The FDIC Response to Penn Square Bank and the Local Implementation of National Policy

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THE FDIC RESPONSE TO PENN SQUARE BANK AND THE LOCAL IMPLEMENTATION OF NATIONAL POLICY

MICHAEL MITCHELSON*

In Oklahoma, the general public’s perception of the Federal Deposit Insurance Corporation (FDIC) was most likely formed during the banking crisis of the 1980s. The specific event that brought FDIC to the Oklahoma public’s awareness was the failure of Penn Square Bank, N.A. (PSB) on July 5, 1982. Thus, FDIC is known in Oklahoma as the bank liquidating entity.¹ It should be noted at the outset that FDIC also has a bank supervisory role; however, this paper will not address that role in much detail. Instead, this paper will discuss the bank liquidation function of FDIC and how it was executed at the local level in Oklahoma City.

I. BANK CLOSINGS

FDIC began as a federal government response to the great wave of bank failures during the 1930s. Nine thousand ninety-six banks failed from 1930 through the first three months of 1933.² By contrast, during the 1950s through the 1960s only “Seventy-five banks failed, an average of fewer than four banks per year.”³ Under the Federal Deposit

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1. During the 1980s, FDIC had two major operational divisions. Those divisions were respectively: Division of Bank Supervision and Division of Liquidation. The Division of Liquidation is the operational part of FDIC best known by Oklahomans.


3. Id.
Insurance Act (Act), FDIC provides deposit insurance for banks that participate in the deposit insurance program. In exchange for the insurance coverage, the banks submit to regulation by FDIC in addition to the regulation provided by the chartering entity of the bank. In addition to its supervisory role, once the bank is declared insolvent, FDIC is authorized to act as “receiver” of the failed bank.4

FDIC has used three basic methods to handle failing or failed banks: purchase and assumption transactions (P&A), deposit payoffs, and open bank assistance transactions. Of the three, P&As are the most common.5

The basic P&A is a resolution transaction in which a healthy institution purchases some or all of the assets of a failed bank or thrift and assumes some or all of the liabilities, including all insured deposits. The contrast between a deposit payoff and P&A is stark. In the deposit payoff, FDIC does not cover the portion of a customer’s deposits that exceeds the insured limit. For that reason, P&As are less disruptive to communities than payoffs. “In the two decades prior to the 1980s, most failing banks were resolved through P&As which passed all deposits to the acquiring institution.”6

Over the years, FDIC has developed many variations of P&As. The assets acquired vary depending on the type of P&A.7 FDIC, in its capacity as “receiver,” typically retains the claims against former directors and officers, claims under bankers blanket bonds and director and officer insurance policies, prepaid assessments, and tax receivables.

The deposit payoff is another form of bank resolution utilized by FDIC. The two variations of the deposit payoff most used by FDIC are the straight deposit payoff and the insured deposit transfer. As will be discussed below, a third form calls for the FDIC to establish a Deposit Insurance National Bank (DINB) to handle the deposits. The DINB is seldom used by FDIC.8

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4. 12 U.S.C. § 1819(a) Ninth (2002). This statute authorizes FDIC to act as receiver of federally chartered banks and state banks. Each state must have an authorizing statute appointing FDIC as receiver/liquidating agent of its failed banks. Oklahoma’s statute is OKLA. STAT. tit. 6 § 1205 (2002).
5. FDIC Resolutions Handbook, supra note 2, at 19.
6. Id. at 20.
7. “Some of the assets, typically loans, are purchased outright at the bank or thrift closing by the assuming bank under the terms of the P&A. Other assets of the failed institution may be subject to an exclusive purchase option by the assuming institution for a period of thirty, sixty, or ninety days after the bank or thrift closing.” FDIC Resolutions Handbook, supra note 2, at 19.
8. Id. at 41.
“In a straight deposit payoff, the FDIC determines the insured amount due each depositor and prepares a check for that amount. Arrangements are made either for the depositors to come to the bank and get the checks or for the FDIC to mail the checks to the depositors.”

In an insured deposit transfer, the FDIC also determines the insured amount due each depositor. Arrangements are then made with a healthy institution that is willing to act as agent for the FDIC and to pay insured deposits to customers of the failed institution. The FDIC transfers insured deposit accounts and secured liabilities of the failed bank or thrift, along with an equal amount of cash or other assets, to the healthy institution. Service to customers with insured deposits is uninterrupted.

