a substantial degree of authority to the agency by the use of (the language in § 1818(b)(1))”).
36. Groth, supra note 20, at 127.
sive nature of banking regulation. However, this argument fails to account for situations where capital infusions would do more harm than good, such as where the entire organization would be financially damaged by the order.

3. The Early Cases

The FRB’s first use of the term “Source-of-Strength” occurred in *First Southwest Bancorporation*. In *First Southwest*, the FRB denied a Texas BHC’s application to acquire four banks because of the holding company’s questionable managerial practices which the FRB determined were likely to harm the subsidiaries and minority shareholders. The FRB, in rejecting the application, stated that “a holding company should be a source of financial and managerial strength for the banks in its systems rather than vice versa.”

The FRB elaborated on this theme in *Downs Bancshares, Inc.*, in which it denied Downs’s application for approval of its formation of a BHC, which would also operate a general insurance agency, because of capital deficiencies which would result in the BHC’s inability to meet unexpected contingent needs. In considering Downs’s application, the FRB first noted that “consummation of the proposal would not eliminate significant existing or potential competition, increase the concentration of banking resources, or have an adverse effect on other banks in the relevant market . . . .” However, after closer examination, the FRB decided to reject the application, stating that even though the principals had provided personal guarantees to amortize the debt incurred by the transaction, “the debt retirement program does not provide [Downs] with the necessary financial flexibility to service the acquisition of debt while maintaining Bank’s capital at an acceptable level.” The FRB finally determined

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37. *Id.* at 130. Risks of recapitalization may involve slowed BHC growth, discouragement of BHC diversification or adverse financial impact on the BHC itself. Keeton, *supra* note 11, at 62; *see also* Fahey v. Mallonee, 332 U.S. 245, 250 (1947) (observing that the banking industry is one of the most heavily regulated).

38. 58 FED. RES. BULL. 301 (1972).

39. *Id.* at 302; Fallon, *supra* note 2, at 1365 n.134 (discussing *First Southwest* and the FRB’s reasons for denying the company’s application); *see also* 1 HARVEY L. PITT ET AL., *THE LAW OF FINANCIAL SERVICES* 40.1 (1992) (citing cases discussing BHCs’ need to serve as sources of strength to its subsidiaries).

40. 61 FED. RES. BULL. 673 (1975).

41. *Id.* at 674.

42. *Id.*

43. *Id.*
that "the financial requirements . . . [of the transaction] could prevent it from resolving any unforeseen problems that may arise at Bank and thereby impair Bank's ability to continue to serve the community as a viable banking organization." Not only was capital flexibility a requirement, but the FRB would presumably require a showing that such capital flexibility would be used in the event of subsidiary need.

The FRB's rejection of an application in Seilon, Inc.\textsuperscript{46} to acquire a Nevada BHC provides insight into the FRB's analysis of managerial considerations. Seilon sought to purchase a controlling interest in the First Bancorporation of Reno, Nevada, then the fourth largest of Nevada's eight commercial banks.\textsuperscript{47} Although the FRB initially determined that the transaction would have no anticompetitive or anticonvenience effects, rejection was based upon both financial and managerial deficiencies.\textsuperscript{48} The FRB noted that Seilon's nonbanking activities were operating at a loss.\textsuperscript{49} Acquisition of the bank would be the only way that Seilon could expect to show a profit; thus, showing that Seilon would not only fail to be a "Source-of-Strength" to its subsidiary, but it would also have significant incentive to "endeavor to improve its financial condition at the expense of Bank through liberal or excessive dividends or management fees drawn from Bank."\textsuperscript{50} The Seilon decision also focused upon managerial deficiencies. The FRB noted that the bank would be subject to absentee management.\textsuperscript{51} In addition, no member of the board had any in-depth banking experience.\textsuperscript{52} Thus, Seilon's application was denied.

However, the FRB will approve an application where the applicant commits to an acceptable capital improvement program. \textit{Northern States Financial Corp.}\textsuperscript{53} involved the formation of a BHC through the acquisition of the City National Bank of Detroit, Michigan. At the

\textsuperscript{44} \textit{Id.}
\textsuperscript{45} \textit{See, e.g., Seilon, Inc., 58 Fed. Res. Bull. 729 (1972) (stating that "[t]he Board has previously stressed the importance of financial strength of a [BHC] so that it can assist its subsidiaries with capital if the need arises").}
\textsuperscript{46} \textit{Id.}
\textsuperscript{47} \textit{Id.}
\textsuperscript{48} \textit{Id.}
\textsuperscript{49} \textit{Id.}
\textsuperscript{50} \textit{Id. at 729-30.}
\textsuperscript{51} \textit{Id. Only one of Seilon's five directors was a Nevada resident.}
\textsuperscript{52} \textit{Id.}
\textsuperscript{53} \textit{58 Fed. Res. Bull. 827 (1972).}
time, City National had $529 million in deposits and operated thirty offices in the greater Detroit area. Although the FRB could not find any anticompetitive tendencies, it noted that Northern States, being a newly formed entity, would have to rely upon its potential bank subsidiary for its financial and managerial soundness. The FRB observed that while the banks had satisfactory finances, as banking subsidiaries, their capital positions required improvement. Thus, approval of the applications was based upon a $25 million capital improvement program directed at strengthening the bank and at enhancing its prospects.

Generally, the banking community accepted this form of the Source-of-Strength doctrine. However, Board of Governors v. First Lincolnwood Corp., an unsuccessful challenge to the doctrine, provided further confirmation of the validity of the doctrine at the BHC application level.

