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Is the Cross-Guarantee Constitutional?

Jennifer J. Alexander

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Is the Cross-Guarantee Constitutional?

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I. INTRODUCTION

Banks play a unique and important role in our economy. They serve tremendously useful economic functions; for this reason, our society has become irretrievably dependent upon them. Banks safeguard our life savings and business profits, and provide capital to those who need it to buy, invest, or grow.1 Although these functions could be performed without an intermediary—private citizens may freely lend their cash to other private citizens who need it—banks are viewed as safer and more efficient controllers of cash flow.2 They allow depositors to pool their cash resources collectively in one institution; then, retaining a relatively low amount of capital in reserve, they lend the rest to qualified borrowers, thereby channeling the money in an efficient manner.3

1. See, for example, 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, 1345 (1991) (discussing the traditional economic reasons for the existence of banks).
2. Id.
In order to be successful in this role, however, banks must be perceived as “safe” places to store cash. Otherwise, depositors will not trust banks with their money, and borrowers’ ability to obtain capital will be severely restricted. Banks are dependent on depositor confidence for survival.4

At the same time, depositors are just as dependent, if not more dependent, on the soundness of banks. Banks have gained such a dominant role in our economy that most people and corporations trust them with everything—their livelihoods, their profits, and all or nearly all of their money. Consequently, if banks falter or fail, depositors stand to lose everything. The stability of banks affects nearly everyone in profound ways, and is therefore an important public matter.5

The delicate interdependence of banks and depositors, and the importance of that relationship to individuals and society as a whole, has led to pervasive governmental regulation of the banking industry.6 Although the regulatory landscape is continually changing, one constant remains: the looming presence of the government overshadowing the industry. For over a century, the federal government has restricted bank practices,7 required certain levels of capital mainte-
nance, established special insolvency procedures, and imposed liability on bank and thrift managers for abusive or fraudulent practices.

Modern governmental monitoring of the banking system began during the Great Depression, after the breakdown of depositor confidence and the subsequent slew of devastating bank failures. In response to the crisis, the government assumed a more influential regulatory role to better protect depositors from the effects of bank failures. Thus was born the federal deposit insurance system. The system, which is overseen by the Federal Deposit Insurance Corporation (FDIC), guarantees that depositors will be insured up to $100,000 in the event of bank failure. The vast majority of affiliation of banks and nonbanks through a holding company. See note 50 and accompanying text.


9. For instance, regulators may choose to keep a faltering bank open by providing financial assistance, or may arrange the merger of a failed bank and a healthy one. 12 U.S.C. § 1843(c) (1994 ed.). Professor Swire observes that government regulators have accumulated a "remarkable group of superpowers" for dealing with bank insolvency, equivalent to a monopoly over insolvency procedures. Swire, 42 Duke L. J. at 481-82 (cited in note 6). For a case challenging the exercise of insolvency powers as a violation of the Takings Clause, U.S. Const. Amend. V, see Golden Pacific Bancorp v. United States, 15 F.3d 1066 (Fed. Cir. 1994).

10. See Swire, 42 Duke L. J. at 485 (cited in note 5) (listing rules applying to bank insiders found to be partially responsible for bank failures).

11. Banks had been subjected to regulation prior to the Great Depression. For example, from the Civil War era until the Depression, shareholders of failed federal banks were not entitled to limited liability, but were held liable for up to the par value of their shares "in addition to the amount invested in such shares." National Banking Act of 1863, ch. 58, 12 Stat. 665, 668. Many states had parallel double liability provisions that applied to state-chartered banks. In fact, by 1931, all but ten states had implemented double liability rules. Macey and Miller, 27 Wake Forest L. Rev. at 37 (cited in note 4). The two purposes of double liability were (1) to ensure that the depositors—the creditors of the failed bank—received as much of their money back as possible, and (2) to give the shareholders an incentive to monitor bank managers, in order to decrease the probability that the bank would fail. Id. at 36 (citing Cong. Globe, 37th Cong., 3d Sess. 824 (1863); Cong. Globe, 38th Cong., 1st Sess. 1069 (1864)).

The double liability system was pushed to its limits during the Great Depression, and was finally abolished in 1933. Macey and Miller, 27 Wake Forest L. Rev. at 37 (cited in note 4). The downfall of the policy was due to the political backlash it received after the slew of bank failures between 1929 and 1933. Id. The bank "runs" that occurred in rapid succession during this period were the product of the breakdown of the delicate balance between banks and depositors. Because depositors lost confidence in their banks, they wanted to retrieve their money. Because banks did not keep enough capital in reserve to pay all of their depositors at once, they were forced into insolvency. Depositors lost everything and the economy crashed. See id. at 38 (discussing the factors leading to double liability's elimination: "political resentment by bank shareholders against assessment, the perception that double liability had failed as a regulatory system, and the creation of a substitute regulatory system, [deposit insurance]").

12. See Macey and Miller, 27 Wake Forest L. Rev. at 38 (stating that most people at the time thought deposit insurance would be a far more effective guarantor of bank stability than was double liability).

depositor are fully protected by the guarantee, and thus will suffer no loss if their bank fails. The advent of federal deposit insurance dramatically shifted the risk of bank failure: whereas previously the shareholders and the depositors bore the risk, the new scheme placed the risk almost entirely on the federal government.

The deposit insurance system was intended to be self-sufficient; that is, banks were charged a flat-rate premium to be pooled into a single deposit insurance fund, and the money in the fund was meant to be dispersed to depositors as needed. An underlying assumption was that deposit insurance would ensure the stability of the banking system by securing depositor confidence, and thus the insurance fund would, most likely, never be depleted.

For fifty years, this assumption proved true. Bank failures were few and far between, and the deposit insurance fund remained solvent. Then, in the late 1970s and into the 1980s, the economic and regulatory climate changed dramatically, bringing into focus the major problems with the deposit insurance system.

One of these flaws, which recent legislative reforms have, in part, attempted to address, is the moral hazard problem, which inheres in any insurance system. The moral hazard problem lies at
the other end of the spectrum from the problem of bank runs. With no governmental protection, depositors have every incentive to ensure that their banks do not engage in unduly risky practices, but the transaction costs of such monitoring are too high to bear.\textsuperscript{20} With full governmental protection, however, depositors have no reason to monitor their banks. In addition, shareholders tend to favor risk-taking so as to increase their potential dividends. There are no effective agents of discipline to prevent bank management from risking the solvency of the institution.\textsuperscript{21}

The moral hazard problem was one of the underlying causes of the recent crisis in the financial institution system.\textsuperscript{22} The savings and loan crisis of the 1980s was marked by a wave of thrift failures.\textsuperscript{23} Banks also failed in large numbers; as a result, the insurance funds were rapidly depleted.\textsuperscript{24} The thrift insurance fund was wiped out, and Congress voted to appropriate funds to complete the bailout.\textsuperscript{25} The public grew increasingly outraged as taxpayer dollars were used to...
salvage a system that was supposed to be self-supporting, and that was failing because of the inadequacy of both public and private discipline of management practices. The President and Congress looked for better ways to ensure the stability of the banking system, and enacted the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA").

FIRREA's related purposes are to promote the stability of banks and their counterparts and to secure the solvency of the deposit insurance fund. To accomplish these objectives, the statute shifts some of the risks of insolvency back to the shareholders of financial institutions, and increases the obligations of the shareholders. Perhaps the most controversial and far-reaching provision of FIRREA, and the one that this Note will analyze, is known as the "cross-guarantee" power.

The cross-guarantee is narrow in that it does not apply to all financial institutions, but applies only to "commonly controlled insured depository institutions"—affiliates of bank holding companies. On the other hand, it is relatively broad in that it essentially eliminates limited liability for those affiliates. The cross-guarantee provides that, in the event the FDIC must financially assist any member of a bank holding company, all of the other affiliates are liable for the cost incurred by the FDIC. Essentially, the cross-guarantee serves as a risk-shifting mechanism: whereas before the federal government

26. Public and congressional indignation about the savings and loan debacle continued even after FIRREA was passed in an attempt to reform the system. See 136 Cong. Rec. S17748-49 (Oct. 2, 1990) ("It is outrageous that taxpayers are being asked to pay billions of dollars to clean up the S&L mess. It would be even worse if we did not try our best to prevent a similar crisis at the FDIC") (statement of Sen. Lautenberg, Dem.-N.J.).


29. See, for example, L. William Seidman, Testimony on the Financial Institutions Reform, Recovery and Enforcement Act of 1989 in Thrift Mergers and Acquisitions After FIRREA Including Bank Holding Company Acquisitions of Thrifts 818, 837 (Practicing Law Inst., 1990) (noting that the cross-guarantee "was designed to keep multi-institution holding companies from abandoning failing insured affiliates").

30. See 12 U.S.C. § 1815(e)(1)(A) (1994 ed.) (establishing liability of commonly controlled depository institutions for losses or anticipated losses of the FDIC). Thus, if Bank A and Bank B are controlled by the same holding company, Bank B may be assessed for the cost of an FDIC bailout if Bank A fails or approaches default.

31. Id. § 1815(e).
bore the entire risk of an affiliate’s insolvency, that risk is now shared by the shareholders of the siblings of that affiliate. The cross-guarantee is intended to fulfill the goals of FIRREA by increasing shareholder discipline over holding company management so as to prevent failure, while simultaneously ensuring the solvency of the deposit insurance fund by forcing shareholders to reimburse the FDIC for its losses.

Implementation of the cross-guarantee power has potentially drastic effects on bank holding companies. The failure of one holding company member may drive the other members into insolvency as each is assessed for the failure of the others. Consequently, all of the shareholders of a holding company may lose their investments due to the failure of just one affiliate. Because of this dramatic impact, the cross-guarantee has recently been challenged on constitutional grounds. Critics of the provision argue that forcing affiliates to pay for the debts of other corporations effects a fifth amendment taking without just compensation. Because holding company shareholders relied on the notion of limited liability when they invested, and because cross-guarantee assessments may destroy the entire value of their shares, the use of the cross-guarantee power alters their property rights so drastically that it constitutes a taking. Those who have been assessed under the cross-guarantee provision should therefore be compensated for their losses.

32. See Broome, 26 U.C. Davis L. Rev. at 960-63 (cited in note 15) (analyzing the cross-guarantee’s effect on the risks shareholders face in the event of bank holding company affiliate failure). See also notes 89-93 and accompanying text (providing an in-depth illustration of the cross-guarantee’s operation).


35. See U.S. Const. Amend. V (“[N]or shall private property be taken for public use, without just compensation”).

36. See Branch on Behalf of Maine Natl. Bank v. United States, 31 Fed. Cl. 626, 637 (1994) (finding the cross-guarantee unconstitutional), certified for appeal, 42 F.3d 1409 (Fed. Cir. Nov. 18, 1994). But see Meriden Trust and Safe Deposit Co. v. FDIC, 62 F.3d 449 (2d Cir. 1995) (finding the cross-guarantee constitutional); Broome, 26 U.C. Davis L. Rev. at 986-89 (cited in note 15) (concluding that the exercise of the cross-guarantee is constitutional). See also Jonathan R. Macey and Geoffrey P. Miller, Banking Law and Regulation at 657 (Little, Brown,
Two cases alleging that the cross-guarantee effects a taking have recently come before the lower federal courts. In *Meriden Trust and Safe Deposit Co. v. FDIC*, the United States District Court for the District of Connecticut upheld the cross-guarantee as constitutional. In *Branch on Behalf of Maine Natl. Bank v. United States*, however, the Court of Federal Claims found the cross-guarantee to constitute a taking without just compensation. *Meriden* has been affirmed by the Second Circuit; *Branch* has been certified for appeal in the Federal Circuit. The ultimate decision regarding the constitutionality of the cross-guarantee will have tremendous import. If the cross-guarantee is found to effect a taking, the federal government will be forced to pay millions of dollars of compensation to shareholders; the probable effect will be to force the government to eliminate the cross-guarantee altogether and to look for an alternative policy. On the other hand, if the measure is upheld, the shareholders of bank holding company affiliates face dramatic risks of liability. Whichever way the issue is decided will have lasting effects on financial institution reformers, shareholders, and taxpayers.

This Note examines the constitutionality of the cross-guarantee power and concludes that the provision does not effect a taking without just compensation. Part II discusses the regulatory scheme governing bank holding companies and describes the cross-guarantee’s purposes, provisions, and impact on that regulatory scheme.

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1992 (asking how “the federal government [can] simply insert itself in the priority hierarchy above existing interests without the payment of just compensation”); David A. Segal, Note, A Note to Congress and the FDIC: After FIRREA Where’s the BIFI?, 59 Fordham L. Rev. 411, 451 (1991) (noting that the cross-guarantee may be open to constitutional challenge, but that it is unclear what level of scrutiny would apply).


38. 31 Fed. Cl. 626 (1994), certified for appeal, 42 F.3d 1409 (Fed. Cir. Nov. 18, 1994).

39. Id. at 637 (holding that, unless the trial court finds that the individual banks within a holding company have ignored separate corporate form, it cannot constitutionally uphold a cross-guarantee assessment of any of those banks).

40. 62 F.3d at 449.

41. 42 F.3d at 1409.

42. The cross-guarantee’s failure, either as a policy or on constitutional grounds, is an important concern for taxpayers, who stand to lose billions of dollars if the deposit insurance system breaks down.


44. Because of *Branch*’s importance, the FDIC will almost certainly appeal the case to the Supreme Court if necessary. Id.; Nicholas Zeppos, Developments in Administrative Law 50 (draft 1995) (on file with the Author).
Part III provides an overview of takings jurisprudence, describing the current analyses the Supreme Court utilizes and recent trends in the law.

Part IV describes the facts and dispositions of the Meriden and Branch cases. Part V analyzes whether the cross-guarantee violates the Takings Clause, using the recent cases as a point of departure. It first looks at the investment-backed expectations of affiliate bank shareholders, and then measures the economic impact of the cross-guarantee on those shareholders. It concludes that the measure does not defeat reasonable expectations so radically, and does not affect property rights so adversely, as to require governmental compensation. Part V also considers the efficacy of the cross-guarantee as an economic policy. It argues that the cross-guarantee is not only a legitimate policy measure, but also one of the best ways to redistribute the risks of bank failure so as to ensure the stability of the banking system and the solvency of the deposit insurance fund. The efficacy of the cross-guarantee is strong enough to outweigh and therefore justify the economic burdens placed upon bank holding company shareholders.

II. THE REGULATION OF BANK HOLDING COMPANIES AND THE CROSS-GUARANTEE'S IMPACT

Before FIRREA was enacted, bank holding companies, like other financial institutions, faced a formidable set of rules and restrictions governing their operations. This Part describes this general regulatory scheme.

A. The General Regulatory Landscape Governing Holding Companies

The Bank Holding Company Act of 1956 ("BHCA") is the primary source of rules regarding the creation and activities of holding companies. Bank holding companies require governmental

45. See Jackson, 107 Harv. L. Rev. at 510-11 (cited in note 19) (discussing the increasing regulation of financial holding companies over the past twenty years).
47. In essence, a bank holding company is a company that substantially controls the management, activities, and, most importantly, the capital of another bank. 12 U.S.C. § 1841. "Control" may be established in one of three ways: (1) ownership, control, or power to vote on 25% of the voting shares of the bank, 12 U.S.C. § 1841(a)(2)(A), (2) control over the election of a majority of the directors or trustees of such bank, 12 U.S.C. § 1841(a)(2)(B), or (3) a determination of the Board of Governors of the Federal Reserve System that the company exerts a "controlling influence over such bank's management or policies," 12 U.S.C. § 1841(a)(2)(C).
approval for their very existence.48 According to the BHCA, the Board of Governors of the Federal Reserve System ("Board") must pre-approve any action causing a company to become a holding company or a subsidiary of a holding company; such institutions must formally apply to the Board to receive holding company status.49 Additionally, the BHCA restricts the activities of bank holding companies. Except for limited exemptions, such entities are prohibited from owning or controlling voting shares in any company that is not a bank.50 In other words, bank holding companies are essentially restricted to the business of banking and related ventures.