II. PENN SQUARE BANK RECEIVERSHIP

Many in Oklahoma know that PSB was placed in FDIC receivership on July 5, 1982. PSB was one of forty-one banks closed that year. PSB was one of just 7 banks closed under the deposit payout method that year. PSB has other distinctions in FDIC history. PSB was one of the

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<td>11.</td>
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<td>5. Insurance Fund</td>
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last banks where FDIC utilized the DINB to assume the insured deposits of the failed bank.\textsuperscript{13} The Banking Act of 1933 authorized the use of the DINB.\textsuperscript{14} PSB with 24,534 deposit accounts totaling $470.4 million and $516.8 million in assets, was handled in as a DINB.\textsuperscript{15} Until the Independence Bank, Los Angeles, liquidation in 1992, PSB was the largest straight deposit payoff handled by FDIC.\textsuperscript{16}

A. Early History of Oklahoma City Consolidated Office

Initially, the PSB receivership was the sole FDIC bank liquidation operation in Oklahoma City. As more Oklahoma banks were placed into receivership, the Oklahoma City office of FDIC grew and became a “consolidated office” within FDIC’s bank liquidation system. During the period 1982 through 1986, 39 institutions insured through the Bank Insurance Fund (BIF) were closed in Oklahoma.\textsuperscript{17} During that same time

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\textsuperscript{13} See FDIC Resolutions Handbook, \textit{supra} note 2, at 41.

\textsuperscript{14} \textit{Id.} at n.2.

\textsuperscript{15} \textit{Id.} at 43.

\textsuperscript{16} \textit{Id.} Independence Bank had $564.2 million in total assets, and 33, 677 deposit accounts totaling $503.4 million in deposits.

\textsuperscript{17} FDIC: HSOB Bank & Thrift Failures, Table BF01, Closing and Assistance Transactions (Oklahoma), \textit{available at} FDIC website, www.fdic.gov. Then click on “Bank Data” button. Then click on “Historical.” Then click on “Historical Statistics on Banking.” Then make the following selections:
period, a total of 431 institutions insured through BIF were closed nationwide.\textsuperscript{18} At the beginning of the PSB receivership, FDIC was not prepared to fully staff a receivership office. The reason for the lack of staffing is quite understandable and prudent. Part of FDIC's mission is to ensure the safety and soundness of member banks by periodic examinations. Accordingly, the bulk of FDIC's staffing is on the supervisory side.\textsuperscript{19} FDIC increases the staffing of the Division of Resolutions and Receiverships, formerly the Division of Liquidation, only as required.\textsuperscript{20} From 1970 through 1979, only seventy-nine banks

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\textsuperscript{18} FDIC: HSOB Bank & Thrift Failures, Table BF02, Closing and Assistance Transactions (United States), \textit{available at} www.fdic.gov. Then click on "Bank Data" button. Then click on "Historical." Then click on "Historical Statistics on Banking." Then make the following selections:

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\textsuperscript{20} FDIC also contracts as the bank liquidation (now called resolution) business declines. The Resource Management Section of the 2002 Annual Performance Plan notes that total employment has declined from approximately 23,000 in 1992 to about 6,300 at year-end 2001. See FDIC, 2002 Annual Performance Plan, \textit{available at}
nationwide failed that were insured through BIF. During the same time period, only one bank in Oklahoma failed that was insured through BIF. Thus, it was understandable that FDIC was not prepared to provide in-house legal staff to the Oklahoma City Consolidated Office immediately. The early arrangement was to hire local fee counsel and provide


21. FDIC: HSOB Bank & Thrift Failures, Table BF02, Closing and Assistance Transactions (United States), available at www.fdic.gov. Then click on “Bank Data” button. Then click on “Historical.” Then click on “Historical Statistics on Banking.” Then make the following selections:

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23. The Oklahoma City law firm of Reynolds, Ridings and Hargis was hired on or about July 5, 1982, as the local counsel to represent the PSB receivership in Oklahoma City. Additional firms, including Gable & Gotwals out of Tulsa and the then Edward Roberts and Winterstein, were hired to represent the PSB receivership in the numerous cases in litigation.
supervision of the legal matters from Washington, D.C. However, it quickly became apparent to FDIC legal that in-house local presence would be required.

Within the first year of the PSB receivership, FDIC established a local in-house legal staff. Initially, the staff was authorized for twelve attorneys. 24 These attorneys all lacked prior FDIC experience and had to be trained to handle the supervision of outside law firms, direct collection on assets by restructure and litigation, and bankruptcy litigation. Additionally, the attorneys were called upon to address deposit insurance questions related to collection on the assets. 25 As more banks failed in Oklahoma, the size of the liquidation and legal staffs in the Oklahoma City Consolidated Office increased. One of the natural outcomes of that decision was further training of the temporary legal staff in FDIC internal decision making, budgeting, recruiting, and training. This was an on-going effort described by one member of the local legal staff as “building the plane while in flight.” This task was accomplished in a satisfactory manner although there were many bumpy moments.