4. The First Lincolnwood Decision

In First Lincolnwood, the majority stockholders of the First National Bank of Lincolnwood organized a holding company (First Lincolnwood Corp.) with the intention of exchanging their bank stock for holding company stock. In addition, the BHC would assume $3.7 million in debt the stockholders incurred in acquiring control of the bank. The dividends that the BHC received on the bank’s stock would be used to amortize the debt over a twelve-year period. Finally, the arrangement would have allowed the bank and the BHC to file consolidated tax returns, thus providing a significant tax benefit.

54. Id. at 828.
55. Id.
56. Id.
57. Id.
58. Fallon, supra note 2, at 1366 & n.136.
60. Id. at 237.
61. Id. Pursuant to the transaction, the stockholders would remain secondarily liable under the $3.7 million obligation. Id. at 237 n.3.
62. Id. at 238.
63. Id. Allowing the group to file a consolidated tax return would allow it to deduct debt service interest from the bank’s gross income. The tax benefit could then be transferred to the BHC as a tax-free intercorporate dividend, which could subsequently be used to retire the debt incurred through the acquisition. Id. at 238 n.4; see also Internal Revenue Code of 1954, 26 U.S.C. § 1501 (1958) (allowing an affiliated group of corporations to file consolidated tax returns).
The initial proposal was approved by the local Federal Reserve Bank on the strength of the bank's future prospects and strong management. However, the Comptroller of the Currency, upon independent review determined that the application should be denied because the bank's capital position was "inadequate," and was unlikely to improve under the proposal. A modified plan was submitted and was approved by both the Chicago Federal Reserve Bank and the Comptroller, but was rejected by the FRB staff after a determination that material capital improvement was necessary.

The Seventh Circuit, upon rehearing, set aside the FRB's order holding that section 3(c) of the BHCA justified denial of an application based on the Source-of-Strength doctrine only where the deficiencies were "caused or enhanced by the proposed transaction," which was a mere reshuffling of ownership interests in the organization.

The Supreme Court reversed, holding that the FRB's interpretation of section 3(c) was supported by both the language of the statute and Congressional intent. Initially, the Court stated that section 3(c) required the FRB to evaluate a BHC's financial and managerial soundness "in every case, not just in cases in which the Board finds that the transaction will have an anticompetitive effect." Second, in examining legislative intent and subsequent amendments to the BHCA, the Court determined that there was no ambiguity concerning the weight which may be attached to financial and managerial factors in connection with language borrowed from the Bank Merger Act. Third, the Court noted that upholding the doctrine was supported by the principle of great deference to an agency's long-standing interpretation of its statutory mandate, "especially when Congress has refused to alter the administrative construction." Finally, the Court held

64. Board of Governors v. First Lincolnwood Corp., 439 U.S. 234, 239 (1978). The Court defined "capital position" as "the ratio of equity capital to total liabilities less cash on hand, known as the invested-asset ratio." Id. at 239 n.6.
65. Id. at 240-41. The FRB further found that "even if the bank's optimistic earnings projections were realized, respondent would lack the financial flexibility necessary both to service its debt and to maintain adequate capital at the bank." Id.
66. Id. at 242.
67. Id. at 243.
68. Id. at 245 n.11. The Court stated that even though there may have been some ambiguity, it was resolved in favor of the Source-of-Strength doctrine by Senator Robertson, Chairman of the Senate Banking and Currency committee, who stated that "if there are no substantial anticompetitive effects and no tendency to create a monopoly and no suggestion of restraint of trade, the banking agency will proceed to consider the merger on the basis of the financial and managerial resources and future prospects of the existing and proposed institutions and the convenience and needs of the community to be served." Id.
69. Id. at 248. The Court also stated that "Congress has been made aware of this
that the doctrine was not limited to situations where the unsoundness would be either caused or exacerbated by the transaction.\textsuperscript{70} In addition to finding no intent to so limit the doctrine, the Court relied once again on its deference to agency interpretations.\textsuperscript{71} The Supreme Court, by validating the Source-of-Strength doctrine and refusing to limit it to merely unsatisfactory transactions, set the stage for the evolution of the doctrine into its present form as an all-purpose enforcement weapon.

5. Regulation Y and the 1987 Policy Statement

In 1984, the FRB promulgated section 225.4(a)(1) providing that "[a] bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner."\textsuperscript{72} The new regulation was promulgated without explanatory remarks. Industry analysts simply assumed that the regulation was a mere codification of the original Source-of-Strength policy.\textsuperscript{73}

It soon became apparent that the FRB intended to expand the Source-of-Strength doctrine rather than to merely codify it.\textsuperscript{74} In 1987, the FRB attempted to use the Source-of-Strength doctrine to force Iowa’s Hawkeye Bancorp to recapitalize a failing subsidiary after a debt restructuring; however, the FRB abandoned the charges.\textsuperscript{75} The FRB took the position that the parent’s failure to serve as a Source-of-Strength was an unsafe and unsound practice.\textsuperscript{76} Although the BHC refused to comply with the order, state banking authorities closed the subsidiary and the FRB withdrew its charges.\textsuperscript{77}

In response to the Hawkeye Bancorp case, the FRB released a policy statement in 1987 clearly indicating the FRB’s intent to hold

\textsuperscript{70} Id. at 249.

\textsuperscript{71} Id. at 251.

\textsuperscript{72} 12 C.F.R. § 225.4(a)(1) (1992). Section 225.4(a)(1) was promulgated as part of the FRB’s comprehensive 1984 revisions to Regulation Y. Fallon, supra note 2, at 1368.

\textsuperscript{73} Fallon, supra note 2, at 1368 n.159.