One purpose behind these rules is to prevent holding companies from abusing the deposit insurance system.51 Because the structure of the holding company allows it to shift capital and assets from one entity to another, and because so great a percentage of bank deposits are controlled by banks that are affiliates of bank holding

48. Id. § 1842(a).
49. Id. The factors the Board considers are: (1) the financial resources and soundness of the applicant institution, (2) whether the proposed holding company formation would tend to lessen competition or create a monopoly, and (3) the needs of the community. Id. § 1842(c). Importantly, any bank that is either a holding company or an affiliate of such a company must be federally insured. Id. § 1842(e). See notes 211-27 and accompanying text for a discussion of Meriden.
50. 12 U.S.C. § 1843(a)(1). The most important exception to this prohibition provides that bank holding companies may acquire businesses "the activities of which the Board after due notice and opportunity for hearing has determined... to be so closely related to banking or managing or controlling banks as to be a proper incident thereto." Id. § 1843(c)(8)(ii). Although this exemption is broad in the sense that bank holding companies potentially can acquire interests in numerous nonbank activities, it is important to note that the Board must pre-approve such acquisitions. Id. The intent is to give regulators the ability to monitor and control bank holding company expansion. See Fallon, 66 N.Y.U. L. Rev. at 1354 n.58 (cited in note 1) (discussing the factors the Board considers in deciding whether to allow a nonbank acquisition).
51. The BHCA's stated purposes are "to control the [accumulation] of banking assets within a single corporate entity" and to monitor the combination of bank and nonbank activities in a bank holding company. Bank Holding Company Act Amendments of 1970, S. Rep. No. 91-1084, 91st Cong., 2d Sess. 2 (1970). With regard to the required separation of bank and nonbank activities, the fear is that holding companies will acquire nonbank enterprises, and then divert assets from the affiliates that are banks to those that are not, or engage in transactions harmful to the bank but favorable to the nonbank affiliate. If the bank affiliates fail because of these practices, its depositors will be reimbursed through the deposit insurance system, while the holding company will make huge profits from the activities of the nonbank affiliates. See Jackson, 107 Harv. L. Rev. at 555 (cited in note 19) ("[T]he assumption seems to be that holding companies are also apt to possess controlling interests in unregulated entities and that the holding companies might be inclined to exploit their influence over regulated subsidiaries to favor those unregulated affiliates"). See also notes 58-60 and accompanying text (explaining the incentive holding companies have, with the security of deposit insurance, to exploit and then abandon their failing bank affiliates for the benefit of healthy affiliates).
companies, the government perceives a public need to prevent bank holding companies from exploiting the deposit insurance system to the detriment of the FDIC.

B. Specific Regulatory Efforts to Control the Moral Hazard Problem

As previously mentioned, the moral hazard problem substantially weakens the stability of federally insured banks and bank holding companies. There are two aspects to the problem. First, an inherent problem exists due to the security of deposit insurance, leading to a dearth of depositor discipline over management. Second, the moral hazard is exacerbated by the principle of limited liability, which leads to an inadequacy of shareholder discipline over management. In addition to the BHCA's general control over bank holding company status and activities, there have been specific legislative and regulatory attempts to deal with these related problems.

The moral hazard problem is not unique to the deposit insurance system, but is inherent in the insurance relationship. The basic problem may be described as follows: if one is insured against a certain type of adversity, and will be compensated if befallen by that adversity, one has far less incentive to avoid the risk of that adversity. For instance, the moral hazard theory would suggest that someone with fire insurance will be less careful about smoking in bed, installing smoke detectors, etc., because she will be compensated if a fire breaks out. Depositors likewise have little incentive to ensure that the institution in which their funds are kept remains solvent because most depositors are guaranteed full reimbursement in the event of failure.

52. As of December 1988, the 6,474 bank holding companies controlled 91% of the assets of all commercial banks. See Pauline B. Heller, Federal Bank Holding Company Law xx (Law Journal Seminars, 1995).

53. See Garten, 50 Ohio St. L. J. at 1186 (cited in note 5) ("The principal hazard created by deposit insurance should be the willingness of insured depositors to continue to fund banks that are excessively risky or mismanaged").

54. See id. at 1176-87 (discussing in-depth the incentives of shareholders and depositors to discipline bank management).


56. On the other side of the coin, Professor Broome argues that bank management has a major incentive to take enhanced risks in order to reap the benefits that insurance provides. Broome, 26 U.C. Davis L. Rev. at 949-50 (cited in note 15). Professor Broome states that, in the absence of deposit insurance, a bank must pay for the riskiness of its activities; if a bank is nearing insolvency because of undue risk-taking, the cost of attracting and keeping depositors will increase, because the depositors will become more and more insecure about losing their money. Id. at 950. The only way to take advantage of the "subsidy" that deposit insurance provides, then, is for management to increase the risks taken. Id. See also Department of the
The moral hazard problem is augmented by the principle of limited liability. Although shareholders stand to lose their investment if the bank fails, and will thus exert some discipline over management, the shareholders will gain a great deal if the bank's profits skyrocket. Therefore, there is little for shareholders to lose, but much to gain if the bank takes large risks. Moreover, the encouragement of risk-taking will increase as a bank nears insolvency; because the shareholders are not liable if the bank loses big, they have nothing to lose by gambling with the bank's funds.9

The moral hazard problem is further exacerbated by the holding company structure.58 Because capital and control are concentrated in a single corporate shareholder, that shareholder has the incentive and the ability to increase the riskiness of its insured subsidiaries in order to increase its profitability. It may ask insured subsidiaries to pay excessive dividends, exact unduly high management fees, or engage in other illicit practices, while the FDIC bears the risk of failure.59 In addition, holding companies are prone to "aband0n" a bank subsidiary that is nearing insolvency by shifting that subsidiary's assets to healthy subsidiaries and letting the FDIC bear the loss when the ailing subsidiary fails.60 The "safety net" of

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9. See id. at 565 (explaining that "moral hazard problems common to all financial institutions are exacerbated when a single corporate shareholder who is well-situated to exploit the moral hazard controls the entire equity interest of a financial institution"); Fallon, 66 N.Y.U. L. Rev. at 1383 (cited in note 1) (noting that the above-described problem was one of the justifications for the source-of-strength doctrine).

58. Professor Jackson describes the "hungry wolf" justification for increasing the obligations of holding companies:

One way that the holding company structure might compound the moral hazard problem common to all financial intermediaries is by providing a vehicle through which equity ownership, which is otherwise dispersed among many shareholders, can become concentrated and impose on regulated subsidiaries more risky business strategies than management would otherwise pursue. Under this view, the significance of holding company ownership is that it provides dispersed shareholders with a mechanism for influencing regulated entities that is not available when shareholders own those entities directly. Jackson, 107 Harv. L. Rev. at 566 (cited in note 19).

59. See id. at 565 (explaining that "moral hazard problems common to all financial institutions are exacerbated when a single corporate shareholder who is well-situated to exploit the moral hazard controls the entire equity interest of a financial institution"); Fallon, 66 N.Y.U. L. Rev. at 1383 (cited in note 1) (noting that the above-described problem was one of the justifications for the source-of-strength doctrine).

60. See Basis for Fed's "Source-of-Strength" Policy Is Questionable, Breeden Says, 49 Banking Report (BNA) 541, 541-42 (Sept. 21, 1987) (quoting the assertion of the Board's General Counsel, Michael Bradfield, that a bank holding company "can't mismanage an institution, [allow it to] have inadequate capital, and walk away from that bank"). See also notes 98-98 and
deposit insurance encourages the abuse of asset-shifting capabilities to the detriment of the FDIC and, eventually, the taxpayers.

The problems described above have received a great deal of legislative and regulatory attention in the past. Many of the measures enacted have attempted, in one way or another, to provide discipline through increasing the liabilities of shareholders and management and increasing the enforcement authority of government regulators. The legislative efforts to combat the moral hazard problem help explain the cross-guarantee's enactment. In addition, they illustrate the general type of regulatory regime to which bank holding company shareholders subject themselves when they invest.

1. The Double Liability System: Deviating from Traditional Corporate Law

Since the nineteenth century, the liability of most corporate shareholders has been limited to the amount invested in the corporation. Except in limited circumstances, such shareholders accompanying text (describing how the cross-guarantee is intended to remedy the moral hazard problem unique to bank holding companies).

61. See Jackson, 107 Harv. L. Rev. at 514-39 (cited in note 19) (describing the evolution of financial holding company regulation and the increasing obligations such companies face, and arguing that most of these regulations are "aimed at insulating regulated subsidiaries from holding company abuse"). For close to twenty years, thrift regulators insisted that thrift holding companies guarantee, at least to some degree, the solvency of their subsidiaries. Id. at 519. This policy was relaxed by regulators in 1988. Id. at 521-22. About the same time, in the banking industry, the FDIC modified its policy with regard to the closure of failed holding company affiliates. It accorded lower priority to loans made by solvent affiliates to insolvent affiliates than it did to other unsecured creditors of the failed affiliates; in this manner, the FDIC shifted some of its resolution costs to holding company affiliates, and thereby to the holding companies themselves. Id. at 534-35.

These regulatory initiatives, along with the double-liability scheme and the source-of-strength doctrine discussed below, demonstrate that the practices and stability of bank holding company enterprises have been of primary concern to regulators. See notes 45-52 and accompanying text (noting that the general regulatory regime governing bank holding companies is in part directed at preventing and controlling abuses). These measures were similar, in purpose and method, to the cross-guarantee. See notes 87-88 and accompanying text.

62. The nature of the regulatory scheme at the time of investment affects the evaluation of an investor's claim that a particular regulation deviates so sharply from that scheme as to effect an unconstitutional taking. Lucas v. South Carolina Coastal Council, 112 S. Ct. 2886, 2899, 120 L. Ed. 2d 798 (1992) (stating that takings analysis is guided by the expectations of investors as to the rights they acquire when they invest).

63. See Model Business Corporation Act §§ 6, 22 (ABA, 1969). See also Larry D. Soderquist and A. A. Sommer, Jr., Corporations 41 (Michie, 3d ed. 1991) (citing limited liability as the most important advantage of organizing a business in the corporate form).

It is significant that, although limited liability has gained an almost revered status in corporate law, see id. at 7 (quoting former Columbia University President Nicholas Murray Butler: "the limited liability corporation is the greatest single discovery of modern times"), it has never been accorded the status of a constitutional right. Instead, the rule is statutory in origin, suggesting that legislatures may eradicate or diminish it with impunity. See Zeppos,
are not held responsible for the debts of the corporation that they own. In contrast, until the Great Depression and the introduction of deposit insurance, many American bank shareholders were subject to "double liability" in the event of failure. If a bank or bank holding company failed, its shareholders were liable for up to the par value of their shares. Legislators replaced double liability with deposit insurance, believing that insurance would protect depositors from bank failure more fully than had the limited market discipline

*Developments in Administrative Law* at 52-54 (cited in note 44) ("Legislative in origin are these rights and particularly with bank shareholders Congress and the states have over the years felt free to change the rules of the game").

Moreover, for much of the time that limited liability has automatically been granted to most corporate shareholders, bank and bank holding company shareholders have been denied that privilege. See Macey and Miller, 27 Wake Forest L. Rev. at 31 (cited in note 4) ("For three quarters of a century—between roughly, the Civil War and the Great Depression—shareholders in American banks were responsible not only for their investments, but also for a portion of the bank's debts after insolvency"). Limited liability, then, is far from an absolute right of bank holding company shareholders. See Part V.A (arguing that bank holding company shareholders have, at most, only a qualified expectation of limited liability).

64. Although limited liability is the general rule, courts will "pierce the corporate veil" and hold shareholders liable for corporate debts under certain limited circumstances. See Soderquist and Sommers, Corporations at 143-60 (cited in note 63) (examining a number of factual scenarios in which courts pierce the corporate veil). In the context of a multi-corporate enterprise, such as a bank holding company, additional grounds for piercing are commonly cited. As Professors Soderquist and Sommers state:

*Usual problems that may lead to piercing are (1) failing properly to approve and document intercorporate transactions, (2) treating multiple corporations as if they were one business, and (3) setting up contractual arrangements that favor one corporation at the expense of another.*

Id. at 155. This Note contends that bank holding companies, by virtue of their structure and the security of deposit insurance, are uniquely positioned to engage in these practices. The cross-guarantee, accordingly, is justifiable as a "presumptive" piercing mechanism. See Part V.A.

65. See note 11. *Anderson v. Abbott,* 321 U.S. 349 (1944), upheld the imposition of double liability on bank holding companies. The Court noted that, if double liability were imposed on independent banks but not on holding companies, it would be far too easy for shareholders to circumvent liability simply by creating a holding company. Id. at 359. The Court would not allow the important statutory policy underlying double liability to be defeated by excusing holding companies from responsibility. Id. at 362-63.

The import of *Anderson* is that it represents an early recognition of the Court that limited liability in the holding company context is not a sacrosanct principle and may be eliminated "when the sacrifice is essential to the end that some accepted public policy may be defended or upheld." Id. at 362 (citation omitted). Investors in holding companies should be aware at the time they invest that both regulators and courts have supported the imposition of added liabilities to ensure stability and prevent abuse. See Part V.A.

66. National Banking Act of 1863 § 12, 12 Stat. at 668. The double liability system was intended, in part, to deal with the lack of adequate shareholder discipline over management. Greater liability would encourage shareholders to monitor management more carefully. See Macey and Miller, 27 Wake Forest L. Rev. at 33 (cited in note 4) (stating that double liability transforms shareholders into investors who are better served by decreased risk-taking by management). See also note 11.
provided by double liability.57 Certainly deposit insurance resulted in protected depositors, as it placed nearly the entire risk of failure on the government. The moral hazard problem, however, was an inevitable result of the implementation of the deposit insurance system.68

Double liability represented a deviation from the traditional statutory right to limited liability enjoyed by other corporate shareholders. Its existence illustrates that banks have always been treated differently by the government; potential investors should be on notice of this tendency.

2. The Source-of-Strength Doctrine

Another regulatory measure intended, in part, to combat the deleterious effects of the moral hazard problem in bank holding companies was the source-of-strength doctrine.69 In the spring of 1987, the Federal Reserve Board issued a policy statement declaring that bank holding companies have a continuing obligation to maintain financial strength at the holding company level and to provide financial support to subsidiaries in times of trouble.70 Failure to comply

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57. Deposit insurance was originally implemented in the Banking Act of 1933 § 12B, 48 Stat. at 168. For a discussion of the political reasons for the termination of double liability, see note 11.

68. Indeed, Professors Macey and Miller advocate reexamination of the double liability system, arguing that it may well be a more effective method of ensuring bank stability than is deposit insurance. Macey and Miller, 27 Wake Forest L. Rev. at 33-35 (cited in note 4). They argue that the moral hazard created by deposit insurance leads to more bank failures overall. Id. On the other hand, because the prospect of added liability in the event of failure encourages shareholders to favor more conservative bank practices, banks would be less likely to drive themselves into insolvency due to excessive risk-taking under a double liability system. Id. Professors Macey and Miller cite historical evidence proving the overall effectiveness of the double liability system. Id. See Part II.C.2 (discussing similar arguments supporting the cross-guarantee).


70. Board of Governors of the Federal Reserve System, Policy Statement; Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks, 52 Fed. Reg. 15707 (1987). The Board's 1987 policy statement was actually a reiteration of what it termed its "fundamental and long-standing" policy requiring bank holding companies to support and recapitalize troubled subsidiaries. Id. See Fallon, 66 N.Y.U. L. Rev. at 1367-72 (cited in note 1) (discussing the history of the source-of-strength doctrine). The Board issued the policy statement in response to the matter of Hawkeye Bancorp, a bank holding company which refused to follow the Board's order to inject $1.2 million into a failing subsidiary, leading to the affiliate's closure. Id. at 1369. The statement clarified bank holding company obligations under the source-of-strength doctrine:

[I]n serving as a source of strength to its subsidiary, a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary
with this obligation "could result in Board enforcement actions, cease-and-desist orders, civil money damages, and other regulatory penalties."71

In essence, the source-of-strength doctrine was an ex ante elimination of limited liability: the gist of the measure was that holding companies would be penalized unless they took responsibility for the financial stability of other corporations, namely, their subsidiaries.72 The Fifth Circuit invalidated the doctrine in 1990, however, as exceeding the Board's statutory authority.73

bonds during periods of financial stress or adversity and should maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting subsidiary banks.

