Government Liability for Defective Regulation in Bank Insolvency Cases

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INTRODUCTION

The record of recent bank failures and near failures reveals that the regulatory structure of bank agencies is defective and unless that structure is recast, there is virtually no hope that the regulatory apparatus will be capable of insuring a safe and sound banking system. Continuation of the present supervisory structure will make it extremely difficult, if not impossible, to correct the deficiencies in banking practices which have cropped up in recent years. Confidence in the Nation's banking system cannot be maintained in this helter-skelter regulatory atmosphere.

The decade of the 1970's was one of the most tumultuous in banking history. All aspects of the industry were severely strained and tested. One symptom of the period was the dramatic rise in the number of bank insolvencies and problem banks. The recent rash of bank failures peaked in 1976 when

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2. Problem banks are typically defined as banks which require special supervisory attention by regulatory agencies. Usually, such classification is the result of a bank's having an excess amount of classified assets (outstanding loans which are of questionable status with respect to repayment), being undercapitalized, or in danger of having its viability impaired for some reason. The FDIC and FRS typically use the term "problem banks" for all banks under their supervision which necessitate special attention. The Comptroller General suggests that the Office of the Comptroller of the Currency (OCC) only considers problem banks as a portion of banks requiring special supervisory attention. This article will follow the general FDIC/FRS usage. U.S. Comp. Gen. Highlights of a Study of Federal Supervision of State and National Banks: Report to the Congress by the Comptroller General of the U.S. 1 (1977).

The methodology used in evaluating assets and banks is complicated. In bank examinations, bank assets are classified either as "substandard," "doubtful," or "loss." Substandard assets are characterized by the distinct possibility that the bank will sustain some loss if deficiencies of the obligor or collateral pledged are not corrected. A doubtful asset is one step worse than a substandard asset: the deficiency makes collection or liquidation in full "highly questionable or improbable." A loss is an asset considered virtually uncollectible, one which should be charged off the balance sheet even though partial recovery may be possible in the future. In computing
thirty-two banks closed or were absorbed by other banks in order to avert closings. After an economic upturn and respite from bank failures in 1977 and 1978, 1980 began on a decided


Statistics on bank insolvencies and problem banks are very difficult to ascertain and compile. The bank regulatory agencies refuse to disclose many of these statistics, especially the "problem bank lists," that is, the names of banks which are more carefully supervised because of their impaired and risky status. Non-disclosure is essentially posited upon the assumption that disclosure would undermine public confidence in banks and the banking system and would inhibit the regulators' efforts to save the endangered banks. The absence of disclosure could and has caused unknowing and innocent people to be injured financially. See Leff, How Secret Should Bank Problem Lists Be?, 161 The Bankers Mag., Sept.-Oct. 1978, at 37.

Of great concern is the fact that all of the ten largest banking failures in U.S. banking history have occurred since 1966 and, of those, the top eight have occurred since 1973. Sinkey, Identifying Large Problem/Failed Banks, supra at 780. The largest failure was the Franklin National Bank of New York which had $1.5 billion in deposits when it closed in 1974. Another growing concern is the fact that the regulatory agencies have reported a rising trend of problem banks. There are essentially three federal agencies which compile these statistics: Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve System (FRS). In 1973, the OCC reported 79 problem banks, banks holding 2.6 percent of the total deposits of all national banks. By 1976, this total had risen to 275 banks holding $200 billion in deposits or 42 percent of all national bank deposits. COMM. ON GOVERNMENTAL OPERATIONS, ADEQUACY OF THE OFFICE OF THE COMPTROLLER OF THE CURRENCY'S SUPERVISION OF FRANKLIN NATIONAL BANK, REP. NO. 32, 94th Cong., 2d Sess. 2 (1976). Similarly, the FDIC reported a rise from 349 problem banks ($20 billion deposits) in 1975 to 368 banks ($61 billion deposits) at the end of 1977. Second Meeting on the Condition of the Banking System: Hearings Before the Comm. on Banking, Housing, and Urban Affairs, U.S. Senate, 95th Cong., 2d Sess. 292-96 (1978). The Federal Home Loan Bank Board (hereinafter FHLBB) has reported similar increases. Even some of the nation's largest and most well-known banks, Citibank and Chase Manhattan, have appeared on the problem bank lists in the last several years. Washington Post, Jan. 11, 1976, at 1, col. 1; Sinkey, Identifying Large Problem/Failed Banks, supra at 779-80. Due to the secrecy of problem bank lists (see note 1 supra), the Post disclosures were actually derived from governmental information leaks.

downbeat amidst renewed fears of bank failures. John G. Heimann, United States Comptroller of the Currency, has warned that some large banks may fail as a result of extremely taut political, economic, and banking conditions. The potential is clear. As recession deepens, many weaker banks could fail.