\textsuperscript{74} See id. at 1369.

\textsuperscript{75} Id. According to Fallon, the FRB dropped the Source-of-Strength charges because enforcement would have caused Hawkeye to violate its debt restructuring agreement. Id.

\textsuperscript{76} Id. The FRB ordered Hawkeye to provide the subsidiary with $1.2 million in new capital. Id.

\textsuperscript{77} Id. Fallon further noted that commentators had stated that the reason the FRB dropped the charges was because it had failed to compile a sufficient record of inadequate capitalization. Id. at 1369-70 n.167.
BHCs financially and managerially responsible for their ailing subsidiaries.\textsuperscript{78} The FRB policy statement ("Policy Statement") opens by reiterating its "long-standing principle" that "bank holding companies should serve as sources of financial and managerial strength to their subsidiary banks."\textsuperscript{79} However, the Policy Statement departs from the original version of the Source-of-Strength doctrine by confirming what was implied in the Hawkeye Bancorp matter; 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 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.\textsuperscript{80}

Next, the Policy Statement asserts prior approval of the doctrine through "frequent pronouncements," section 225.4(a)(1) of Regulation Y, and the First Lincolnwood decision. The Policy Statement also provides that the doctrine is justified through the benefits that BHCs derive at the corporate level from their ability to access Federal Reserve credit and to take in deposits that are federally insured.\textsuperscript{81} Also, the FRB stated that the doctrine was further justified by BHCs' "critical fiduciary responsibilities of depository institutions as custodians of depositors' funds and their strategic role within our economy as operators of the payments system and impartial providers of credit."\textsuperscript{82}

Failure to provide financial support for ailing subsidiaries, according to the FRB, would "be viewed as an unsafe and unsound banking practice or a violation of Regulation Y or both . . . [enforceable by] issuance of a cease-and-desist order or other enforcement action."\textsuperscript{83} However, the FRB also acknowledged that "there may be

\textsuperscript{78} See Policy Statement on the Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks, 52 Fed. Reg. 15,707 (1987), reprinted in Fed. Banking L. Rep. (CCH) ¶ 43,055A, at 22,058 [hereinafter Policy Statement]. The Policy Statement fails to indicate whether a BHC would be held solely responsible for recapitalizing a subsidiary, especially where the BHC does not own all of the subsidiary's stock. The Policy Statement does indicate that exceptions are possible in unusual and limited circumstances. However, presumably, the recapitalization remedy would only be imposed on a party which was in control of the subsidiary in accordance with the FRB's definition of control at 12 C.F.R. § 225.2(e)(1) (1992).

\textsuperscript{79} Policy Statement, supra note 78, at 22,058.

\textsuperscript{80} Id.

\textsuperscript{81} Id.

\textsuperscript{82} Id.

\textsuperscript{83} Id.
unusual and limited circumstances where flexible application of the
[doctrine] might be necessary . . . [and may justify exceptions].”

Fallon identifies three problematic issues raised by the Policy
Statement. First, the Policy Statement fails to specify either the
amount a BHC might be required to transfer to its subsidiary, or the
method for calculating the amount. Second, the Policy Statement
provides no definition of a failure to support that would constitute a
violation. Finally, no assurance was given that BHCs which would
be unable to provide funding would be exempted from the doc-

trine. Moreover, the new Source-of-Strength doctrine was widely
criticized by government agencies such as the Securities and Ex-
change Commission and the FDIC, as well as private organizations
such as the Shadow Financial Regulatory Committee. Thus, armed
with its newly enhanced Source-of-Strength doctrine, the FRB was
prepared for its first major challenge to the expanded doctrine, MCop
Financial, Inc. v. Board of Governors.

II. THE MCoRP DECISION

A. The Facts

MCorp Financial was formed in 1984 as a result of the merger
of the Mercantile Texas Corporation of Dallas and Southwest
Bancshares of Houston. By 1986, with twenty-five subsidiaries and
over $20 billion in assets, MCorp had become the largest Texas BHC
and was ranked in the top twenty-five BHCs nationwide. However,
during this two-year period of growth, MCorp amassed an unsafe
portfolio of classified assets and net operating losses which were

84. Id. It is unclear, however, what situations would justify an exception to the doctrine.
85. Fallon, supra note 2, at 1371.
86. Id.
87. Id.
88. See id. (observing that the problems associated with the Policy Statement caused
"quick and vociferous opposition"); see also Basis for Fed's "Source-of-Strength" Policy is
Questionable, Breeden Says, 49 Banking Rep. (BNA) 541 (Sept. 28, 1987) (noting that the
document could: force BHC directors to breach fiduciary duties to shareholders to avoid
regulatory consequences; adversely affect BHC debt ratings; and contradict business judgment
rule principles dictating that the decision to prop up an ailing subsidiary rests with the
discretion of the company's management); William M. Isaac, Conflicts in the Fed's 'Source
of Strength' Doctrine, AM. BANKER, Dec. 28, 1988, at 4; SFRC Statement, supra note 5
(noting problems with the Source-of-Strength Doctrine).
90. See MCoRP STUDY, supra note 16, at 5.
91. Id.
discovered by both the FRB and the Comptroller of the Currency in their periodic examinations. Despite this, no intervention occurred.\textsuperscript{92} Although these problems were noted in examination reports, MCorp and its subsidiaries "consistently ignored [recommendations and informal memoranda of understanding], internal controls were materially deficient, dividends were paid despite substantial losses, and formal enforcement actions were not initiated by either the FRB or the OCC."\textsuperscript{93} Eventually, primary capital had become so depleted that federal regulators were forced to declare twenty of the twenty-five subsidiary banks insolvent. The cost of the failure is estimated to be over $2.7 billion.\textsuperscript{94}