52 Fed. Reg. at 15707.

71. See Fallon, 66 N.Y.U. L. Rev. at 1370 (cited in note 1).

72. See id. at 1381 ("The essence of this theory is that federal regulators need the power to pierce the veil between a bank subsidiary and the [bank holding company] and to force the [bank holding company] to inject capital into the bank, otherwise a [bank holding company] will be tempted to let a troubled insured bank fail and shift the costs of rescuing the bank to the FDIC and, eventually, the taxpayer").

73. MCorp Financial, Inc. v. Board of Governors of the Federal Reserve System, 900 F.2d 852 (5th Cir. 1990), rev'd in relevant part, 503 U.S. 32 (1991). In MCorp, a bank holding company was charged under BHCA with engaging in "unsafe and unsound" practices, considered "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 the subsidiary Banks." Id. at 853. The Federal Reserve Board then ordered the holding company to recapitalize those subsidiary banks that were experiencing trouble; MCorp's subsidiaries had been weakened due to losses on real estate and energy loans. Id. at 853-54. In March of 1989, the Comptroller of the Currency declared insolvent twenty of MCorp's twenty-five subsidiaries, and placed them in receivership. Id. at 853-54. The Board then charged the holding company with failing to act as a source of strength for its subsidiaries. Id. at 854.

The Fifth Circuit found that the Board's issuance of the source-of-strength regulation exceeded its statutory authority under the BHCA. Id. at 860-82. Although the court conceded that the Board could condition its approval of a holding company application on a guarantee that the company would maintain the financial soundness of its subsidiaries, id. at 862 n.5, it nevertheless held that the BHCA's "unsafe and unsound practices" provision did not authorize the Board to use source-of-strength doctrine after approval, id. at 863. The implication of this decision was to invalidate a regulatory tool that could combat the moral hazard problem and prevent further bank failures and depletion of the deposit insurance fund. See Petition for Certiorari 17, Board of Governors of the Federal Reserve System v. MCorp Financial, Inc., 502 U.S. 32 (1991) (arguing that, without the source-of-strength doctrine, there is an "incentive for holding companies to maximize the short-term, cyclical profits of their subsidiary banks, regardless of risk, because the bank insurance fund—not the parent holding companies—would ultimately bear the costs if the subsidiaries later fail").

The Supreme Court, however, reversed the Fifth Circuit's decision holding that the court did not have the jurisdiction to enjoin the Board. MCorp Financial, 502 U.S. at 32. The Court did not reach the statutory authority question. Id. at 35 n.6.

The Board received some additional relief from Congress through the adoption of FIDICIA, 105 Stat. at 2236. Under this statute, the Board retains limited source-of-strength powers, including the authority to force a failing holding company subsidiary to adopt a recapitalization plan to which the holding company must guarantee compliance. Id. § 131(c)(2), 105 Stat. at 2256-57. In sum, bank holding company shareholders have been almost continuously subjected
The common thread between the double liability system and the source-of-strength doctrine is the way the government attacked the moral hazard problem. Instead of targeting the depositor-creditors of the bank holding company by restricting or reducing insurance, these regulations either increased the liabilities of shareholders, increased the enforcement authority of regulators, or both.

Two themes emerge from this discussion. First, anyone investing in a bank holding company should be aware of the legislative and administrative attention such structures receive and of the magnitude of the government's control over them. Second, considering the objectives and types of prior regulation, the enactment of the cross-guarantee should have come as no surprise to investors.

C. The Cross-Guarantee

FIRREA, which included the cross-guarantee power, was passed during a literal disaster-in-progress in the financial institutions industry. As before, the reforms enacted, including the cross-guarantee, were intended to control the moral hazard problem, and the drain on the insurance fund it causes, by imposing added liabilities on shareholders and management, and by increasing regulatory enforcement powers.

1. Background

The increases in the failures of financial institutions in the 1980s were dramatic. Whereas between 1943 and 1974 fewer than ten banks failed in any given year, more than 200 failed each year between 1987 and 1990. Many experts believed the crisis to be the worst since the Great Depression.

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74. See, for example, H.R. Rep. No. 101-54 at 302 (cited in note 23) (“The nation’s thrift industry and its deposit insurance fund, the Federal Savings and Loan Insurance Corporation, are currently in precarious financial condition and consumer confidence in the savings and loan industry is waning”).


76. Department of the Treasury, Modernizing the Financial System at I-30 table 8 (cited in note 14).

77. See Deposit Insurance Reform and Financial Modernization, Hearings before the Senate Committee on Banking, Housing, and Urban Affairs, 101st Cong., 2d Sess. 6 (1990) (statement of Robert N. Downey, Chairman, Securities Industries Association) (“The crises surrounding our federally insured thrifts will he with us for quite some time. We all... have an interest in extricating this country from this mess”).
The moral hazard problem of deposit insurance facilitated many of the abuses that caused the crisis. The Reagan administration's implementation of limited-enforcement policies and deregulation left the industry without adequate governmental supervision, further exacerbating the problem. These factors facilitated unwarranted risk-taking, abuse, and fraudulent practices by bank managers, which in turn increased the numbers of failures.

FIRREA's legislative history provides a detailed analysis of the causes of the savings and loan crisis and sheds some light on the perceived need for reforms such as the cross-guarantee. The analysis cites poor management, fraud, and abuse as important causes of the crisis:

We found that extensive and repeated violations of laws and regulations characterized the 26 failed thrifts we reviewed. Virtually every one of the thrifts was operating in an unsafe and unsound manner and was exposed to risks far beyond what was prudent. H.R. Rep. No. 101-54 at 300 (cited in note 23) (citation omitted). The House Report discusses how management engaged in rapid growth schemes, risky investment strategies, and extravagant spending, and relates regulators' conclusion that nearly 40% of thrift failures were caused by some form of fraud or insider abuse. Id. See also Swire, 42 Duke L. J. at 510-11 (cited in note 6). Professor Swire argues that it is relatively easy for bank insiders to commit fraud upon their banks because "banking involves transactions that are (1) numerous, (2) in highly liquid form, (3) easily forgeable, and (4) involve large amounts of money which (5) often cross jurisdictional boundaries." Id. at 510. Such factors make it difficult for either shareholders or regulators to detect wrongful or highly risky strategies. Id. See also note 325 and accompanying text (arguing that the difficulty of and costs involved in discovering fraud or undue risk-taking make across-the-board measures like the cross-guarantee more efficient to enforce than are measures aimed at individual wrongdoers).

In addition to the abuses described above, there were several other articulable causes of the market breakdown. First, technological advances and new forms of competition combined to decrease the traditional market for commercial banks. Second, the economic climate of the time weakened the banks' stability. Banks have historically had a well-established market due to the prohibitive transaction costs of entering the business. See Fallon, 66 N.Y.U. L. Rev. at 1345 (cited in note 1). Banks were considered to be the most efficient channelers of capital because they could afford to pay the high transaction costs of obtaining financial and credit information. Those seeking to borrow or deposit capital relied on banks to gather and use that information. In this manner, banks secured for themselves a niche in the market. See id.

This niche, however, was diminished due to new advances in computer and telecommunications technology, which enabled non-bank actors to gain the information they needed relatively cheaply. Id. Because these innovations reduced the transaction costs of borrowing and lending, those who purchased and sold the use of capital were increasingly able to sidestep banks and deal with each other directly. Id. Banks were also plagued by new forms of competition. Along with institutionalized savings competitors such as money-market accounts, other capital sources emerged that eroded commercial bank markets, including foreign banks, the Eurodollar markets, and corporate lenders such as General Electric Capital Corporation. Id. at 1345-46.

Additionally, the prevailing economic conditions of the period precipitated a general trend toward bank failure. Record interest rates and inflation during the late 1970s and early 1980s pushed up the costs of obtaining depositors. Arlin, 33 Wm. & Mary L. Rev. at 301 (cited in note 34). The crash of the New England real estate market, as well as adverse conditions in
The slew of bank failures placed great strain on the FDIC. The FDIC experienced its first ever net operating loss in 1988, and, by mid-1990, the Bank Insurance Fund ("BIF") had been depleted to $11.4 billion, approximately six-tenths of one percent of all insured deposits, half the percentage it contained five years earlier.\textsuperscript{81} Even more dramatic was the breakdown in the savings and loan industry, which completely devastated the Federal Savings and Loan Insurance Corporation's ("FSLIC") reserves. Waves of savings and loans failed in the early 1980s; in 1982 alone, the numbers equaled seven percent of all FSLIC-insured institutions.\textsuperscript{82} As the FSLIC was forced to reimburse more and more savings and loan depositors, its funds were rapidly depleted; the amounts owed to depositors eventually exceeded the fund's capabilities by billions of dollars.\textsuperscript{83} Congress was finally forced to complete the bailout with taxpayer money, and public and legislative outrage was the predictable result.\textsuperscript{84}

The government responded to these events by reevaluating the regulatory scheme governing financial institutions, in hopes that changes could be made to strengthen the industry's stability and to ensure that the deposit insurance system would remain viable. In February of 1989, President Bush proposed FIRREA, announcing his intent to reform the savings and loan industry so that financially troubled institutions could be dealt with more effectively and promptly.\textsuperscript{85} The proposal passed through both houses of Congress rapidly, and FIRREA was signed into law on August 9, 1989.\textsuperscript{86}

2. Purposes, Provisions, and Implications of the Cross-Guarantee

FIRREA's stated purposes are to reform and recapitalize the deposit insurance system, to strengthen the regulatory enforcement
powers of the FDIC and related entities, and to increase the criminal and civil sanctions for fraud and abuse.\textsuperscript{87} The cross-guarantee is intended to achieve the first objective—to restore and maintain the solvency of the deposit insurance fund.\textsuperscript{88} As discussed above, depletion of insurance funds is directly caused by the two-pronged moral hazard problem, which encourages exploitation of the insurance system, and which is compounded in the holding company structure. Therefore, like the regulatory measures that preceded it, the cross-guarantee represents an attempt to control the moral hazard problem. It achieves this objective by imposing added liabilities on shareholders.

The cross-guarantee measure provides that, in the event a holding company or holding company subsidiary should require FDIC assistance, all of the insured subsidiaries of the holding company are liable for the costs the FDIC incurs.\textsuperscript{89} Thus, if a subsidiary bank fails or nears default, its commonly controlled affiliates may be charged for the cost of the bailout.\textsuperscript{90} Likewise, if a holding company is in financial straits, all of its subsidiaries are liable if the FDIC steps in.\textsuperscript{91}

The FDIC’s right to collect cross-guarantee payments is subordinate to depositor rights and rights of secured creditors. It has priority, however, over the rights of other commonly controlled institutions and shareholders, including bank holding companies.\textsuperscript{92} Thus, while

\textsuperscript{87} Id. at 187.

\textsuperscript{88} See 55 Fed. Reg. at 21935 (cited in note 33). See also Swire, 42 Duke L. J. at 497-503 (cited in note 8). Professor Swire notes that one common justification for measures like the cross-guarantee is that they are needed to “save the [deposit insurance] fund.” Id. at 497. He argues that the moral hazard problem, which leads to high-risk practices, along with equitable considerations, and the difficulty regulators face in collection of debts, lend credence to the “save the fund” argument. Id. at 498-501. On the other hand, Professor Swire argues that the “save the fund” argument is too open-ended in that it justifies far-reaching governmental influence over banks. Id. at 501. Overall, Professor Swire is unconvinced that preservation of deposit insurance funds is a valid justification for special bank insolvency rules. Id. at 503.

\textsuperscript{89} FIRREA § 206, 103 Stat. at 201-05. The loss for which such subsidiaries are liable is that which the FDIC either actually incurs or anticipates incurring. Id. § 206(e)(1)(A). The FDIC is required to make a good faith estimate of its anticipated losses. Id. § 206(e)(2)(A). It may recoup additional amounts if it underestimates its costs, and must reimburse each subsidiary its pro rata share if it overestimates its costs. Id. § 206(e)(2)(D). If more than one subsidiary is assessed by the FDIC, each subsidiary will be held jointly and severally liable for the FDIC’s losses. 55 Fed. Reg. at 21935 (cited in note 33).

\textsuperscript{90} FIRREA § 206, 103 Stat. at 201-05. The measure only applies to commonly controlled banks, and only affiliates, not parent companies, may be assessed. “Control” is defined as it is in the Bank Holding Company Act. Id. § 206(e)(9). See note 47.

\textsuperscript{91} FIRREA § 206(e)(1)(A), 103 Stat. at 201-05.

\textsuperscript{92} Id. §§ 206(e)(2)(C)(i)-(ii) (setting forth the priority of cross-guarantee liability). The legislative history explains that the cross-guarantee is subordinate to senior debt holders in order to protect their reliance interest. H.R. Rep. No. 101-54 at 412 (cited in note 23).
all non-affiliated debtholders remain protected under the measure, the holding company structure is forced to absorb the costs involved with affiliate failure.93

Although the measure does not directly impose responsibility on holding companies,94 the cross-guarantee is similar to the source-of-strength doctrine and related measures in that it allows the government to deplete holding company resources by assessing its subsidiaries.95 Because holding companies are, by definition, primary investors in their subsidiaries, any assessment against those subsidiaries is essentially a charge against the holding company. In this manner, the cross-guarantee is designed to encourage holding companies to monitor and discipline the activities of their subsidiaries so as to decrease the moral hazard problem.96

Recall that, in theory, the security of deposit insurance and the limited liability principle give bank management the incentive to engage in riskier than average practices; this incentive remains constant as a bank approaches insolvency. Furthermore, the holding company structure exacerbates the moral hazard problem, because holding companies control an institution, and are thereby able to shift

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93. A number of other provisions serve to soften the cross-guarantee's blow. For example, the FDIC has discretion to waive or reduce cross-guarantee liability if it judges that exemption is in the BIF's best interests, FIRREA § 206(e)(5)(A), 103 Stat. at 203, as long as the exempted institution and its affiliates comply with §§ 23(A)-(B) of the Federal Reserve Act, id. § 206(e)(5)(B). See also 55 Fed. Reg. at 21935-36 (cited in note 33) (delineating guidelines for waiving liability). In addition, for five years after FIRREA's enactment, banks were not obliged to reimburse the FDIC for the failure of affiliated thrifts, and vice versa. FIRREA § 206(e)(6), 103 Stat. at 104. For further discussion of the exceptions to the cross-guarantee, see H.R. Rep. No. 101-54 at 326 (cited in note 23).

94. "Controlling company guarantees," which would force holding companies to reimburse the FDIC for the failure of their affiliates, were proposed as part of FIDICIA, 105 Stat. at 2236. As discussed above, such a provision would have constituted a modified codification of the source-of-strength doctrine, which had been invalidated the year after FIRREA's enactment. See note 73. Congress did not adopt the controlling company guarantee, but did provide for a limited guarantee to be imposed on holding companies in some circumstances. FIDICIA § 131(e)(2)(C), 105 Stat. at 2256. See also Broome, 26 U.C. Davis L. Rev. at 963-67 (cited in note 15) (discussing FIDICIA's guarantee provisions and their implications on insolvency risk distribution).

95. See Jackson, 107 Harv. L. Rev. at 537 (cited in note 19) ("[I]t empowers the federal government to make an indirect claim on the resources of [such companies; moreover] . . . the cross-guarantee provision effectively dilutes a holding company's investment in [its] affiliates and thereby depletes its resources").