One of the pivotal moments in the Oklahoma City Consolidated Office turned out to be the agreement at the division level between Division of Liquidation (DOL) and the Legal Division. Prior to PSB receivership, local DOL personnel handled all collection matters and had a direct relationship with local fee counsel. Although the local fee counsel were hired by the Legal Division, the day-to-day relationship was with the local DOL personnel and the local fee counsel. The creation of the legal staff at the Oklahoma City Consolidated Office changed that relationship within FDIC, especially at the consolidated office level. Initially, no clear line of authority existed. Consequently, there was friction, confusion, and a lack of efficiency in the operation. 26

In March 1984, I became the Senior Attorney for the Oklahoma City Consolidated Office. One of the key developments shortly after my appointment as Senior Attorney was the agreement between the Legal

24. The legal staff allocation at the Oklahoma City Consolidated Office gradually expanded to twenty-four attorneys by approximately 1985.

25. The attorneys and support staff were all hired on one-year contracts that provided flexibility to FDIC to reduce staff as the bank liquidation work declined.

26. The friction reached a crescendo in the struggles between the head of the Oklahoma City Consolidated Office legal staff and the Liquidator in Charge (LIC) of the Oklahoma City Consolidated Office. It was not an even match as all the legal staff were “temporary appointments,” while the LIC was a fully vested permanent employee of the FDIC.
Division and DOL. The agreement was designed to clarify and strengthen the role of local legal staff to serve as the principal lawyers for FDIC at the local level. All fee counsel were hired, fired, and supervised by the local legal staff. Additionally, the local legal staff was allocated a budget and given some autonomy over spending decisions.

B. Reverse Participation Program

One of the major programs of the Oklahoma City Consolidated Office was the reverse participation program. This was especially important with PSB receivership. PSB was less than a $500 million bank at the time it failed. However, PSB was the lead bank on many loans, primarily oil and gas, for which the majority of funding was provided by out of state banks. The major participant banks included Chase Manhattan Bank, Seattle First National Bank, Continental Illinois National Bank, and Northern Trust and Michigan National Bank. The loan participations totaled approximately $2 billion. FDIC, as receiver of PSB, assumed the legal rights and privileges of PSB. Since PSB had retained the lead lender position in the majority of these loans, FDIC shared the same status. This was true even though PSB may have had very little money in the deal. At times, other lenders decided there was reason to extend further funds to the borrower. This was contrary to FDIC’s position and resulted in tension between FDIC personnel and the participating banks. The Loan Transfer Department was a solution to this problem.

The Loan Transfer Department represented a major commitment of personnel and resources by the Oklahoma City Consolidated Office. DOL staffing of the Loan Transfer Department included technicians that prepared the loan packages by checking the documentation for payment histories, collateral agreements, and other important details. Once the package was assembled and approved, the Loan Transfer Department handled all the logistics of the transfer. Local Legal Division personnel provided the support to the Loan Transfer Department.

27. Outside counsel are now clearly under Legal Division control. See the following documents: Information for Prospective Outside Counsel available at www.fdic.gov/buying/legal/ ocbrochure/letter.html; Information for Prospective Outside Counsel available at www.fdic.gov/ buying/legal/ocbrochure/role.html; and Legal Services Agreement available at www.fdic.gov/ buying/legal/outside/APPNDX/D_1.pdf. Also see the documents produced at the end of paper.
C. Delegations of Authority

Decision making at the receivership level was governed by rules and procedures. Much of the authority was set forth in the delegations of authority. The delegations covered everything from initiating litigation, defending litigation, settling lawsuits, and accepting compromise offers. There were levels of authority delegated to the local offices, which transferred to the regional offices when they were created, and then finally residing only in the central office in Washington.\(^{28}\) The delegations also provided for utilization of a committee process at each level.\(^{29}\) This provided for a rigorous review of the dispositions of matters. However, the delegation process was not designed for speed. It also made negotiations of matters somewhat cumbersome as the account officer and the attorney could only make recommendations to the committee holding the authority.\(^{30}\) This process was very cumbersome when attending settlement conferences of matters pending in the U.S. District Court for the Western District of Oklahoma. However, over time a workable solution was reached. It was accomplished in part by the increased experience by the local committee and an increase in the authority of the local committee. Also, the approval process was streamlined to reach faster decisions at the regional office level. The most important part was the adoption of an “administrative closing” procedure by the local federal bench.\(^{31}\) This allowed FDIC time to get the necessary approval once a “sellable” deal was reached.