**B. The Fifth Circuit Opinion**

In October of 1988, prior to the Office of the Comptroller of the Currency's ("OCC") appointment of the FDIC as receiver of twenty of MCorp's banking subsidiaries, the FRB had issued an Amended Notice of Charges alleging unsafe and unsound practices and ordering implementation of "an acceptable capital plan that would ensure that all of MCorp's available assets are used to recapitalize the [subsidiaries]."\textsuperscript{95} Five months later, in March of 1989, a group of MCorp's creditors commenced an involuntary bankruptcy proceeding in the Southern District of New York.\textsuperscript{96} After the OCC appointed the FDIC as receiver, MCorp and two of its subsidiaries voluntarily filed a Chapter 11 petition in the Southern District of Texas.\textsuperscript{97} Shortly thereafter, both proceedings were consolidated in the Southern District of Texas.\textsuperscript{98} The FRB appealed the district court's preliminary injunction staying further prosecution of both the Source-of-Strength and section 23A\textsuperscript{99} administrative proceedings. Bankruptcy court approval

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\textsuperscript{92} Id. The MCORP STUDY defines "Classified Assets" as "assets which have been designated as either substandard, doubtful or loss. They are typically loans which the bank has reason to believe will not be repaid in full." \textit{Id.} at 5 n.1.

\textsuperscript{93} Id. at 5. Further, even though MCorp was financially distressed, an "executive loan" program was instituted which would provide selected senior managers with below-market loans which were easily invested in federally insured certificates of deposit for arbitrage profits. The executive loan program was estimated to have added $8.5 million to the bailout's cost. \textit{Id.} at 18, 20.

\textsuperscript{94} Id. at 6. The MCorp failure is the third largest bank failure in United States history.

\textsuperscript{95} MCorp Financial, Inc. v. Board of Governors, 900 F.2d 852, 853 (5th Cir. 1990).

\textsuperscript{96} Id. at 853.

\textsuperscript{97} Id. at 854.

\textsuperscript{98} Id.

of any further proceedings was also required.\textsuperscript{100}

The Fifth Circuit agreed with the FRB's contention that § 1818(i) of the FISA granted the FRB exclusive jurisdiction over its own administrative proceedings. However, the court also stated that in accordance with \textit{Leedom v. Kyne},\textsuperscript{101} if an agency's actions exceeded its statutory authority, § 1818(i) would not prevent judicial review prior to a final decision by the agency.\textsuperscript{102} The section 23A proceeding was found to be within the FRB's statutory authority.

However, the court then held that the FRB's use of the enhanced Source-of-Strength doctrine exceeded its statutory authority under §§ 1818(b)(1) and (3) of the BHCA to regulate unsafe or unsound practices.\textsuperscript{103} In striking down the doctrine, the court first acknowledged that although \textit{First Lincolnwood} gave the FRB the authority to evaluate financial and managerial soundness in the context of formation and expansion applications, it did not provide this authority beyond that context.\textsuperscript{104} Second, in addressing the FRB's assertion of authority under FISA, C.F.R. § 225.4(a)(1) and its \textit{Policy Statement}, the court observed that although agencies' interpretations of unclear statutory matters should be afforded deference, "the courts may invalidate the agency's interpretation . . . if it is 'unreasonable' or 'impermissible.'"\textsuperscript{105}

In finding the FRB's interpretation of the BHCA impermissible, the court determined that the Congressional definition of "unsafe or unsound" practices\textsuperscript{106} did not entail requiring an infusion of funds which would clearly violate not only principles of corporate separate-

\textsuperscript{100} Board of Governors, 112 S. Ct. at 461.

\textsuperscript{101} 358 U.S. 184 (1958). In \textit{Leedom}, the Supreme Court, speaking through Justice Whittaker, allowed judicial review of a National Labor Relations Board proceeding which, like the instant proceeding, was expressly precluded from judicial review by statute. The Court held that where an agency has exceeded its statutory authority, the courts may intervene to "strike down" the order. \textit{Id}. at 188.

\textsuperscript{102} See \textit{MCorp Financial, Inc. v. Board of Governors}, 900 F.2d 852, 857-58 (5th Cir. 1990).

\textsuperscript{103} \textit{Id}. at 863.

\textsuperscript{104} \textit{Id}. at 861.

\textsuperscript{105} \textit{Id}. at 862.

\textsuperscript{106} The court stated that the authoritative definition of "unsafe or unsound" practices "embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds." \textit{Id}. at 863.
ness, but also standards of prudent operations and fiduciary duties to shareholders. Moreover, Congress consistently failed to include any Source-of-Strength doctrine in any of its revisions of the BHCA. Further, Congress specifically defined limitations “on transactions considered unsound between subsidiary banks and holding companies,” without providing for capital infusions. Thus, the doctrine appeared to have been invalidated.

C. The Supreme Court Opinion

The Supreme Court’s reversal of the Fifth Circuit effectively reinstated the Source-of-Strength doctrine without rendering an opinion as to its validity. First, the Court reaffirmed that both administrative proceedings were squarely within the ambit of the § 1818(i) preclusion. Moreover, the Bankruptcy Code’s automatic stay provision did not apply because the proceedings fell within the “governmental unit’s police or regulatory power” exemption. Finally, Justice Stevens distinguished Leedom v. Kyne on two grounds. First, unlike Leedom, the FRB proceeding provided a framework for subsequent review of its findings. Second, the preclusive language in the FISA was expressly stated, whereas, in Leedom, the preclusion was only implied. In light of the FISA’s clear statutory preclusion, the judiciary was thus precluded from reviewing FRB administrative proceedings unless the respondent would be otherwise deprived of a meaningful opportunity to challenge the decision. Thus, since jurisdiction was lacking, the Court declined to proceed to the merits of the Source-of-Strength doctrine.