96. Therefore, the measure's efficacy is in part dependent on the assumption that holding companies are, in reality, able to control and influence the policies and practices of their subsidiaries. This assumption is weakened in the case where there are so-called "uncommon shareholders" in subsidiary banks, which are likewise subject to cross-guarantee liability, but are unable to control the policies or risk-taking of other subsidiaries. The uncommon shareholders, however, still benefit from the asset-shifting capabilities of the holding company, and are aware of the pervasive governmental regulation of such companies. Thus, it is fair to subject such shareholders to the cross-guarantee. See note 297.
assets from one member of the enterprise to another. In this way, holding companies are particularly well-suited to exploit the deposit insurance system.97

The potential of cross-guarantee liability radically alters these incentives. For example, assume Holding Company wholly owns Bank A and Bank B, the depositors of which are federally insured, as well as several uninsured enterprises. In the absence of the cross-guarantee, Holding Company has the incentive to increase its potential profits by concentrating higher-risk loans in its banks and lower-risk loans in its unregulated subsidiaries. Thus, Holding Company, which controls the practices of all its subsidiaries, will stream the higher-risk loans to Banks A and B, increasing their chances for failure, but also increasing Holding Company's potential to earn large profits. The lower-risk assets will be held by the unregulated subsidiaries, increasing their stability.

If, for example, Bank A neared insolvency due to its plethora of high-risk loans, Holding Company, having only its investment to lose, would have "bet the farm." It would have the incentive to stream risky loans to Bank A in the hopes that the profits made would stabilize it. It would also have the incentive to stream less risky loans from Bank A to its healthy affiliates so that those assets would not be lost in the event of Bank A's failure. If Bank A did fail, its depositors would be compensated by the FDIC. Although Holding Company would lose its investment, it would not be liable for Bank A's debts. On the other hand, because Holding Company had the wherewithal to virtually ensure the stability of its other subsidiaries, its losses from Bank A may have been outweighed by the dividends it received from those entities.

In contrast, since the cross-guarantee's enactment, if Holding Company engages in the same type of asset-streaming, placing Bank A at risk, it faces dire consequences. If Bank A fails, and the FDIC bails out its depositors, all of its insured subsidiaries, including Bank B, may now be assessed for the cost. Because Holding Company owns Bank B, Holding Company will effectively face the cost of any assessment against Bank B. Thus, its incentive to exploit the deposit insurance system is reduced.

Furthermore, Holding Company will have little motive to "bet the farm" as Bank A approaches insolvency. On the contrary, because

97. See notes 53-60 and accompanying text.
it will be held indirectly liable for the entire cost of an FDIC bailout. Holding Company will want to limit Bank A’s losses. Overall, the cross-guarantee will encourage Holding Company to act as if deposit insurance did not exist: the company will want to discourage risk-taking by management in order to prevent the failure of any of its members. In this way, the cross-guarantee serves as a deterrent to the moral hazard problem, and may prevent the insurance fund depletion that the moral hazard causes.\textsuperscript{98}

The impact on Holding Company in the event Bank A does fail may be dramatic. If, for example, Bank A, at the time of insolvency, owes its depositors $10 million, then Bank B may be assessed for that amount, plus other costs to the FDIC. Holding Company is indirectly responsible for that amount. If Bank B has a net worth of $5 million when Bank A fails, the $10 million-plus assessment will drive Bank B into insolvency as well. Because the shareholders of Holding Company are the same as the shareholders of Bank B, Holding Company will, most likely, be bankrupted by these liabilities. Because of Bank A’s failure, the FDIC will probably be able to liquidate and sell the entire holding company structure.

The implications of the cross-guarantee are powerful. In theory, the moral hazard problem may be essentially eliminated by the provision. Conversely, because the exercise of the cross-guarantee power does not depend on a showing of fraud, abuse, or disregard for corporate forms, theoretically it may destroy a holding company structure, worth millions or billions of dollars, which has done its best to avoid risk-taking, but which has been befallen by adversities beyond its control. Issues of fairness and constitutionality thus arise as a result of the cross-guarantee’s enactment. Specifically, critics have argued that the use of the cross-guarantee effects a taking without just compensation, in violation of the Fifth Amendment.

In order to develop the background for analyzing the above criticism, the next Part discusses current takings jurisprudence.

\textsuperscript{98} See Part V.C (arguing that the cross-guarantee effectively achieves this objective).
III. CURRENT TAKINGS JURISPRUDENCE

A. The Analytical Framework for Deciding Takings Issues

The Fifth Amendment states: "... [N]or shall private property be taken for public use, without just compensation." The Takings Clause implies that the federal government has the authority to take private property. This authority is known as the power of "eminent domain." On the other hand, the compensation requirement is an embodiment of the Constitution's overarching philosophy that protection of individual property rights is essential to the preservation of liberty. As the Supreme Court stated in *Armstrong v. United States*: "[The] Fifth Amendment's guarantee... [is] designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole."

Over the years, the Supreme Court has struggled to define a viable analysis for evaluating takings issues. The process is a difficult one. Although the Fifth Amendment clearly requires compensation for any taking, the Court has long recognized that the government should not have to reimburse citizens every time property rights or economic interests are harmed by an action of the state. If such a requirement existed, government would be effectively crippled...
because nearly every type of state-imposed duty or liability hurts economic interests in one way or another. Thus, the proper inquiry is when has the government gone too far, so that its action effects a taking?\footnote{106}{See id. at 415 ("The general rule at least is, that while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking"). This view is in accordance with the "simple insurance model" of takings law. Under this model, the Takings Clause operates as an insurance policy against governmental appropriations of property. In order for the clause to work efficiently, however, it must not be used to require compensation for small diminutions in value or trivial physical intrusions. See Eric Kades, Avoiding Takings "Accidents:" A Tort Perspective on Takings Law, 28 U. Richmond L. Rev. 1235, 1240-42 (1994).}

In attempting to draw this difficult line, the Court has created two major categories of takings: per se takings and regulatory takings. Per se takings include the relatively easy instances of the exercise of eminent domain by the state.\footnote{107}{This rule is derived from English common law and has been a part of American law since colonial times. Ely, The Guardian at 23-25 (cited in note 100).} For example, if the government condemns and takes title to a citizen's home so that a public reservoir may be constructed, it is undisputed that the homeowner must be compensated.\footnote{108}{See, for example, United States v. 403.15 Acres of Land, 316 F. Supp. 655, 655-56 (M.D. Tenn. 1970) (concerning the proper disposition of a compensation award paid to a landowner whose land was taken to facilitate the building of a dam and reservoir project).} Recently, however, the Court has included two other types of state actions in the per se category.

First, the Court has held that, if the government physically occupies\footnote{109}{Physical occupation includes laws authorizing or mandating such occupation, as was the case in Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419, 423 n.3 (1982).} an individual's property, it effects a taking. The seminal case regarding physical occupations is \textit{Loretto v. Teleprompter Manhattan CATV Corp.}\footnote{110}{458 U.S. 419 (1982).} In \textit{Loretto}, a New York law required landlords to allow, for a maximum $1 fee, cable television companies to install cable facilities in their tenants' apartments.\footnote{111}{Id. at 421, 423 n.3.} A landlord challenged the measure, arguing that the forced trespass constituted a taking.\footnote{112}{Id. at 424.}

The Court, drawing on past decisions, found that the statute effected a taking without just compensation.\footnote{113}{Id. at 425-41. The Court pointed to early cases like \textit{Pumpelly v. Green Bay Co.}, 80 U.S. (13 Wall) 166, 177-78 (1871), in which a state was forced to pay a landowner whose property was flooded by a state-built dam, for the proposition that a taking occurs anytime the government permanently physically invades land. \textit{Loretto}, 458 U.S. at 427. Additionally, the Court cited \textit{Kaiser Aetna v. United States}, 444 U.S. 164, 179-80 (1979), in which a governmental imposition of a navigational servitude requiring public access to a pond was found to constitute a taking because the landowner had reasonably relied on the right to exclude others from the pond. \textit{Loretto}, 458 U.S. at 433. Because the owner's right to exclude was "one of the most essential sticks in the bundle of rights that are commonly characterized as property," interfering
the principle that permanent physical invasions of property constitute
per se takings.\textsuperscript{114} Although it set forth a clear category of per se tak-
ings, it emphasized the narrowness of its holding, stating that the
rule did not apply to regulations governing the use of property.\textsuperscript{115} In
the recent case of \textit{Lucas v. South Carolina Coastal Council},\textsuperscript{116} how-
ever, the Court expanded the per se category to include certain regu-
lations of land use, when such restrictions deprive the owner of all
economically viable use of her property.\textsuperscript{117}

In \textit{Lucas}, the plaintiff bought two parcels of beachfront prop-
erty, with the intent to build homes upon them. Before he could do so,
South Carolina passed a law requiring governmental approval to
build on property prone to shore erosion. The landowner was prohib-
ited from developing his lots. He sued, claiming a taking.\textsuperscript{118} The state
supreme court, in denying the claim, relied on previous cases that had
permitted the destruction of property value when the regulation was
intended to prohibit “noxious” land uses, those that harmed the public
health, morals, or safety.\textsuperscript{119}

The \textit{Lucas} Court, however, in an opinion by Justice Scalia,
changed its approach to evaluating regulations that eliminate the
value of property. Justice Scalia stated that when such a rule de-
strs all economically viable use of property, it effects a per se tak-
ing.\textsuperscript{120} He argued that no real distinction exists between regulations
that prevent harm and those intended to benefit society; accordingly,
he declared the “noxious uses” justification, which had previously
been used to avoid the compensation requirement, defunct.\textsuperscript{121}
Moreover, in clarifying his addition to the per se taking category,
Justice Scalia stated that a law that effects the elimination of all

\begin{itemize}
  \item \textsuperscript{114} Id. at 441. The Court stated that such a rule avoids line-drawing problems, and noted
  that difficulties with proving invasion will be rare. Id. at 436-38.
  \item \textsuperscript{115} Id. at 441.
  \item \textsuperscript{116} 112 S. Ct. 2886, 120 L. Ed. 2d 798 (1992).
  \item \textsuperscript{117} Id. at 2898-2900.
  \item \textsuperscript{118} Id. at 2900.
  \item \textsuperscript{119} Id. at 2897. The Court cited \textit{Mugler v. Kansas}, 123 U.S. 623 (1887) (upholding a
  prohibition against manufacturing alcoholic beverages); \textit{Hadacheck v. Sebastian}, 239 U.S. 394
  (1915) (permitting a ban on mill operations in a residential area); \textit{Miller v. Schoene, State
  Entomologist}, 276 U.S. 272 (1928) (allowing state destruction of diseased cedar trees to prevent
  the disease from spreading to an orchard); \textit{Goldblatt v. Hempstead}, 369 U.S. 590 (1962)
  (permitting the state to shut down a quarry in a residential area).
  \item \textsuperscript{120} \textit{Lucas}, 112 S. Ct. at 2895.
  \item \textsuperscript{121} Id. at 2898-99.
\end{itemize}
valuable use is permissible only if it is grounded on the state's common law of property or nuisance.\textsuperscript{122}

In sum, \textit{Loretto} and \textit{Lucas} establish two types of per se takings. If the governmental action constitutes a permanent physical invasion of property, or if it destroys all economically viable use of such property, it is an unconstitutional taking.

Another type of takings claim arises when a regulation restricts the use of property or diminishes the property's value. Because of the infinite variety of such measures, so-called "regulatory" takings claims are not treated categorically like per se takings, but instead are analyzed on an ad-hoc basis. The obvious problem for the Court in evaluating these claims was to establish a clear test to discern when the government has gone "too far."\textsuperscript{123}

The Court formulated such a test in \textit{Penn Central Transportation Co. v. New York}.\textsuperscript{124} In that case, the owner of Grand Central Station in New York City challenged the city's Landmark Preservation Law, which placed various obligations and restrictions on owners of certain designated "historical" structures.\textsuperscript{125} The plaintiff wished to construct an office building on top of the standing structure.\textsuperscript{126} The city denied the application to alter the landmark, claiming that the addition would "overwhelm the Terminal by its sheer mass."\textsuperscript{127} The plaintiff sued, arguing that the landmark law

\textsuperscript{122} Id. at 2899. In other words, the state must compensate an owner for destroying her use of property unless it "imposes a restriction that the courts of the state could have enforced under general principles of property or nuisance law." Zeppos, Development in Administrative Law at 256 (cited in note 44).

\textsuperscript{123} See id. at 51 ("The claims court's decision in \textit{Branch} is a predictable consequence of \textit{Lucas}").

\textsuperscript{124} 438 U.S. 104 (1978).

\textsuperscript{125} Id. at 110-15 (describing the operation of the law).

\textsuperscript{126} Id. at 116.

\textsuperscript{127} Id. at 118. The City did, however, give the plaintiff the right to develop an adjacent parcel. Id. at 120.
effected a taking of the plaintiff’s property by diminishing the potential revenues the plaintiff could reap through development.128

Justice Brennan, writing for the Court, rejected the claim.129 In so doing, he set forth a comprehensive analysis of regulatory takings claims. He identified several factors which had, in previous cases, consistently come to the forefront. These were the degree to which the regulation interfered with the property owner’s investment-backed expectations, the economic impact of the regulation on the property owner, and the nature of the governmental action.130

Justice Brennan first argued that, in order for any takings claim to prevail, whether regulatory or per se, the claimant must show at least some interference with her reasonable investment-backed expectations.131 Once a statute abrogating property rights is in place, later purchasers of the regulated property have no reasonable expectation that the statute will not be utilized or enforced.132 Although Penn Central acquired its property before the landmark law was passed, Justice Brennan concluded that the law did not interfere with Penn Central’s expectation concerning the use of the property because it allowed the company to continue to operate the terminal as a railroad station.133

With regard to the economic impact of a regulation, Justice Brennan rejected the argument that a significant diminution of property value will effect a taking when only a few select property owners are adversely affected by the measure. Instead, he stated that legislation often burdens some people more than others, and that such a discriminatory effect does not render the legislation a taking.134 Moreover, when the burden placed on the claimant is combined with concomitant benefits to that claimant, the plaintiff’s argument that

128. Id. at 119.
129. Id. at 138.
130. Id. at 124.
131. Id. at 124-25 (noting that the Court had previously rejected claims where the interest at stake was not “sufficiently bound up with the reasonable expectations of the claimant to constitute ‘property’ for Fifth Amendment purposes”). See also Branch, 51 Fed. Cl. at 630 (acknowledging the requirement of showing interference with investment-backed expectations); California Housing Securities, Inc. v. United States, 959 F.2d 955, 959-60 (Fed. Cir. 1992) (same).
132. This distinction is mandated because takings claims essentially involve challenges to retroactive applications of laws. See Christopher T. Curtis, The Takings Clause and Regulatory Takeovers of Banks and Thrifts, 27 Harv. J. Legis. 367, 388-89 (1990). Mr. Curtis argues that, with regard to the cross-guarantee, the only shareholders who can bring a legitimate takings claim are those who invested prior to FIRREA’s enactment. Id.
133. Penn Central, 438 U.S. at 136.
134. Id. at 138-34.
the value of her property has been diminished is severely weakened.\textsuperscript{135} Although the landmark law did place economic burdens on designated property owners, it did so in a way that benefited the entire city, including Penn Central.\textsuperscript{136} Thus, Penn Central was not severely harmed by the measure.\textsuperscript{137}

The proper standard for evaluating the nature of the governmental action was set forth in \textit{Nollan v. California Coastal Commission}.\textsuperscript{138} Writing for the majority, Justice Scalia held that the governmental action or regulation at issue must substantially advance a legitimate state interest.\textsuperscript{139} He stated that the requirement is more stringent than the rational basis test used to analyze due process and equal protection claims involving economic interests.\textsuperscript{140}

This scrutiny was clarified in the recent case of \textit{Dolan v. City of Tigard}.\textsuperscript{141} In \textit{Dolan}, the owner of a hardware store wished to replace the existing structure with a larger one.\textsuperscript{142} A creek ran through one corner of her lot.\textsuperscript{143} The area surrounding the creek was designated as a floodplain, unusable for commercial development.\textsuperscript{144} The proposed construction would have caused additional water runoff from the floodplain on her property, but did not actually encroach on the floodplain.\textsuperscript{145} The city conditioned the plaintiff’s development permit in part on her promise to deed a portion of the floodplain to the city.\textsuperscript{146}

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\textsuperscript{135} Id. at 134-35. This principle was reiterated in \textit{Connolly v. Pension Benefit Guaranty Corp.}, 475 U.S. 211, 224-25 (1986), and significantly affects the analysis of the cross-guarantee’s fairness. If holding companies benefit from the measure, and from the viability of the deposit insurance system in general, it is equitable to subject them to concomitant liability. See notes 296-97 and accompanying text.