\(^{29}\) Id.

\(^{30}\) Id.

\(^{31}\) The United States District Court for the Western District of Oklahoma has promulgated local civil rules under the authority of Title 28, United States Code, Section 2071 and Rule 83 of the Federal Rules of Civil Procedure. Pursuant to the local civil rules, all cases on a trial docket are automatically set for settlement conference. LCVR 16.2(b). The lead attorney for each party and someone with full settlement authority is required to appear. LCVR 16.2(c). During the 1980s, these requirements were set forth in Local Rule 17(H). The current local rules are available at www.okwd.uscourts.gov and then click on local rules.
D. Special Receivership Powers

As many in Oklahoma learned from the PSB receivership, FDIC, as the receiver, has a number of special powers that have been created by federal law.\(^{32}\) Some of the special powers include repudiation of contracts, placing litigation on hold, and avoiding fraudulent consequences.

Repudiation of Contracts: A receiver may repudiate or disaffirm a contract of the depository institution if the receiver deems it burdensome, and finds that repudiation would promote the orderly administration of the receivership estate.\(^{33}\) Placing Litigation on Hold: The receiver is substituted as a party for litigation pending against the failed bank or thrift. However, because the receiver may need time to assess and evaluate the facts of each case to decide whether and how to proceed, the law permits the receiver to request a court to put the litigation on hold.\(^{34}\)

Avoiding Fraudulent Conveyances: A receiver has the power to avoid certain fraudulent conveyances. Under federal banking law, a receiver may avoid a security interest in a property, even if perfected, in which the security interest is taken in contemplation of the institution's insolvency or with the intent to hinder, delay, or defraud the institution or its creditors.\(^{35}\) The receiver may avoid any transfers made by obligors within five years of the appointment of the receiver.\(^{36}\) Those rights are superior to any rights of a trustee or any other party.\(^{37}\)

In addition to the foregoing powers, FDIC has obtained certain special defenses through federal statutes and court decisions. These are generally known as the D'Oench Doctrine and its statutory counterparts, 12 U.S.C. §§ 1821(d)(9)(A), 1823(e), which recognize that, unless an agreement is properly documented in the institution's records, it cannot be enforced either in making a claim or defending against a claim by the receiver.\(^{38}\) Therefore, an argument by an obligor on a promissory note


\(^{33}\) FDIC Resolutions Handbook, supra note 2, at 73.

\(^{34}\) Id.

\(^{35}\) Id. at 74.

\(^{36}\) Id.

\(^{37}\) Id.

\(^{38}\) Id. at 75. See also Statement of Policy Regarding Federal Common Law and Statutory Provisions Protecting FDIC, as Receiver or Corporate Liquidator, Against Unrecorded Agreements or Arrangements of a Depository Institution Prior to Receivership, supra note 28.
III. CONCLUSION

As someone who served about three and one-half years with FDIC, all in the Oklahoma City Consolidated Office, my job was to provide some perspective from the inside at the local level. It is hard to concisely describe the operations in Oklahoma City in detail. The Oklahoma City Consolidated Office grew quickly inside the FDIC, which was growing quickly itself. Both legal and liquidation staff were comprised primarily of those new to FDIC. Additionally, both legal and liquidation staff experienced high turnover.39 These two factors meant that training of personnel was both imperative and an ongoing process. Several people from the Oklahoma City Consolidated Office have made a career of FDIC, but most have not.

My general impression is that the majority of the local FDIC personnel worked hard and tried to meet their obligations to the corporation. On many occasions this hard work resulted in unnecessary friction between co-workers. As a general matter, I think most who worked for FDIC would rate it a valuable experience. At the same time, it is undoubtedly true that some debtors were treated in a rough manner. However, the bank liquidation business is not for the meek. The receivership is designed to replenish BIF and pay any uninsured portion of the deposits of the failed bank. Therefore, a high collection percentage is the mission of the receivership staff. On that score, the PSB receivership did well.

One other closing thought concerns the structure of FDIC. As noted earlier in the paper, FDIC maintains a relatively small Division of Resolutions and Receiverships (DRR) staff. If the country, or even a state, experiences a large number of bank failures in a short period of time, DRR will have to staff up quickly. The cycle of recruiting and training will commence again. This will probably be mitigated if FDIC uses “resolution” methods other than deposit payouts.

39. The turnover was due to a variety of factors, including: transfer to another consolidated office; promotion to a regional office or Washington; finding a job with another government agency; finding a job in the private sector; termination; and even death.