107. Id.
108. Id. Also, the Shadow Financial Regulatory Committee stated that Congress failed to permit regulators to issue demands such as those associated with the Source-of-Strength doctrine to BHCs, while specifically allowing the same to occur with “institutions in their charge.” Id.
110. Id. at 463.
114. Board of Governors, 112 S. Ct. at 466.
115. Id. at 464; see also Fallon, supra note 2, at 1378.
III. EVALUATING THE SOURCE-OF-STRENGTH DOCTRINE

A. Justifications for the Doctrine

Several justifications are posed in support of the doctrine. First is the doctrine's ability to combat moral hazard problems inherent in federal deposit insurance.116 According to Groth, federal deposit insurance results in moral hazard problems both from management and depositor viewpoints because federal deposit insurance allows bank managers incentives to incur greater risks with depositors' funds. The same insurance gives the depositor no incentive to inquire into the financial health of his bank.117 The moral hazard issue is linked to the Source-of-Strength doctrine in situations where a bank subsidiary becomes financially weak. In those situations, the BHC's management has increased incentives to engage in high-risk transactions hoping that success will improve the subsidiary's position, and knowing that federal deposit insurance will cover the downside risk.118 Arguably, the Source-of-Strength doctrine may counteract this problem by holding BHCs responsible for the results of the failed transactions. However, the moral hazard problem may be combatted in other, more direct ways, such as risk-adjusted insurance premiums, or prohibitions on certain transactions for banks with inferior CAMEL ratings.119 In fact, as of November 14, 1991, the Comptroller links CAMEL ratings to decisions to commence enforcement proceedings.120

A second justification is that the doctrine will prevent BHCs from engaging in improper transfers of funds between subsidiaries.121 In this situation, transfers in violation of the principles of corporate separateness justify disregard of the corporate form, and thus, the doctrine may be useful here.

A final justification of the doctrine posits that the possibility of

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116. Moral hazard is a problem encountered when an insurance plan results in the insured having either no incentive to avoid risk, or the incentive to affirmatively seek out risk. WILLIAM J. BAUMOL & ALAN S. BLINDER, ECONOMICS: PRINCIPLES AND POLICY 550 (3d ed. 1985).

117. See Groth, supra note 20, at 137. Moreover, banks' federal deposit insurance premiums do not depend on investment risk levels, thus contributing to managers' incentives to incur particularly unsafe risks.

118. Id. at 138.


120. Id. at 21.

121. See Fallon, supra note 2, at 1383.
capital infusion orders give BHCs incentives to maintain proper capitalization at its subsidiaries. However, as discussed in the section below on corporate separateness, BHCs have every incentive to properly maintain adequate capital reserves at their subsidiaries.

B. Statutory Alternatives

1. Cross-Bank Guarantees

The FDIC's cross-guarantee provision provides undercapitalized bank subsidiaries with a congressionally-supported alternative to the Source-of-Strength doctrine. Section 206 of the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA") provides that:

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[a]ny insured depository institution shall be liable for any loss incurred by the [FDIC] ... in connection with (i) the default of a commonly controlled insured depository institution; or (ii) any assistance provided by the [FDIC] to any commonly controlled insured depository institution in danger of default. Further, the cross-guarantee provisions provide for discretionary waiver of assessments "if the [FDIC] determines that such exemption is in the best interests of the Bank Insurance Fund ...."
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The cross-guarantee provisions were submitted in response to cases such as MCorp, in which a number of subsidiaries would become insolvent while others retained profitability. The problem arose, of course, where the BHC would not call upon its profitable subsidiaries to support the troubled ones.

In requiring the healthy banks to support the ailing ones, the FDIC resolves the problem of inferior benefits of geographic diversification. Given cross-guarantees, BHCs would be forced to utilize the risk-spreading benefits of geographic diversity rather than to merely allow subsidiaries to fail automatically. Therefore, a BHC would at least have to make a prudent attempt to restore the financial

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122. Id.
123. 12 U.S.C. § 1815(e)(1)(A) (Supp. III 1991). The provision defines "commonly-controlled" as institutions "which are controlled by the same depository institution holding company ..." Id. § 1815(e)(9)(A). Therefore, BHCs' subsidiaries are governed by this section.
124. Id. § 1815(e)(5)(A).
125. See Keeton, supra note 11, at 58.
126. Id.
127. See supra note 14 and accompanying text; Keeton, supra note 11, at 58-59.
128. See Keeton, supra note 11, at 59.
stability of its subsidiaries where it is feasible. Cross-guarantees also promote safe banking by removing the incentive for a BHC to strip its failing subsidiaries of assets for the benefit of more profitable subsidiaries.

Keeton points out several drawbacks to the cross-guarantee scheme. First, cross-guarantees might discourage potentially efficient mergers because, after the merger, the shareholders would be exposed to greater downside risks if their bank remains profitable but is forced to pay for the bailout of a failed acquisition. Second, BHCs will find it more difficult to obtain capital because investment returns will be reduced by the cost of bailouts. Third, federal regulators will find it harder to dispose of the assets of failed institutions because BHCs will be less willing to purchase failed banks. Fourth, the cross-guarantee provisions, by virtue of express statutory language, only allow the FDIC to recover when the subsidiary has either failed or is already in need of assistance. Finally, the FDIC may only recover from other subsidiaries, not the BHC itself.