\textsuperscript{136} \textit{Penn Central}, 438 U.S. at 134-35.

\textsuperscript{137} Id.

\textsuperscript{138} 438 U.S. 825 (1987). \textit{Nollan} concerned a challenge by owners of beachfront property who were required to grant a public easement across their lot in order to obtain permission to construct a bungalow on the lot. Id. at 828. The Nollans argued that the state must show a direct relationship between the condition and the policy behind it—ensuring public access to the beach. Id. The Court found the state’s argument that the bungalow would prevent “visual access” to the beach unworkable, and instead held that the condition did not meet even the roughest means-ends test, as no “essential nexus” was established between the state’s interest and the condition imposed. Id. at 838-39.

\textsuperscript{139} Id. at 834.

\textsuperscript{140} Id. at 834 n.3 (“We have required that the regulation ‘substantially advance’ the ‘legitimate state interest’ sought to be achieved, not that ‘the state ‘could rationally have decided’ that the measure adopted might achieve the State’s objective’” (citation omitted)).

\textsuperscript{141} 114 S. Ct. 2309, 129 L. Ed. 2d 304 (1994).

\textsuperscript{142} Id. at 2313.

\textsuperscript{143} Id.

\textsuperscript{144} Id.

\textsuperscript{145} Id. at 2315 (relating the City Planning Commission’s finding that there would be “increased storm water flow from the subject property to an already strained creek and drainage basin” (citation omitted)).

\textsuperscript{146} Id. at 2314.
The city claimed that the requirement of dedication was necessary in order to deal with the water runoff problem, but the plaintiff sued, arguing that the requirement bore no substantial relation to the proposed development.\textsuperscript{147}

The Court agreed with the plaintiff, holding that the government bears the burden of proving that there is a "rough proportionality" between the requirement imposed on the owner and the problem the exaction is intended to solve.\textsuperscript{148} In other words, the government must show that the regulation is somewhat related in nature and degree to the purpose it is intended to achieve.\textsuperscript{149} Using this test, the Court found that the dedication requirement constituted a taking.\textsuperscript{150} It found that the city's need to deal with the runoff problem could be met without appropriating the plaintiff's land.\textsuperscript{151} Thus, the permit condition was not "roughly proportional" to the problems it was intended to solve.\textsuperscript{152}

The analytical framework the Court has established to evaluate takings claims is relatively simple. There are two classes of takings, per se and regulatory. In asserting either type, the plaintiff must establish a frustration of her reasonable investment-backed expectations. Then, if the plaintiff shows either a physical invasion of her land or a deprivation of all economically viable use of her land, the Court will find a per se taking. If she can only show a diminution in the value of her property, the Court will apply the three-pronged \textit{Penn Central} test. It will consider the degree to which her legitimate expectations have been frustrated, and, in related fashion, will determine how the measure impacted her economically at the time it was passed. On the other side of the scale, the Court will decide

\begin{footnotesize}
\begin{enumerate}
\item Id. at 2315.
\item Id. at 2319. The Court explained its analysis as follows: 
In evaluating petitioner's claim, we must first determine whether the "essential nexus" exists between the "legitimate state interest" and the permit condition exacted by the city. If we find a nexus exists, we must then decide the required degree of connection between the exactions and the projected impact of the proposed development. We were not required to reach this question in \textit{Nollan}, because we concluded that the connection did not meet even the loosest standard. Id. at 2317 (citation omitted). In \textit{Dolan}, the Court resolved that question by declaring that the exaction must be "roughly proportional" in nature and extent to the development's impact. Id. at 2319-20.
\item Id.
\item Id. at 2322.
\item Id. at 2320.
\item Id. at 2321.
\end{enumerate}
\end{footnotesize}
whether the regulation substantially advances a legitimate governmental interest by applying a rough proportionality test.

Although the analysis of takings issues has been simply formulated, the sheer variety of claims that come before the courts has made it difficult to apply the analytic framework with much certainty. This Note next discusses some patterns that have emerged in recent takings decisions, and which suggest the Supreme Court's likely stance on the constitutionality of the cross-guarantee.¹⁵³

B. Recent Trends in Takings Jurisprudence

1. In General

The right to be compensated for a governmental taking of one's property is an economic right, and the Court's posture toward economic constitutional rights suggests that it would uphold most governmental actions that burden property rights.¹⁵⁴ Indeed, the Court's analytical framework in takings cases tilts in favor of the government: only in cases of actual seizure, physical occupation, or economic destruction must the government automatically compensate the property owner. In all other cases, the Penn Central test will be used.

The Penn Central analysis has proved very beneficial to the government. Few regulatory takings claims have survived judicial scrutiny. The reasons for judicial deference to the government when it comes to regulations adversely affecting economic interests are many and controversial. It is clear, however, that challenges to the cross-guarantee will be difficult to win on regulatory takings grounds. More specifically, courts have been wary of claims involving highly regulated entities, especially banks.

¹⁵³. These patterns also place potential holding company investors on notice of the likelihood that governmental regulations affecting the value of their investments will be upheld by the courts. Such notice in turn decreases their investment-backed expectations, and weakens the argument that a takings claim will be upheld. See Part V.A.

¹⁵⁴. Since the New Deal, the Supreme Court has taken a deferential stance with regard to governmental regulations that burden economic rights. See, for example, Nebbia v. New York, 291 U.S. 502, 539 (1934) (upholding a state-imposed price floor for milk); West Coast Hotel Co. v. Parrish, 300 U.S. 379, 400 (1937) (upholding a minimum wage law); Home Building and Loan Association v. Blaisdell, 290 U.S. 398, 448 (1934) (upholding an act providing temporary relief from foreclosure against a contracts clause challenge); Williamson v. Lee Optical of Oklahoma, Inc., 348 U.S. 483, 491 (1955) (upholding a law forbidding opticians from fitting eyeglasses without a prescription). For a detailed analysis of the Court's approach to economic rights cases in modern times, see Ely, The Guardian at 119-132 (cited in note 100).
2. Regulatory Takings Claims of Investors in Regulated Entities

Courts have generally been reluctant to uphold takings claims when the claimant is an investor in a highly regulated industry. This general pattern stems from an analysis of those investors' reasonable investment-backed expectations. Because such investors are aware of the nature and the extent of the regulatory scheme governing the entity when they invest, they cannot legitimately expect that those regulations will not change in a way that hurts them economically.155

George Miller and Jonathan Abram note that a debate has been going on in the courts regarding reasonable expectations in a regulated economy.156 The disagreement concerns the requisite relationship between the preexisting regulatory scheme and the new regulation. Must the state reserve the authority to enact a subsequent measure so as to forewarn investors specifically, or is a more general prior regulatory scheme sufficient?157 Miller and Abram state that Lucas requires specificity in the preexisting regulatory system. That case suggests that the takings issue turns on whether the post-investment regulation deviates from the law at the time the owner invested.158 Miller and Abram also note, however, that the lower courts have not read Lucas so restrictively.159

For example, in Preseault v. United States,160 the Court of Federal Claims considered the constitutionality of the “Rails to Trails” statute, which governed owners of property subject to railroad easements.161 According to the statute, the Interstate Commerce

155. See, for example, Preseault v. United States, 27 Fed. Cl. 69, 96 (1992) (holding that the complex regulatory scheme governing the claimants at the time of their acquisition of certain property interests eliminated any reasonable expectation they may have had that burdensome regulation would not be enacted).
157. Id. at 865.
158. Id. at 864.
159. Id. at 865 (“The Court of Federal Claims ... suggests that the preexisting regulatory scheme need not have addressed the later-prohibited use very specifically at all”). Perhaps this deviation can be explained by the fact that Lucas does not apply to cases where a regulation deprives a property owner of only part of her value or use. Instead, Lucas's rule appears to govern only those cases where a court finds total economic destruction has been exacted by the state. Lucas, 112 S. Ct. at 2899 (“Where the State seeks to sustain regulation that deprives land of all economically beneficial use, we think it may resist compensation only if ... the proscribed use interests were not part of his title to begin with” (emphasis added)).
161. Id. at 92-94.
Commission ("ICC") had the authority to preserve railroad easements on private property for future railroad use and to build recreational trails on the easements in the interim. A group of property owners sued, claiming that the easements had been abandoned prior to the enactment, and had thus reverted to the plaintiffs; therefore, when the ICC asserted title to the land, it effected a taking.

The court rejected the claim despite the fact that it relied on the Lucas holding. It warned that the mere reference to a general regulatory scheme is insufficient to undermine an owner's reasonable expectation of her right to use the property without interference, but nevertheless concluded that the preexisting scheme, while not specifically precluding the plaintiffs' exercise of their reversionary interests, had undermined their expectation of such a reversion. Thus, the court seemed to depart from the reading of Lucas that mandates that, to forestall a takings claim, the specific preclusion be part of the prior regulatory scheme.

3. Regulatory and Per Se Takings Cases Involving Bank Regulations

As the above discussion illustrates, it is unclear how specifically a preexisting regulatory scheme must provide for a subsequent prohibited use. It seems evident, however, that the sheer magnitude of the government's control over banks makes courts wary of upholding takings claims by bank shareholders. Numerous claims have been brought by bank shareholders challenging a wide variety of banking regulations, but to no avail. Courts are reluctant to uphold takings

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164. Id. at 94.
165. Id.
166. Miller and Abram, 42 Cath. U. L. Rev. at 885 (cited in note 156). Miller and Abram also note that earlier cases were even more deferential to the state. Cases such as American Satellite Co. v. United States, 26 Cl. Ct. 146, 159-60 (1992), found no frustration of legitimate expectations when the new measure was consistent with the preexisting regulatory scheme. In American Satellite, the Federal Claims Court held that a person who contracted with the government to launch a space satellite had no legitimate expectation that, in the wake of the Challenger disaster, the government would not cancel the contract. Id. at 160.
167. See, for example, American Continental Corp. v. United States, 22 Cl. Ct. 692, 693 (1991) (denying a claim that placement into FSLIC receivership effected a taking); California Housing Securities, 959 F.2d at 955 (denying a thrift's claim that placement into Resolution Trust Corporation receivership constituted a physical seizure of the thrift's assets and therefore worked a taking); Golden Pacific Bancorp, 15 F.3d at 1066 (denying a similar claim where a bank argued that the Comptroller of the Currency improperly caused the bank to fail by "reneging" on a commitment to count "Yellow" certificates of deposit as assets rather than as deposits).
claims in banking cases because bank shareholders, having invested in one of the nation's most regulated entities,168 have very low investment-backed expectations.

In American Continental Corp. v. United States,169 a thrift was placed into receivership by the Federal Home Loan Bank Board ("FHLBB") due to its determination that the thrift was in an "unsafe and unsound condition."170 The shareholders of the thrift claimed the seizure effected a per se taking.171 They argued that the corporation's expectations had been defeated because, at the time the corporation was chartered, the federal government had no power to appoint a receiver.172

The Federal Claims Court disagreed. The court stated that it is not reasonable for an investor in a highly regulated entity to expect that regulations will not be "buttressed by subsequent amendments to achieve the legislative end."173 Therefore, although the corporation was established before the power to appoint a receiver was conferred upon the federal government, the later enactment of that power did not frustrate the corporation's expectations.174

American Continental also addressed the reasonable expectations of the thrift's shareholders. The shareholders argued that they had a reasonable expectation that they could retain the right to control their property, the thrift.175 The court held that they did not have such an expectation, because the law at the time they invested gave the government the power to appoint a receiver if it deemed the thrift to be engaging in unsafe or unsound practices.176 The court implicitly precluded the possible argument that the shareholders' expectations could be defined by considering the law at the time the corporation was chartered.177

168. See American Continental, 22 Cl. Ct. at 695 (noting that the federal government regulates many aspects of the operations of savings and loan associations in order to protect the strong public interest in maintaining the stability of such entities). See also Part II (detailing the regulatory scheme that governs banks).


170. Id. at 693.

171. Id. at 694.

172. The plaintiffs brought both a shareholders' derivative action on behalf of the corporation and an action on behalf of the shareholders themselves. Id.

173. Id. at 697.

174. Id. (quoting FHA v. The Darlington, Inc., 358 U.S. 84, 91 (1958)).

175. Id. at 700.

176. Id. at 694.

177. Id. at 697.

178. This argument was made and accepted by the Court of Federal Claims in Branch, 31 Fed. Ct. at 626, which struck down the cross-guarantee as a taking. Id. at 634, 637. It makes
Another pattern evident in the banking cases is the unwillingness of courts to find that bank regulations effect per se takings. In California Housing Securities, Inc. v. United States, thrift shareholders argued that the government effected a per se taking when it placed the thrift into receivership. Relying on Loretto, the plaintiffs claimed that the seizure constituted a physical occupation of their property, the thrift. In denying the claim, the court rejected the plaintiffs' argument that their property had been physically invaded, pointing to the lack of a real-world expectation that the thrift would not be seized if it was deemed to have engaged in unsafe or unsound practices. Thus, the plaintiffs' attempt to avoid an expectations analysis by relying on a Loretto argument was unsuccessful. Furthermore, because the seizure of a bank or thrift is probably as close to physical occupation as is possible in banking cases, the California Housing decision should spell doom for per se takings claims in other banking cases.

Overall, the trend in the banking cases is to deny takings claims. Courts are loath to find a per se taking, and are very reluctant to find a regulatory taking due to the fact that bank shareholders have limited investment-backed expectations. These trends should impact the assessment of the cross-guarantee's validity.

4. Connolly and Concrete Pipe

Finally, two Supreme Court cases will significantly affect the evaluation of the cross-guarantee. Connolly v. Pension Benefit Guaranty Corporation and Concrete Pipe and Products of Cal. v. Construction Laborers Pension Trust for Southern Cal. addressed the constitutionality of pension plan regulations rather than bank regulations, but are relevant because they involve governmental more sense, however, to follow American Continental, analysing a property owner's "real world" expectations from the time she invests, rather than from the time that the entity was created. This is the approach advocated by Lucas. 112 S. Ct. at 2899. See also Part V.A.1.

179. The American Continental court, in fact, cautioned against applying Loretto in cases brought by bank shareholders: "The Loretto per se approach should not facilely be extended in cases where the historically rooted expectations that underlie the Loretto decision do not remotely apply. The instant case involves a regulatory action in a highly regulated industry in which the government took actions that reasonably should have been expected by plaintiffs." 22 Cl. Ct. at 701.
180. 959 F.2d 955 (Fed. Cir. 1992).
181. Id. at 957.
182. Id. at 955-57.
185. 113 S. Ct. 2264, 124 L. Ed. 2d 539 (1993).
elimination of limited liability in a structure similar to a holding company. In both cases, employers challenged the withdrawal liability provision of the Multiemployer Pension Plan Amendments Act of 1980 ("MPPAA"). The MPPAA amended the Employee Retirement Income Security Act of 1974 ("ERISA") to mandate that any employer who withdrew from a multiemployer plan faced liability in proportion to that employer's share of the plan's unpaid-for benefits. The purpose of the additional liability was to ensure that the employees covered under the plan were paid, and to preserve simultaneously the solvency of the Pension Benefit Guaranty Corporation ("PBGC"), which was charged with providing insurance to pension beneficiaries. Thus, the withdrawal liability provision and the cross-guarantee work in similar fashion.

In Connolly, the employers argued that the MPPAA added obligations that were not included in the contracts establishing their multiemployer plans; under the contracts, the employers were liable only for a designated contribution, not for a proportionate share of the benefits. The employers claimed that the provision forced them to make an uncompensated transfer of their assets to the PBGC and therefore effected a taking. The Court denied the claim. The Court noted that it had long recognized that the government may adjust economic benefits and burdens without compensating affected parties, even if such adjustments take the form of added duties or enhanced liabilities. It specifically found permissible the elimination of the limited liability "right" found in the pension plan contracts. Additionally, the Court

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186. Connolly, 475 U.S. at 220; Concrete Pipe, 113 S. Ct. at 2270-71.
189. See Connolly, 475 U.S. at 215-17.
190. See notes 87-88 and accompanying text. Because of the characteristics these measures share, the Court's evaluation of the MPPAA should impact its analysis of the cross-guarantee. For a discussion of the general similarities between multi-employer pension plans and financial holding companies, see Jackson, 107 Harv. L. Rev. at 540-42 (cited in note 19).
191. 475 U.S. at 218.
192. Id. at 221.
193. Id. at 222-23.
194. Id. at 223. The Court cited Usery v. Turner Elkhorn Mining Co., 428 U.S. 1, 15-16 (1976), for the proposition that rights and burdens may be regulated, as a general matter, without effecting a taking. Connolly, 475 U.S. at 223.
195. Connolly, 475 U.S. at 224. The Court's statement demonstrates that limited liability is not a fundamental or inviolate right, but is subject to governmental diminution or
noted that the liability imposed would not be made "in a vacuum," but was directly dependent on the employers’ relationship with the plan; thus, the economic impact on the employers would not be inordinate.