The cross-guarantee provisions may be viewed as complementary to the Source-of-Strength doctrine, however, the Source-of-Strength doctrine has never been formally enacted by Congress, which opted instead for the “Prompt Corrective Action” provisions of the FDIC Improvement Act (“FDICIA”).

2. The FDIC Improvement Act of 1991

One of the regulatory repercussions of the MCorp decision was the addition of the “Prompt Corrective Action” provisions of the FDICIA. Section 131(e) of the Act provides that undercapitalized institutions will be monitored, and in addition, must submit

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129. Id.
130. Id.
131. See id. at 59.
132. See id. However, Keeton suggests that these decreased returns might be mitigated by linking a bank's insurance premiums and capital requirements to its degree of geographic diversification. Id.
133. Id. Keeton observes that the disincentive to engage in “Whole-Bank” transactions is unfortunate because certain benefits are derived from these transactions, such as maintenance of the failed bank as a going concern and positive customer relations. Id. However, this problem could be easily mitigated by waiving cross-guarantees for these transactions. Id.
134. See 12 U.S.C. § 1815(c)(1)(A); Groth, supra note 20, at 133.
135. Groth, supra note 20, at 134. However, this factor may be insignificant if the majority of the organization's capital is held at the subsidiary level.
137. Id.; see also Fallon, supra note 2, at 1379.
138. The FDIC Improvement Act defines “undercapitalized” as “[a failure] to meet the
a capital restoration plan to the appropriate federal banking agency.\footnote{Id. \S 1831o(e). This section calls for close regulatory monitoring of institutional condition, compliance with capital restoration plans, restrictions or requirements imposed, and periodic review of the plan, restrictions and requirements.}

An acceptable capital restoration plan would:

i) specify—
   (I) the steps the insured depository institution will take to become adequately capitalized;
   (II) the levels of capital to be attained during each year in which the plan will be in effect;
   (III) how the institution will comply with the restrictions or requirements then in effect . . . and
   (IV) the types and levels of activities in which the institution will engage; and
(ii) contain such other information as the appropriate Federal banking agency may require.\footnote{Id. \S 1831o(e)(2)(B).}

The FRB would accept a plan that (1) complies with section 131(e)(2)(B), (2) is based on realistic assumptions and is likely to succeed, and (3) would not increase the institution’s exposure to risk. Also, the controlling institution must guarantee compliance with the plan until full capitalization has been achieved for at least four calendar quarters, and must provide assurances of performance.\footnote{Id. \S 1831o(e)(2)(C).}

Section 131 appears to be, and has been stated to be, tantamount to the current Source-of-Strength doctrine.\footnote{See Fallon, supra note 2, at 1379 (noting that “Treasury Secretary Nicholas Brady correctly noted that this provision is tantamount to the Board’s source-of-strength doctrine”).} Nevertheless, Congress appears to have rejected the FRB’s version of the doctrine insofar as BHC liability is limited to the lesser of five percent of the subsidiary’s total assets at the time the subsidiary became undercapitalized, and the amount which would bring the subsidiary into compliance with the FRB’s capital requirements. Clearly, section 131 does not subject the BHC to potentially unlimited liability as is possible under the Source-of-Strength doctrine.\footnote{12 U.S.C. \S 1831o(e)(2)(E); Fallon, supra note 2, at 1379.} These requirements are superior to Source-of-Strength capital requirements because not only are they more concrete, but the presence of set limits prevents regulators from demanding capital infusions which may be either financially

\footnote{12 U.S.C. \S 1831o(b)(1)(C).}

\footnote{139. Id. \S 1831o(e). This section calls for close regulatory monitoring of institutional condition, compliance with capital restoration plans, restrictions or requirements imposed, and periodic review of the plan, restrictions and requirements.}

\footnote{140. Id. \S 1831o(e)(2)(B).}

\footnote{141. Id. \S 1831o(e)(2)(C).}

\footnote{142. See Fallon, supra note 2, at 1379 (noting that “Treasury Secretary Nicholas Brady correctly noted that this provision is tantamount to the Board’s source-of-strength doctrine”).}

\footnote{143. 12 U.S.C. \S 1831o(e)(2)(E); Fallon, supra note 2, at 1379.}
futile or not feasible for the BHC. Also, the FDICIA’s requirements are unlikely to require a capital transfer which would be viewed as corporate waste by shareholders.

C. Non-Statutory Issues

1. The Necessity of Corporate Separateness in BHC Regulation

In general, business organizations adopt the corporate form primarily to limit investor liability. Likewise, holding corporations will maintain corporate separation from their subsidiaries for the same reasons. Regardless of the organization’s structure, courts will generally recognize the corporate form in the absence of certain conditions. These principles are no less important in the banking industry. Thus, doctrines such as Source-of-Strength, which are implemented notwithstanding corporate separateness and the requirements for disregard of corporateness, do violence to these concepts and erode their usefulness in the banking context.

The special character of the banking industry provides at least four overarching motives to promote corporate separateness in BHC governance and regulation. Use of agency-contrived methods of disregard for corporate separateness, such as the Source-of-Strength doctrine, threaten the sanctity of this principle.