Finally, the 

Connolly

Court evaluated the investment-backed expectations of the employers who had participated in the regulated plan. It held that the plaintiffs had notice at the time that they joined the plan that pension plans were of significant concern to the government, were currently being regulated, and could be subject to changes in the regulatory scheme. The Court concluded that the withdrawal liability provision was constitutional.

In 

Concrete Pipe,

decided in 1993, the claim was slightly different. Again, the employer pointed to a contractual “right” to limited liability established when it entered the plan, which the Court dismissed by reference to 

Connolly.

In addition, however, the employer claimed that none of its employees could have vested benefits because the employer had not contributed to the plan for a sufficient period of time. The government’s assessment of liability therefore bore no rational relationship to the employer’s contributions and was unconstitutional.

In rejecting this argument, the 

Concrete Pipe

Court made a significant point. It stated that multiemployer pension plans essentially operate as a single entity, not as a group of separate individuals. Such plans allow a group of employers to pool their resources so that each employer’s contributions benefit all the employees cov-
ered, not just their own. In the same manner, the employers spread among the entire membership the risks of their employees' benefits vesting, so that each employer faces a lower average level of risk than it would under a single employer plan. The Court concluded that, because the MPPAA spreads the costs among the employers in essentially the same manner as the employers would have spread the costs among themselves, the liability provision was entirely fair, despite the fact that some employers like Concrete Pipe might face liabilities that did not stem from their own employees. By joining the plan, Concrete Pipe assumed the risk of this possibility. In this sense, the Concrete Pipe Court reiterated the Penn Central Court's view that the economic benefits to a takings claimant should be considered along with the costs.

This reasoning may be translated into an analysis of the cross-guarantee. Holding companies resemble multiemployer pension plans in that the structure allows the members to spread the risks of loss among a number of members. Holding companies therefore also have the ability to operate as a single entity rather than as a group of separate member banks. Because they benefit from the structure they assume and from the security of deposit insurance, bank holding companies should bear the concomitant costs that arise from the utilization of those privileges.

Connolly and Concrete Pipe seem to place the Court's stamp of approval on regulations that increase the liabilities or risks of investors who also benefit from the regulatory scheme governing their property. These cases coincide with the general trend of rejecting regulatory takings claims, which is especially pronounced when the burdened property is highly regulated.

Despite these clear patterns, however, the cross-guarantee failed to withstand constitutional scrutiny in one of the two cases to analyze it. The next Part describes the facts and holdings of each case, setting the stage for an assessment of the measure's validity.

203. Id. at 2288.
204. Id.
205. Id.
206. Id. With regard to Concrete Pipe's takings claim, the Court primarily relied on Connolly to dismiss all of the plaintiff's arguments. Id. at 2295.
207. See notes 97-98 and accompanying text.
208. See notes 255-96 and accompanying text.
IV. MERIDEN AND BRANCH: THE FIRST CASES EVALUATING THE CROSS-GUARANTEE

Meriden Trust and Safe Deposit Co. v. FDIC209 and Branch on Behalf of Maine Natl. Bank v. United States,210 both decided in 1994, are the first two cases to address the constitutionality of the cross-guarantee.211 Each case involved a challenge to an assessment of liability pursuant to the cross-guarantee, rather than a facial challenge to its validity.212

A. Meriden Trust and Safe Deposit Co. v. FDIC

In connection with the 1991 failure of Central Bank for Savings, a “commonly-controlled” affiliate of the Meriden Trust and Safe Deposit Co., the FDIC assessed Meriden for the losses it incurred in the bailout.213 The assessment totaled almost $152 million.214 Meriden sought review of the FDIC’s assessment, which was upheld by the administrative law judge and the FDIC’s board of directors.215 The U.S. District Court for the District of Connecticut affirmed this final agency action, granting the FDIC summary judgment.216

In rendering its decision, the court summarily rejected the argument that the cross-guarantee effected a taking.217 The court reasoned that, because Meriden had voluntarily purchased federal

211. In Meriden, the district court based its decision entirely on the plaintiff’s voluntary renewal of deposit insurance, and did not consider the other pertinent issues regarding the cross-guarantee’s overall constitutionality. 868 F. Supp. at 33. The Second Circuit, in affirming Meriden, also based its decision on the renewal of deposit insurance, but gave limited attention to other issues as well. See 62 F.3d at 455 (concluding that the appellants failed to overcome the “heavy burden” faced by those alleging a regulatory taking). The Court of Federal Claims evaluated these issues in Branch and found the cross-guarantee, as enacted, to be a compensable taking to the extent that the plaintiff bank had acted in accordance with its separate corporate form. 31 Fed. Cl. at 637. Because Branch provides a more complete analysis of the questions surrounding the cross-guarantee, it will be used as the primary point of departure for this Note’s evaluation.

These cases also demonstrate the impact of a court’s decision on the cross-guarantee’s validity. The contrary holdings of the Meriden and Branch cases literally decided the disposition of millions or billions of dollars, along with the life or death of two holding company structures, showing the importance of carefully and finally resolving this issue.

212. Meriden, 868 F. Supp. at 31 (describing the assessment leveled against each institution); Branch, 31 Fed. Cl. at 629 (same).
214. Id.
215. Id.
216. Id. at 30.
217. Id. at 33.
deposit insurance after FIRREA was passed, maintaining the ability to accept deposits from the public, it chose to subject itself to the risk of a cross-guarantee assessment.\textsuperscript{218} Thus, the shareholders of the trust company could not legitimately expect that they would not be held liable by the FDIC.\textsuperscript{219}

\textit{Meriden} was affirmed by the Second Circuit.\textsuperscript{220} Again, the court held that, because Meriden had chosen to participate in the deposit insurance system, and had continued to participate in the system after the enactment of the cross-guarantee, it assumed the risk of a cross-guarantee assessment.\textsuperscript{221} Moreover, the court argued that, even if deposit insurance renewal was not dispositive, the cross-guarantee assessment did not effect a taking.\textsuperscript{222} First, the adverse impact Meriden suffered was partially due to its subsidiary's failure, and could not be blamed entirely on the cross-guarantee's assessment.\textsuperscript{223} Second, the cross-guarantee did not disrupt Meriden's reasonable expectations because Meriden operated in a highly regulated field.\textsuperscript{224} Finally, the government's action merely adjusted economic rights and burdens to promote the public interest.\textsuperscript{225}

On the other hand, the \textit{Branch} court rejected the argument that voluntary renewal of deposit insurance negates a takings claim.\textsuperscript{226} Furthermore, it reached the opposite conclusion from \textit{Meriden} with respect to the evaluation of the \textit{Penn Central} factors.\textsuperscript{227}

\textbf{B. Branch on Behalf of Maine Natl. Bank v. United States}

The \textit{Branch} plaintiff was the Chapter 7 trustee of the estate of the Bank of New England Corp. ("BNEC"), the holding company and sole shareholder of Maine National Bank ("MNB").\textsuperscript{228} MNB was chartered in 1889, and was acquired by BNEC in 1985.\textsuperscript{229} BNEC owned several other subsidiaries, including the Bank of New England, N.A.

\begin{footnotesize}
\begin{itemize}
  \item \textsuperscript{218} Id.
  \item \textsuperscript{219} Id.
  \item \textsuperscript{220} 62 F.3d at 449.
  \item \textsuperscript{221} Id. at 455.
  \item \textsuperscript{222} Id.
  \item \textsuperscript{223} Id.
  \item \textsuperscript{224} Id.
  \item \textsuperscript{225} Id.
  \item \textsuperscript{226} \textit{Branch}, 31 Fed. Cl. at 628.
  \item \textsuperscript{227} Id. at 635.
  \item \textsuperscript{228} Id. at 628.
  \item \textsuperscript{229} Id.
\end{itemize}
\end{footnotesize}
("BNE"), and Connecticut Bank and Trust Co., N.A. ("CBT").

MNB and CBT remained healthy during the financial institutions crisis in the late 1980s. BNE, however, began to experience financial troubles in 1986. BNEC made efforts to stabilize the company by transferring assets to its accounts, but the measures were futile. The Office of the Comptroller of the Currency ("OCC") declared the subsidiary and BNEC insolvent on January 6, 1991, and placed them into FDIC receivership. That day, the FDIC served MNB with a Notice of Assessment of Liability pursuant to the cross-guarantee power. The assessment totaled just over $1 billion.

At the time it was charged, MNB's net worth totaled about $65 million. Because the cross-guarantee assessment was considered a valid debt of MNB, the OCC declared it insolvent, and placed it into receivership as well. Similar action was taken regarding BNE and CBT. BNEC was forced to file a petition for bankruptcy on January 7, 1991. The FDIC, as receiver of all of the holding company members, subsequently sold them to the Fleet/Norstar Financial Group, Inc. Through its use of the cross-guarantee, the FDIC was able to effect a transfer of the ownership of an ailing holding company structure.

MNB filed suit in the Court of Federal Claims, alleging that the exercise of the cross-guarantee power had driven it into insolvency and therefore constituted a taking of its property for a public use without just compensation. MNB argued that it should be compensated for at least its entire net worth at the time of the cross-guarantee assessment, $65 million. The government moved for summary

230. Id.
231. Id.
232. Id. at 629.
233. Id.
234. Id.
235. Id.
236. Id. This amount was later lowered by the FDIC to $98,985,000. Id. at 629 n.2.
237. Id. at 629.
238. Id.
239. Id.
240. Id.
241. Id.
242. It is probable that the FDIC's ability to effect transfers of entire bank holding companies through exercise of the cross-guarantee power, thereby retaining the going-concern value of those companies, is a main purpose behind the measure. Retention of going-concern value is a central goal of bankruptcy law. Thomas H. Jackson, The Logic and Limits of Bankruptcy Law 14-15 (Harvard U., 1986).
244. Id.
judgment, arguing that the facts were undisputed and that the cross-guarantee was constitutional as a matter of law.\textsuperscript{245} In particular, the government argued that the assessment did not effect a regulatory taking because MNB voluntarily subjected itself to a pervasive regulatory scheme and thus "lacked the requisite investment-backed expectation" that it would not be held liable.\textsuperscript{246} The government also emphasized the fact that the cross-guarantee was intended to further the public interest in a sound banking system.\textsuperscript{247} Finally, the government stated that, overall, FIRREA benefited BNEC; therefore, even if MNB was forced to bear a heavier share of the burden of the cross-guarantee, that burden deprived BNEC of only a "strand" in its "bundle" of property rights.\textsuperscript{248}

MNB argued that the assessment constituted a per se taking.\textsuperscript{249} Because the FDIC was able to seize the assets of the bank subsequent to charging it with cross-guarantee liability, it had physically appropriated the bank's property.\textsuperscript{250} MNB alternatively argued that the assessment effected a regulatory taking as evaluated under \textit{Penn Central}.\textsuperscript{251} First, it argued that the assessment was not carried out for the public good, but was instead intended to preserve the FDIC.\textsuperscript{252} Next, it disputed the government's assertion that the burden imposed by the cross-guarantee was somewhat beneficial to MNB; to the contrary, the assessment destroyed the institution.\textsuperscript{253} Finally, MNB claimed that the enactment of the cross-guarantee radically frustrated its reasonable investment-backed expectation of limited liability.\textsuperscript{254} It argued that the BHCA and established legal precedent stood for the principle that the separate corporate status of members of bank holding companies would be respected, and that such members would not be held responsible for each others' debts.\textsuperscript{255}

\begin{thebibliography}{99}
\bibitem{245} Id. at 630-31.
\bibitem{246} Id. at 630.
\bibitem{247} Id.
\bibitem{248} Id. at 630-31 (citation omitted).
\bibitem{249} Id. at 631.
\bibitem{250} Id.
\bibitem{251} Id.
\bibitem{252} Id.
\bibitem{253} Id.
\bibitem{254} Id.
\bibitem{255} Id. MNB also argued that its continuation of deposit insurance was not voluntary, but was mandatory under the BHCA. The fact that it was federally insured therefore could not constitute a waiver of its rights under the Takings Clause. Id.
\end{thebibliography}
The court considered all of these arguments, and denied the government's motion for summary judgment. The court concentrated its analysis on the historically rooted expectations of MNB. It affirmed the principle that, to constitute a taking, a measure must, at least to some degree, frustrate the claimant's legitimate expectations. The court recognized Preseault's proposition that the expectations of an investor in a highly regulated industry must be evaluated in light of the regulatory scheme. It distinguished that case, however, arguing that the claimant in Preseault had purchased her property long after the general regulatory scheme had been enacted. Conversely, MNB was chartered in 1889, long before the passage of FIRREA, and FIRREA was not a continuation or a logical extension of any regulatory scheme governing MNB in 1889. Therefore, while the expectations of the Preseault plaintiff could be measured against a 'backdrop of pervasive regulation, MNB's expectations could not be calculated in this way. Instead, the cross-guarantee's impact had to be measured by comparison to the regulatory scheme existing in 1889.

Using this approach, the court held that the cross-guarantee defeated MNB's expectations. It stated that the cross-guarantee's enactment disrupted the bank's expectation that, if it complied with governmental regulations, it would not be held responsible for another corporation's debts. According to the court, MNB had reasonably relied on the principle of limited liability. The court noted that MNB was operating in a highly regulated industry, but stated that this fact did not amount to a waiver by MNB of all of its property rights. Instead, the court held that the waiver of property rights is limited to what foreseeably could be waived at the time of the investment. Because the cross-guarantee operated

256. Id. at 637.
257. Id. at 632 (explaining the rationale behind the rule that expectations must be evaluated as "a way of limiting takings recoveries to owners who could demonstrate that they bought their property in reliance on a state of affairs that did not include the challenged regulatory scheme") (quoting Loveladies Harbor, Inc. v. United States, 28 F.3d 1171, 1177 (Fed. Cir. 1994)) See also notes 131-33 and accompanying text.
258. Branch, 31 Fed. Cl. at 632.
259. Id.
260. Id. at 633-34.
261. Id. at 633.
262. Id. at 633-34.
263. Id. at 632.
264. Id. at 632 ("The cross-guarantee's enactment was an unforeseeable and radical departure from the system under which MNB had been operating for almost a century").
265. Id. at 634.
266. Id.
to deprive MNB of all of its assets, it exacted a total forfeiture of the bank’s property rights, and thus went too far.\textsuperscript{267}

The court held that, because the cross-guarantee had deprived MNB of all of its assets, regulatory takings analysis was improper. Instead, it found the assessment to effect a per se taking.\textsuperscript{268} Although the court found that the cross-guarantee was intended to serve the public good, as the government contended, it declined to consider that factor, deeming it inapplicable in a per se taking evaluation.\textsuperscript{268}

Even though it held the charge against MNB to be a per se taking, the court took the added step of distinguishing \textit{Connolly} and \textit{Concrete Pipe}. It found that the withdrawal liability impositions in those cases, though economically harmful to the employers, were at least proportionate to those employers’ experience in the plan because they directly depended on the contributions made.\textsuperscript{270} In contrast, the court found that the cross-guarantee liability imposed on MNB was in no way proportionate to any debt MNB owed to the FDIC or related to any interaction it had with the FDIC.\textsuperscript{271} Instead, the liability effected a destruction of MNB’s entire net worth, based entirely on another corporation’s failure.\textsuperscript{272} Thus, the cross-guarantee could not be validated under \textit{Connolly} and \textit{Concrete Pipe}.\textsuperscript{273}

In sum, the court held that MNB’s historically-rooted expectation of limited liability was frustrated by the cross-guarantee’s enactment. Furthermore, the assessment of MNB was so drastic as to destroy MNB’s property interests completely, thereby constituting a per se taking under \textit{Lucas}. The court held that, absent a showing of fraud, abuse, or disregard for separate corporate forms—the traditional ways in which limited liability may be extinguished—the government could not hold MNB liable for the debts of another bank.\textsuperscript{274}

\begin{footnotesize}
\begin{enumerate}
\item[267.] Id. at 635.
\item[268.] Id. at 635-36.
\item[269.] Id. at 635. The court also dismissed the government’s argument that the cross-guarantee deprived BNEC of only a piece of its “bundle” of property rights. Id. Rather, the court found that the fact that BNEC happened to own other property was irrelevant to whether the government must compensate for the total appropriation of one of its assets. Id.
\item[270.] Id. at 636.
\item[271.] Id. at 637.
\item[272.] Id. at 633.
\item[273.] Id. at 636-37.
\item[274.] The court did, however, give the government a second chance by remanding the case for a determination of whether MNB and BNEC were operating as separate corporations or as a single entity. Id. at 637. The court stated that, if the government could prove that the holding company members were disregarding corporate separateness, those members could have no reasonable expectation that they would not be treated by the law as a single corporation; thus, imposition of cross-guarantee liability would comport with the Takings Clause. Id.
\end{enumerate}
\end{footnotesize}
Overall, the *Branch* court seemed fundamentally concerned with the imposition of potentially destructive “no-fault” liability on holding company members. It was troubled by what it termed the cross-guarantee’s “irrebuttable presumption” of manipulation and disregard for separate corporate status within holding companies. The court believed that imposing liability on “innocents” is unconstitutional.

The *Meriden* and *Branch* cases are tremendously important, and the issues they raise will almost certainly be litigated in the Supreme Court. Both decisions, however, are flawed. *Branch*, in particular, raises a number of problems. The next three Sections of this Note illustrate the major problems with *Branch* and address important issues not addressed by that case.

V. ANALYSIS

A. The Reasonable Investment-Backed Expectations of Bank Holding Company Shareholders

The *Branch* decision focused on the issue of whether the cross-guarantee frustrates a holding company’s reasonable expectations. Its specific inquiry was: At the time the cross-guarantee was enacted, did the shareholders of the subsidiary have a legitimate expectation that they would not be held liable for the debts of another corporation?

1. The Proper Analysis of Investment-Backed Expectations

The *Branch* court set forth an unworkable approach for measuring investment-backed expectations. It’s statement that MNB’s...
shareholders had relied on the principle of limited liability since its incorporation in 1889 suggests that expectations should be analyzed as of the time the invested-in entity was created. This statement is confusing because it implies that it is the expectations of the original owners of the entity that matter in analyzing a takings claim by a later investor.

These suggestions are clearly wrong. On a basic level, the “real-world” expectations of a takings claimant are those that the claimant had at the time of her acquisition. Thus, a court should ask two questions: (1) Who is the claimant, or true party in interest?, and (2) When that party invested, what reasonable expectations did she have? The Branch court answered both of these inquiries incorrectly with the wrong answer to the second question resulting from the wrong answer to the first. The Branch court’s problem was its insistence that MNB was the entity whose expectations were to be measured, because it was MNB that was driven into insolvency by the cross-guarantee assessment. It seemed natural, perhaps, to view expectations from MNB’s perspective; hence, the court looked to the original investors to analyze expectations.

The court neglected to recognize, however, that MNB’s liability was, by definition, the liability of its shareholders; the shareholders were the ones who suffered as a result of the cross-guarantee assessment. Moreover, because MNB’s sole shareholder was BNEC, which was in turn owned by its shareholders, it was in actuality the shareholders of BNEC who bore the brunt of MNB’s assessment. Logical expectations analysis therefore mandates that BNEC’s shareholders’ expectations be the focal point. Because BNEC’s shareholders had no property interest in MNB until they acquired the subsidiary, their expectations regarding MNB’s right to limited liability arose at the time of that acquisition.

279. Lucas, in fact, endorsed this analytical approach. 112 S. Ct. at 2899 (stating that takings analysis begins with an inquiry into the claimant’s “title to begin with”). See also American Continental, 22 Cl. Ct. at 700 (finding no frustration of reasonable expectations because the law at the time of acquisition allowed appointment of a government receiver); notes 176-78 and accompanying text.


281. In general, the Branch court’s mistake demonstrates the importance of a precise analysis of reasonable expectations; the problem of imprecision is likely to arise frequently in the confusing world of holding company structures.
2. Investment-Backed Expectations of Holding Companies

The Branch court argued that, even though MNB was subject to a pervasive regulatory scheme, it had a legitimate expectation of limited liability. This conclusion was wrong for several reasons.

First, the court was incorrect in suggesting that the members of a holding company structure have virtually a fundamental right to limited liability that can be abrogated only in the traditional common law ways. The court did not explicitly state such a proposition, but its holding that the government must make an actual showing of fraud, abuse, or disregard for corporate separateness prior to utilizing the cross-guarantee implies that holding companies have an absolute right to limited liability unless they engage in such wrongdoing.

The court's position was radical, suggesting that any augmentation of corporate shareholder liability would frustrate legitimate expectations, due to the exalted principle of limited liability. No prior court, however, has suggested that limited liability is a near-constitutional right. Indeed, limited liability was statutorily created during the last century and has been modified and abrogated in various ways with no ill constitutional effects. Connolly and Concrete Pipe also demonstrate that the Court has not elevated limited liability to the status of a fundamental right.

A proper evaluation of a holding company's expectations focuses not on its "right" to limited liability, but on its reliance on that privilege. The analysis should begin at the point when the holding company acquired the shares of its subsidiary, thereby becoming a holding company under the BHCA. Its expectations at that point depend in part on the historical and current regulatory scheme to which the holding company subjects itself.

As the above discussion demonstrates, banks and bank holding companies are highly regulated; even prior to the Great Depression, these institutions received constant legislative attention because of the public interest in preserving a sound banking system. When a holding company acquires a subsidiary, it does so with full knowledge of the overall regulatory scheme. It knows that its application to

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282. Branch, 31 Fed. Cl. at 634.
283. See note 64 (detailing several common law rationales for piercing the corporate veil).
284. See notes 63-64 and accompanying text (discussing the history of limited liability principles).
286. See Part II.B.1 (describing the double liability system); notes 6-10 and accompanying text.
obtain holding company status may be denied by the Federal Reserve Board due to the company's lack of financial soundness, and it knows that the reason for this condition is to prevent weak institutions from acquiring concentrated capital. It knows that its business activities will be restricted because of the same fears. It knows that it will be subjected to numerous and constantly changing rules, restrictions, and obligations. Before FIRREA, the holding company's (or its subsidiary's) entitlement to limited liability was but one piece in a regulatory puzzle designed to achieve certain legislative aims; it was not a "right" pulled from the heavens.

Consideration of the policies behind the regulatory scheme proves even more telling with regard to the holding company's reasonable expectations. The holding company is on notice not only that legislation governing its operations exists, but that the legislation is in great part intended to stifle the moral hazard problem facilitated by deposit insurance. It is aware of past legislative and administrative efforts to combat the problem, such as the source-of-strength doctrine and the double liability system. It can recognize that these regulatory efforts generally operated either by enhancing governmental enforcement powers or by imposing added liabilities on some or all of the holding company members. Given the numerous past attempts to deal with the moral hazard problem, the holding company should know that the government is likely to look for ways to increase its liabilities and obligations when it acquires a subsidiary.

The holding company should also recognize that numerous cases have held that expectations in a highly regulated industry are very limited. Courts are generally deferential to the government

287. See notes 49-50 and accompanying text.
288. See note 50 and accompanying text.
289. See Parts II.A, II.B.1-2 (describing the pre-FIRREA regulatory scheme governing holding companies).
290. See notes 53-62 and accompanying text.
291. See Parts II.B.1-2.
292. See id.
293. See notes 156-67 and accompanying text. Although in a theoretical sense it is troublesome to argue that case law on takings should influence reasonable expectations, as a practical matter holding companies know of legal trends and know how those trends will affect them. As in other areas of the law, where reasonable expectations provide the standard for evaluating an abridgment of the claimant's rights, analyzing the reasonable investment-backed expectations of a takings claimant is a circular process. The state of takings jurisprudence, as described above in Part III.B, certainly shapes the expectations of potential investors. Simultaneously, the expectations of those investors are a crucial factor that a court considers in deciding whether to uphold the claim. Penn Central, 438 U.S. at 124. Compare Katz v. United States, 389 U.S. 347.
regarding challenges to legislation directed at highly regulated entities, particularly banks. Therefore, a holding company is aware that it is unlikely to win a constitutional battle involving any new regulation, restriction, or liability it may face when it acquires a subsidiary.

The past and present regulatory scheme, and the case law upholding that scheme, certainly put holding companies on notice that measures like the cross-guarantee might be passed by Congress and upheld by the courts. A clear counter argument, however, is that, even though a holding company should expect certain additional burdens and obligations to be implemented, it should not be held to expect that its entitlement to limited liability will be stripped away as part of some last-ditch attempt to salvage the FDIC. In other words, one could argue that there is a line that the government cannot cross, and the cross-guarantee's destruction of the century-old rule of limited liability crosses that line.

It becomes evident, however, that the cross-guarantee does not cross the line when one recognizes that the holding company structure and the existence of deposit insurance essentially enable those companies to act in ways similar to those that would traditionally allow the piercing of the corporate veil. The Branch court, by elevating limited liability to the level of a fundamental right, ignored the evidence that the structure of bank holding companies, and the protection given them by deposit insurance, gives them the capability and the incentive to act as a single enterprise.

In a nutshell, the very reason bank holding companies like the deposit insurance system and want to be a part of it is the same reason such companies should have a very limited expectation of limited liability. As mentioned above, because in holding companies a single group of shareholders "controls" the operations of several different entities, those shareholders have the capability to move assets from one entity to another, strengthening one subsidiary at the expense of another. In addition, because of deposit insurance, such companies are free to engage in such asset-shifting without the fear that, if one

(1967) (holding that reasonable expectations regarding a person's "zone of privacy" will determine whether or not a fourth amendment search has occurred). 294. See notes 167-83 and accompanying text.

295. See Curtis, 27 Harv. J. Legis. at 389 (cited in note 132) ("Because a bank holding company group functions economically as a single entity, it is reasonable to assemble the value of the entire system for the purpose of protecting the system's depositors"). But see Jackson, 107 Harv. L. Rev. at 566-67 (cited in note 19) (arguing that there is no evidence that holding companies act in this manner).

296. See notes 56-61 and accompanying text.
of the affiliates fails, its depositors will have to be compensated. Because holding companies have the ability and motivation to act as a single enterprise, it is reasonable to allow the corporate veil of such entities to be pierced by the cross-guarantee.

On a more basic level, holding companies are aware that Penn Central and Concrete Pipe stand for the equitable proposition that a property owner should pay for the benefits that she receives from a regulatory scheme. The ability of holding companies to act as a single enterprise because of their structure and deposit insurance constitutes a benefit that should put them on notice that they will have to face added liabilities.

In sum, history, theory, and case law suggest that holding companies do not have a reasonable investment-backed expectation of limited liability. Traditional takings analysis thus operates against a finding that the expectations of bank holding company shareholders have been defeated by the cross-guarantee. The threshold requirement for establishing a viable takings claim has not been met.\(^\text{297}\)

\(^{297}\) A separate consideration with regard to determining reasonable expectations concerns the expectations of those shareholders of holding company affiliates who are not also shareholders of the holding company parent. Because under the BHCA "control" does not require 100% ownership of a subsidiary's shares, 12 U.S.C. § 1841(a)(2), there may be "uncommon" shareholders of such a subsidiary who will face cross-guarantee liability. See note 96. The inquiry regarding these shareholders is whether they have a more legitimate expectation of limited liability due to the fact that they are not technically part of the holding company structure. The Branch court did not have occasion to address this issue, as MNB was a wholly-owned subsidiary of BNEC. Branch, 31 Fed. Cl. at 628.

Such shareholders would certainly argue that they have a reasonable expectation that their entitlement to limited liability will not be stripped away. They would claim that they have no measure of control over the assets or operations of the other members of the holding company structure. Because of this lack of control, they cannot be contributors to the moral hazard problem. Such shareholders would argue that they are not exploiting the deposit insurance system and are not to blame if the other owners of the subsidiary are engaging in such exploitation.

The uncommon shareholders' argument is flawed on all levels, however. Such shareholders have no more legitimate an expectation of limited liability than do their holding company counterparts. First, the uncommon shareholders should be aware of the pervasive regulatory scheme governing holding companies. Even if they invested in the bank prior to the holding company's acquisition of a controlling share, once the bank becomes part of a holding company, all of its shareholders should know of the regulations which then take effect. If the uncommon shareholders are unhappy with the new regulatory regime, they may sell their shares.

Perhaps more importantly, the uncommon shareholders are unlikely to be displeased with the fact that their bank has joined a holding company because they will directly benefit from the holding company's ability to exploit deposit insurance. Even though the uncommon shareholders have no direct control over the assets of the other members of the holding company, they will receive higher returns due to the holding company's ability to act as a single enterprise. Thus, uncommon shareholders have no greater expectations of limited liability than do the common shareholders. The uncommon shareholders have chosen to invest in an entity
3. Economic Risk-Assumption Theory

This Section examines an alternative approach to analyzing the expectations of bank holding company shareholders that is not generally expressed in case law, but is nevertheless instructive. This approach posits that bank holding company shareholders have assumed the risk of adverse governmental regulation through a discount on the price of their investment. Because the negotiated acquisition price of a subsidiary bank reflects the possibility of regulatory modifications which add liabilities, obligations, or restrictions, the acquiring holding company has no legitimate expectation that it will be compensated later when those regulatory changes take place.

Investors regularly factor risks into a determination of the price that they will pay for a capital acquisition. According to microeconomic theory, an investor's decision regarding whether to buy is determined by a comparison of the present value of the expected returns from that investment with the offered price. If the expected returns are greater than the cost of investing, the investor will buy. The expected returns from any given investment are in part dependent on the risks involved. The question is how to measure the effect the identifiable risks will have on the investment's returns.

Economists Robert Pindyck and Daniel Rubinfeld argue that in order to quantify risk, one must recognize all possible outcomes of a particular action and the probability that each outcome will occur. Of course, it is impossible to know either of these things with complete certainty. It is possible, however, to predict the range of possible outcomes and the probability of their occurrence with some degree of accuracy. Such predictions rely largely on experience. How often has a particular event happened in the past? What types of occurrences are typical?

Although economists usually think of different types of outcomes when they speak of risk—business success and failure rates,
for example—it is entirely plausible to assume that investors consider
the risk of adverse governmental regulation when they decide
whether to buy into regulated entities. They may draw on their
knowledge of past governmental measures to know which types of
legislation are likely to be enacted. Likewise, they can measure the
frequency of change in the regulations governing the entity in which
they wish to invest. Thus, they can measure the probability of
adverse regulatory modifications. Such a determination will not be
absolutely accurate, but it will nevertheless affect the investors’
calculation of the “optimum price.”

Another element involved in the measurement of risk’s effect
on expected returns focuses on the value of each particular risk. For
example, if an investment will decline by $X per share if Event A
occurs, then Event A’s effect on each share’s value is its predicted
probability of occurrence multiplied by X.\(^3\) Again, potential investors
in highly regulated entities may draw on experience to calculate the
likely economic impact of adverse regulatory change.

Thus, potential investors in regulated entities have a sound
methodology by which to measure the effects of adverse regulatory
changes on the expected returns of their investment. A rational com-
pany thinking of acquiring a subsidiary and becoming a holding com-
pany would consider the above factors in determining its optimum
acquisition price. Knowing that holding companies are highly regu-
lated, that regulations frequently change, and that such change may
adversely affect their return, the company will negotiate a price that
is lower than it would be if such factors were not present. In other
words, holding company shareholders pay a lower price per share,
reflecting the added risk they are assuming by investing in a highly
regulated entity. Having assumed this risk, such shareholders may
not claim a legitimate expectation that adverse regulatory measures
will not be enacted. Indeed, forcing the government to compensate
investors who have assumed such a risk gives those investors an
undue windfall.