First, corporate separateness minimizes the likelihood that bank deposits would be used in ways that would increase the overall risk exposure of the banking subsidiary. For example, a BHC may be


145. See id. at 354-56 (discussing corporate separateness among parent and subsidiary corporations).

146. Id. at 355-56. Henn & Alexander posit that the corporate form will be recognized “absent illegitimate purposes” unless: (1) transactions, employees or assets of the entities are commingled; (2) the entities are not treated as separate entities through observance of separate corporate formalities; (3) the entities are undercapitalized; (4) the entities are not held out to the public as separate entities; and (5) the policies of one of the affiliated entities is directed towards the interests of the other entity rather than its own. See id.


tempted to use its banking subsidiary's funds to rescue a failing non-banking subsidiary. This goal of separateness directly conflicts with the Source-of-Strength doctrine which directs that such a scenario occur even though the relevant entities are legally independent.

Second, separateness prevents banking subsidiaries from using federally insured deposits, obtained at below-market rates, to fund its non-bank activities.9

Third, separateness aids in the independent regulation of each of the BHC's entities. Several of the BHC's subsidiaries may be subject to separate reviewing authorities, such as state banking or insurance regulators. Corporate separateness allows each regulatory agency to evaluate the relevant subsidiary without overlapping with another agency's responsibilities.10 Professor Clark states that this motive is the most important component in the argument for corporate separateness because risk assessment becomes much easier when each entity is considered separately.11 Otherwise, industry regulators would not only have to evaluate the risk of the individual entity, but would also have to determine how that risk contributes to and is influenced by the other subsidiaries.12

Finally, BHCs have the incentive to form separate entities in order to decrease overall risk.13 Black, Miller, and Posner argue that risk may be decreased through diversification into both permissible non-banking fields as well as geographic diversification (where possible).14

These motives assume that an assumption of independence is made.15 This assumption posits that in addition to the aforementioned forbearance from inter-subsidiary fund transfers and independent risk evaluation, the capital market views the subsidiaries as inde-

149. Id. at 146.
150. Id.
152. Id.
153. See Fischer Black et al., An Approach to the Regulation of Bank Holding Companies, 51 J. BUS. 379, 393 (1978). But see Keeton, supra note 11 (discussing increased risk resulting from BHC diversification).
154. Black et al., supra note 153, at 393. Black, Miller, and Posner also argue that BHC risk may be increased in instances such as runs on subsidiary banks following a non-banking subsidiary's failure, or where bank deposits are used bail out a non-banking subsidiary. Id. at 394.
pendent. Competing with this view is the dependence assumption. This assumption posits that in addition to engaging in inter
subsidiary fund transfers, corporate insiders, depositors, and the capital markets view the BHC and its subsidiaries as an interdependent whole. It is the dependence assumption that lends undue credence to the perceived efficacy of the Source-of-Strength doctrine.

Provided that BHCs encourage a policy of formal separateness, outside constituencies should likewise evaluate the BHC and its subsidiaries as separate entities. Professor Clark argues that the problem of unnecessary runs on healthy subsidiary banks after a non-banking subsidiary fails could be mitigated simply by operating the subsidiaries under different names. Coextensively, sophisticated lenders will recognize the legal and practical distinctions between the BHC and its subsidiaries and will structure their lending policies with less regard to covariant risks. In fact, one commentator argues that if banking regulators adopt a clearer policy stance on this issue, it would further reassure these constituencies. Concomitantly, while courts are unlikely to disregard the corporate form, they are especially unlikely to do so in the banking context. Moreover, stronger regulation on intercompany transactions, dividend policy, and capital adequacy would achieve the same results.

An implicit fear in the Source-of-Strength doctrine is that a BHC

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156. Id. The competing view argues that an assumption of dependence should be made. This view posits that the capital market sees the BHC and its subsidiaries as an integrated whole and assumes that risks to one subsidiary are borne by all the subsidiaries.

157. Id. at 78.

158. See Chase & Waage, supra note 147, at 268 (observing that the FRB, while acknowledging the separate nature of BHCs from their banking subsidiaries, still keeps their "consolidated nature" in mind); Comyn et al., supra note 147, at 476-77 (noting that banking regulators view BHCs as integrated entities).

159. Clark, supra note 151, at 838. Full disclosure should, of course, be provided. Nonetheless, operating subsidiaries under names other than that of the BHC or another well-known name deprives the organization of a certain amount of "brand equity." See generally PHILIP KOTLER, MARKETING MANAGEMENT: ANALYSIS, PLANNING, IMPLEMENTATION, & CONTROL 441-49 (7th ed. 1991) (discussing brand decisions from a marketing perspective).

160. See Chase & Waage, supra note 147, at 268. Rating agencies will often rate BHC long-term debt differently than subsidiary debt. Id. But see Comyn et al., supra note 147, at 472-76 (discussing public and market participants' view of BHCs).


162. See Chase & Waage, supra note 147, at 264-66; Clark, supra note 151, at 836-48.
will simply allow a banking subsidiary to fail, using the doctrine of corporate separateness as a shield. However, notwithstanding the separate nature of the BHC and its subsidiaries, it is unlikely that a BHC would allow a subsidiary to fail where it would be economically feasible for it to survive.\textsuperscript{163} However, in some situations, it is economically feasible for any firm to shut down a losing subsidiary.\textsuperscript{164} The government should not interfere with so fundamental a decision by imposing mandatory recapitalization requirements. Moreover, the Shadow Financial Regulatory Committee has criticized the Source-of-Strength doctrine \textit{inter alia} as an improper bank closure policy, interfering with rational liquidation decisions and encouraging inefficient investment.\textsuperscript{165}

Absent the presence of one of the traditional conditions for disregarding the corporate form, the Source-of-Strength doctrine contradicts the fundamental principle of corporate separateness. In doing so, the doctrine not only interferes with investors' rational expectations, but also injects a certain level of uncertainty into transactions with BHCs and encourages inefficient investment.