Because a frustration of reasonable expectations is essential to
establish a taking, and because the cross-guarantee does not defeat
those expectations, the measure should pass constitutional muster.
The next two Sections, however, assume a defeat of expectations, and

\(^{303}\) Id. at 135.
consider the other factors relevant in deciding whether the cross-guarantee effects a taking.

B. The Economic Impact of the Cross-Guarantee

This section evaluates the second prong of the *Penn Central* test: the economic impact of the cross-guarantee on the shareholders of holding company affiliates. The economic impact of the measure may not be nearly as great as the *Branch* court found. First, the court was misguided in its analytical approach to the issue in that it measured the effect of the cross-guarantee at the wrong time. Second, the *Branch* court was wrong in finding that the exercise of that power constituted a per se taking. This Section then examines different ways to measure the reduction in the value of the shareholders' property as of the time the cross-guarantee was enacted.

1. The Timing of the Economic Impact

The *Branch* court made an erroneous assumption in evaluating the economic impact the cross-guarantee had on MNB. It considered the economic harm to be the amount of the assessment, over $1 billion. The court reached this figure by measuring impact as of the time the cross-guarantee was exercised, rather than as of the time of its enactment. This analysis is flawed: the cross-guarantee had its effect on holding companies as soon as it was enacted. As soon as Congress enacted FIRREA, the owners of BNEC had the opportunity to sell their ownership in MNB and mitigate their losses. Any additional harm caused by the FDIC's exercise of the power was a risk assumed by the holding company.

When the cross-guarantee was enacted, holding companies felt an immediate diminution of their wealth because the statute placed additional risks of liability upon the shareholders of all bank holding company affiliates. At that point, the holding companies knew that if they did not exert greater discipline over bank management to minimize the risk of any affiliate's failure, they would face the possibility of an assessment in the future. Thus, they had several options: (1) do nothing and potentially face losing their entire investment due to one bank's failure, (2) expend greater resources on monitoring bank management so as to prevent failure, or (3) sell their subsidiaries (or their shares in such subsidiaries) for a lower price,
taking a potential loss on their investments. Any option would harm the shareholders economically.

If a holding company picks option one, however, risking the loss of its investment, it cannot claim at the time it is wiped out by the assessment that the government destroyed the entire value of its property. The holding company had the choices of minimizing the risk of failure by increasing monitorization at the time the provision was passed, or of selling its subsidiaries so as to completely avoid the risks of the cross-guarantee. By declining to exercise either of these options, it assumed the risk of losing it all. Compensating the holding company for risks it has assumed would give the company a windfall it does not deserve.

If a holding company picks option two, it will also face diminished wealth because its marginal costs of doing business will increase. It will have to spend more money to discipline bank management by way of inspections, audits, and the like. Its shareholders will consequently receive smaller dividends. Again, by declining to sell its subsidiaries so as to completely avoid the risk of cross-guarantee liability, the holding company assumes the risk that, despite its preventive measures, an affiliate may fail. Thus, when the holding company is assessed, it may not rightly claim that the government has destroyed its investment.

The above discussion leads to the conclusion that the correct measure of a holding company’s loss at the time of the enactment of the cross-guarantee is the decrease in the sale price of the subsidiaries plus transaction costs. If, for example, the holding company could have sold its subsidiaries for $X prior to the cross-guarantee’s passage, then its loss will be the difference between $X and $Y, the price it can get after the enactment, plus $Z, the transaction costs of selling the subsidiaries. Any additional costs are properly deemed risks that the holding company has assumed.

The next Sections attempt to measure the diminution of the fair market value of holding company subsidiaries that resulted from the cross-guarantee’s enactment.

2. Per Se Taking?

MNB argued that the FDIC’s assessment against it effected a physical appropriation of its assets, and was therefore a per se tak-
The court agreed, stating that because the assessment drove MNB into insolvency, allowing the government to seize its assets, it constituted a physical appropriation. Although the court used the wrong analysis, it left the operative question open: If the cross-guarantee's impact is measured from the correct perspective, is it possible that it may effect a per se taking?

It is unlikely that the enactment of a measure like the cross-guarantee could possibly physically appropriate holding company property, because it merely places a risk of liability on those companies, and is not an automatic assessment against them. As noted above, holding companies have the immediate option of selling their subsidiaries so as to avoid the risk. Thus, they may retain some value in their investment, and may likewise avoid the physical asset seizure experienced by MNB. The cross-guarantee's passage did not effect a per se taking of holding company property.

Trends in the case law also militate against finding the enactment of the cross-guarantee to be a per se taking. As discussed above, courts are loathe to read Loretto and Lucas to govern banking takings cases, even where the government actually seizes all of the bank's assets upon placing it into receivership.

In general, then, the enactment of the cross-guarantee cannot effect a per se taking. The next question is: How much did the cross-guarantee's passage reduce the value of holding company property?

3. The Diminution of the Value of the Holding Companies' Property

Courts generally are wary of upholding a takings claim involving a regulation that merely diminishes the value of the claimant's property. To begin upholding such claims would be to start down a slippery slope, invalidating any governmental actions that harm people economically. However, the Penn Central Court mandated that economic burdens be considered in evaluating a takings claim. Thus, it is imperative to approximate the impact the cross-guarantee had on holding companies when it was enacted.

As mentioned above, the passage of the cross-guarantee reduced the wealth of holding companies by placing an added risk of

305. Branch, 31 Fed. Cl. at 629.
306. Id.
308. See Part III.B.2.
309. See note 154 and accompanying text.
310. 438 U.S. at 137.
liability upon them. The wealth reduction is properly measured by taking the difference between the fair market value of the holding companies' subsidiaries before and after the measure was passed, and adding transaction costs.\textsuperscript{311} How much will fair market value drop? That question must be answered from the perspective of a potential post-cross-guarantee holding company investor. Given the additional risks, how much will such an investor pay? Several factors indicate that the reduction will not be drastic.

First, the increased costs the potential investor must incur to discipline management may, to some degree, be passed down to the bank's customers in the form of higher interest rates on loans and lower rates on deposits. Of course, the ability to transfer the costs depends on several factors. The demand for bank holding company services may be relatively elastic due to the existence of competitors providing similar services.\textsuperscript{312} In addition, there may be legal limits to the banks' ability to pass down the costs of the cross-guarantee.\textsuperscript{313} Overall, however, it is reasonable to assume that a portion of the cross-guarantee's burden will fall on depositors, not on potential investors.

Second, although a post-cross-guarantee investor will have to spend money to discipline management so as to avoid affiliate failure, it is predictable that those costs will decrease in the long-run. This is because of the \textit{ex ante} effect such disciplinary measures will have. As managers become more aware of the adverse consequences of engaging in risky practices, they will be more likely to discipline themselves. Because the threat of the cross-guarantee is so grave, management will learn quickly that risking an affiliate in order to earn big profits can spell doom, and may cost executives their jobs. As self-discipline increases, the costs of shareholder discipline fall, as does the economic burden of the cross-guarantee on those shareholders.\textsuperscript{314}

Finally, because the cross-guarantee imposes an essentially controllable risk on holding companies, rather than an uncontrollable risk of liability, it will have less of an economic impact upon them. As

\begin{itemize}
\item \textsuperscript{311} See Part V.B.1.
\item \textsuperscript{312} For a general discussion regarding demand elasticity, see Pindyck and Rubinfeld, \textit{Microeconomics} at 28-32 (cited in note 298).
\item \textsuperscript{313} For instance, state usury laws limit the interest rates banks may impose on borrowers, constraining banks' ability to pass down the cross-guarantee's costs in this manner. \textit{See}, for example, N.Y. General Obligations Law § 5-501 (McKinney 1989 & Supp. 1995) ("Rate of Interest; usury forbidden").
\item \textsuperscript{314} See note 56 (arguing that bank management has some incentive to exert self-discipline even in the absence of the cross-guarantee's threat).
\end{itemize}
an illustration, if the state passed a law providing for the condemnation of several houses out of a particular group, all of the homeowners would face an uncontrollable risk. If they tried to sell their homes, a potential buyer would pay a lower price reflecting that risk. If, on the other hand, the law stated that houses with overgrown, weed-filled lawns would be condemned, the potential buyers would be able to control the risk of condemnation, and would thus be willing to pay a relatively higher price. The cross-guarantee resembles the second example. Because the risk of liability may be reduced through discipline over management, potential new investors will be willing to pay more than they would if the risk were uncontrollable. Therefore, the economic impact of the cross-guarantee is not as drastic as it may first appear.

In conclusion, the proper analysis of the cross-guarantee's economic impact focuses on the time of its enactment. If a court takes all of the above factors into consideration, it will likely conclude that the economic impact on the shareholders is not so drastic as to effect a taking. Moreover, the cross-guarantee is one of the most efficient ways in which to control the moral hazard problem, and is thus highly beneficial to the public interest. When this positive impact on the public interest is balanced against the comparatively lower long-term impact on holding companies, it becomes clear that the cross-guarantee is both efficient and equitable.

C. The Nature of the Governmental Action: Minimizing External Costs to Society Through Risk Allocation

Until now, this Note has analyzed the effect the cross-guarantee has had on bank holding companies. It has argued that such companies have no legitimate expectation that they will never be held responsible for another company's debts, noting that the cross-guarantee's economic impact at the time of its enactment may not be so great as it initially appears. Thus, the cross-guarantee is fair in the sense that it does not unduly burden holding companies. This Section considers the other side of the equation—the efficiency of the cross-guarantee, using economic analysis to show that the measure passes the means-ends test set forth in Dolan.315

Recall that the recent case of Dolan set forth the requirement that a challenged regulation's means must be roughly proportional to

315. 114 S. Ct. at 2309. See notes 147-53 and accompanying text.
the ends it intends to achieve.316 Thus, the proper inquiry regarding the cross-guarantee is whether it is roughly proportionate to its goal of combating the moral hazard problem. This Section posits that, in economic terms, the cross-guarantee is intended to force holding companies to internalize an externality—the costs to society caused by the moral hazard problem, and concludes that the cross-guarantee is an effective internalization mechanism.

The explanation for the necessity of governmental regulation of banks begins with the Coase Theorem.317 The Coase Theorem posits that, in a world of zero transaction costs, the most efficient way to eliminate the costs to society caused by the “externalities” of doing business is to let parties bargain for the right to cause or prevent those externalities.318 For instance, if a factory is polluting a stream in which fishermen fish, the most efficient solution is either to let the fishermen pay the factory to stop polluting or to let the factory pay the fishermen for the right to pollute.319 The problem, however, is that transaction costs exist in such a situation: the fishermen may be disorganized, the parties must pay to negotiate, etc.320

The moral hazard problem presents a classic Coase scenario. Bank holding companies cause an external cost to society because the marginal costs of doing business as a holding company are artificially low due to the protection of deposit insurance.321 Taxpayers, who would bear the loss if the insurance funds were depleted,322 suffer the effects of this externality. Under the Coase Theorem, the taxpayers and bank holding companies could negotiate a private solution to the moral hazard problem. The transaction costs of such a solution, however, would be enormous, far higher than the parties would be

316. 114 S. Ct. at 2319-20.
318. See Polinsky, Introduction to Law and Economics at 11-12 (cited in note 55) (using an analogous example involving a negotiated solution between a factory emitting air pollution and the residents of the town affected by the pollution).
319. Id.
320. Id. at 12-14.
321. With insurance, holding companies can offer risk-free deposits to customers, and can thus attract such customers at a much lower cost than is possible without insurance.
322. Of course, it is possible that Congress could refuse to use taxpayer money to bail out failed financial institutions. In that event, the depositors would bear the loss to the extent the insurance funds were inadequate to fully reimburse them. As discussed above, however, Congress chose to bail out the failed S&Ls in the most recent crisis. See note 84 and accompanying text. This is the most likely sequence of events because of the strong public interest in maintaining depositor confidence. See note 6 and accompanying text.
Therefore, governmental regulation is the most efficient way of forcing bank holding companies' marginal costs back up to the level at which they would be without deposit insurance. The cross-guarantee effectively accomplishes this objective. By shifting some of the risks of bank failure back to holding company shareholders, the cross-guarantee works efficiently to minimize the external costs caused by the moral hazard problem.

The cross-guarantee's efficacy may also be measured by comparing it to alternative policies that impose liability only on those holding companies that can be shown to have engaged in abusively risky practices. Any measure encouraging banks to behave more conservatively will cause those banks to be more careful about lending. As such, credit will be more difficult to obtain when banks are subject to increased risks of liability. In analyzing an across-the-board rule like the cross-guarantee, one must compare the increased costs of credit it causes with the costs of using more particularized measures. For example, if the government decided to impose cross-guarantee liability only on those institutions that can be shown to have engaged in fraud or abusively high-risk behavior, the costs of making that determination must be weighed against the increased availability of credit that will result. The practice of imposing greater liability based on abusively risky behavior may work in other settings; in the automobile insurance industry, for instance, it is relatively easy to determine when the insured gets three speeding tickets and causes two accidents that she has engaged in risky behavior. Given the high liquidity of bank assets, and the rapid transferability of such assets among members of a holding company, however, it seems likely that the government's costs in spotting high-risk practices will outweigh the benefits of the increased availability of credit.

Thus, it is far

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323. This is due to the diffuseness and disorganization of taxpayers. See note 20 (discussing the diffusion of bank creditors).

324. For a full description of how legal measures can reduce the cost-free external effects of doing business, see Pindyck and Rubinfeld, *Microeconomics* at 644-53 (cited in note 298).

325. See note 78 (discussing the ease with which banks can commit fraud or engage in risky practices unnoticed by regulators). One particularized measure—risk-based deposit insurance premiums—has been implemented in an attempt to shift costs to bank shareholders, thereby encouraging shareholder discipline over bank management. See note 16.

Another alternative that would, theoretically, improve depositor discipline over bank management, is co-insurance, whereby depositors would be forced to absorb a percentage of any loss their bank incurred. See Jonathan R. Macey and Geoffrey P. Miller, *Banking Law and Regulation* 265 (Little, Brown, 1992) ("One example [of a private insurance market mechanism to combat the inherent moral hazard problem] is coinsurance: The insured is required to bear a part of the risk insured against, thus reducing the insured's incentives to let the harm occur"). Establishing co-insurance, however, may be politically infeasible because it imposes greater liabilities on depositors. In addition, depositors would likely have inadequate information about
from clear that particularized policies are more efficient than the cross-guarantee.

In sum, the cross-guarantee should withstand even exacting scrutiny by a court. It is effectively designed to minimize the deadweight loss to society caused by the moral hazard problem, and is superior to alternative policies.

VI. CONCLUSION

It seems clear that the cross-guarantee is constitutional and does not effect a taking without just compensation. It is both an equitable and an efficient way to combat the moral hazard problem and to prevent another financial institutions crisis from occurring.

Holding company shareholders are well aware of what they are getting into when they invest. They willingly submit to a wide range of regulations intended to prevent or stifle the exploitation of the deposit insurance system. They know that a great deal of legislative attention has been paid to preserving both bank stability and the solvency of the deposit insurance fund. They may, in fact, have paid less for their shares because of these factors. Moreover, holding companies directly benefit from the system to which they subject themselves. Deposit insurance facilitates the activities in which holding companies engage, so as to increase their overall profitability. It is entirely fair to place the risks of failure on those who enjoy the benefits of success.

In addition, these shareholders have not lost everything as a result of the advent of the cross-guarantee. The measure undoubtedly imposes additional short-term costs upon holding companies, decreasing the value of their shares, but those costs may be reduced over the long run. The diminution in value is not so drastic as to render the measure unconstitutional.

the nature of their banks’ practices, making it difficult to discipline management effectively, and thus rendering co-insurance relatively ineffective as a means of ensuring bank stability.
Finally, courts considering the cross-guarantee should take into account its efficacy as a public policy measure. The cross-guarantee is one of the most efficient ways to combat a problem of great public import.

Jennifer J. Alexander*

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