2. Improved Regulatory Oversight as an Alternative

The MCorp bailout reveals a fundamental weakness in the entire federal regulatory scheme—agency inaction. Perhaps, early intervention, rather than post-insolvency capital infusions, would be a more prudent strategy. Clearly, even the early intervention provisions of the FDICIA will not be of any use if they are not utilized.

The MCorp study points out that as early as 1982, the OCC noted "significant financial and operational problems."\textsuperscript{166} As time progressed, the situation grew worse, and little affirmative action was taken. Between 1982 and 1988, regulators only pursued informal

\textsuperscript{163} See, e.g., Chase & Waage, supra note 147, at 262-63 (providing examples of situations where parent corporations aided subsidiaries partly from "managerial pride" and partly from "good business judgment").

\textsuperscript{164} See Baumol & Blinder, supra note 116, at 474 (noting that while a firm may operate at a certain level of loss, failure to cover average variable costs necessitates a decision to shut down operations).

\textsuperscript{165} See SFRC Statement, supra note 5. The statement further criticizes the Source-of-Strength doctrine for its vagueness of scope, its discriminatory impact on BHCs, and the FRB's questionable authority to impose such a policy. See also Fed May Lack Authority, supra note 5 (discussing the Shadow Financial Regulatory Committee's statement).

\textsuperscript{166} MCorp Study, supra note 16, at 8. The OCC observed that aside from MCorp's overaggressive expansion scheme and lax loan review procedures, dividends continued to increase and subsidiaries failed to properly deal with problem loans. Id. at 9-10.
methods, which were largely ignored.\textsuperscript{167} By the time the FRB issued its cease and desist order containing the Source-of-Strength capital directives, MCorp was already unable to survive without federal assistance. The resulting bailout cost American taxpayers $2.7 billion.

The House Subcommittee on Financial Institutions Supervision, Regulation and Insurance recommended that a combination of stronger enforcement, early intervention, and prevention of preferential loan programs would prevent further failures on the scale of MCorp.\textsuperscript{168} Thus, requiring federal regulators to take a more active role in BHC oversight might prevent situations where capital infusions are necessary, thus decreasing the importance of the Source-of-Strength doctrine.

**CONCLUSION**

The Source-of-Strength doctrine is not without its usefulness. In evaluating applications for BHC formation and expansion, there is clear utility in the Source-of-Strength analysis. However, the FRB’s attempts to expand the doctrine through nebulous promulgations and without proper regulatory guidelines make the doctrine unpredictable, and thus subject to non-uniform enforcement and litigation.

The implementation of FIRREA’s Cross-Bank Guarantees and FDICIA’s Prompt Corrective Action provisions provide banking regu-

\hspace{1em}167. See id. at 10-16. The OCC and MCorp entered into several informal agreements, yet MCorp ignored these and continued to raise dividends and accumulate risky assets.

\hspace{1em}168. See generally MCorp STUDY, supra note 16 at 21-30 (discussing recommendations). The MCorp case was not the first instance where a major bank failure revealed regulatory inadequacy. See, e.g., STAFF OF HOUSE OF REPRESENTATIVES COMM. ON BANKING, FINANCE AND URBAN AFFAIRS, 102D CONG., 1ST SESS., THE BANK OF NEW ENGLAND FAILURE AND RESOLUTION 161-89 (Comm. Print 1991) (discussing the failure of both the Comptroller and the FRB to effectively supervise the Bank of New England); STAFF OF HOUSE OF REPRESENTATIVES SUBCOMM. ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE OF THE COMM. ON BANKING, FINANCE AND URBAN AFFAIRS, 101ST CONG., 2D SESS., BANKING INDUSTRY IN TURMOIL: A REPORT ON THE CONDITION OF THE U.S. BANKING INDUSTRY AND THE BANK INSURANCE FUND 133 (Comm. Print 1990) (stating that the most attractive option for controlling deposit insurance costs was “a more automatic system of regulatory intervention, ideally supplemented with market-like devices to impel regulators to act in a timely fashion to prevent weak banks from taking more risks”); STAFF OF HOUSE OF REPRESENTATIVES SUBCOMM. ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE OF THE COMM. ON BANKING, FINANCE AND URBAN AFFAIRS, 99TH CONG., 1ST SESS., CONTINENTAL ILLINOIS NATIONAL BANK: REPORT OF AN INQUIRY INTO ITS FEDERAL SUPERVISION AND ASSISTANCE 87 (Comm. Print 1985) (noting that “[a] review of every major bank failure indicates that the signs of later problems were clear many years earlier and a pattern of agency acceptance is apparent. In some instances such as Continental, even the specific nature of the later problems were identified years before the actual failure.”).
lators with congressionally-sanctioned tools which all but duplicate the
Source-of-Strength doctrine, albeit in a more certain form.

Further, the doctrine does violence to the concept of corporate
separateness. Assuming that most BHC managers are both competent
and rational actors, the recapitalization decision will consider econom-
ic efficiency and business realities. If it is economically feasible to
maintain the subsidiary as a going concern, it will be recapitalized. If
not, it will be closed. The Source-of-Strength doctrine disregards
ordinary business judgment in this context, possibly to the financial
detriment of the entire BHC.

Finally, Congressional reports of at least three major bank fail-
ures indicate that regulators either missed tell-tale signs of impending
insolvency altogether, or were unable to effect a managerial response.
Thus, it appears that adequate tools are present. However, to prevent
more MCorps, these tools must be used when and where they were
intended.

Craig L. Brown*