4. Addressing the annual convention of the American Bankers Association on October 8, 1979, Heimann warned that as a result of extremely taut conditions, regulators "should prepare for unanticipated shocks, such as the Franklin National Bank failure (in 1974), which if mishandled could fundamentally shake confidence and undermine" the banking system. Foldessy, Nation Should Get Ready for the Failures of Some Large Banks, U.S. Official Says, Wall St. J., Oct. 9, 1979, at 3, col. 6.

Many bankers and economists assailed Heimann's warning initially. Several months later, more and more experts echoed Heimann's warnings. See Foldessy, Capital Concern: Many Banks Now Face Their Biggest Problems Since '73-'75 Recession, Wall St. J., Jan. 10, 1980, at 1, col. 6. Essentially, the fear is that continuing inflation, high costs of money to banks and savings and loans (much of which is being borrowed by them to cover money loaned out at much lower rates), unprecedented levels of consumer debt, OPEC actions, the instability of foreign nations with large outstanding loans, the Iranian Crisis, and simple overextension by banks will so impair many banks' financial condition that they will fail. The capitalization of many banks today is worse than it was in 1974, the worst year of the last recession. "Capital (basically the excess of a bank's assets over its liabilities) is the final cushion for banks to absorb unexpected losses." Id. At the end of 1974, each dollar of capital supported on the average $21.25 of loans and other assets at each of the nation's 15 largest banks. At the end of 1978, this had risen to an average of $23.75. Some banks had ratios far in excess of the average (e.g., $71.43 at Detroit's Bank of Commonwealth and $32.26 at First Pennsylvania Corporation of Philadelphia). Hence, if many loans are defaulted upon, banks will fail. See Announcements: Uniform Examination Procedure, 64 Fed. Reg. Bull. 920 (Nov. 1978); Facing the Challenges Ahead, speech by Jan Janis, Chairman of the Federal Home Loan Bank Board, made to the Florida Savings and Loan League, released in Fed. HOME LOAN BANK BOARD NEWS, Sept. 24, 1979; Concern Rises Over Third World Loans, U.S. NEWS & WORLD REP., Feb. 18, 1980, at 93; Hyatt, A Losing Gamble: Some Banks, S & Ls Suffer Financial Woes Because They Bet Wrong on Lower Rates, Wall St. J., Feb. 6, 1979, at 38, col. 1; Levine, Risky Maneuvers? Bank-Account Moves By Iran, U.S. Are Seen Setting Bad Precedents, Wall St. J., Nov. 15, 1979, at 1, col. 6; Janssen, Troubled Thrifts: Slumps Usually Help Savings Institutions—But Not This Time, Wall St. J., Oct. 17, 1979, at 1, col. 1.


In late 1979 and early 1980, rising interest rates caused problems at banks and savings and loans which had speculated that rates would fall rather than rise. In anticipation of a drop in interest rates, many financial institutions had committed themselves to buy high-yielding securities. As interest rates rose the prices of the securities (typically bonds) dropped in price turning anticipated profits into losses. Some of these institutions had made commitments which exceeded their own net worth. Until early 1979, regulators had uncovered over 40 cases of "worrisome specu-
Typically, many parties including depositors, shareholders, creditors, borrowers, employees, communities, and governmental agencies are adversely affected by a failure. At the very worst, a chain of failures could precipitate an economic crisis, similar to that of the early 1930’s. The role of the regulator in this process is complex, for he must balance the interests of all parties when dealing with problem banks and failures.

To date the role of the courts in the regulation of financial institutions has been limited. Typically, courts serve as one-shot administrators, judging the fairness of settlement terms in an insolvency case, and then approving or disapproving them. The fall-out litigation from recent large failures, however, has raised an old problem in a new context: Can a regulator be held liable for negligence, error, or misfeasance in performance of his regulatory function? The purpose

6. The FDIC and similar government sponsored organizations (FSLIC, the Federal Savings and Loan Insurance Corporation, and NCUA, the National Credit Union Administrator) insure deposits at banks, savings and loans, and credit unions. Such insurance is currently limited to $40,000 per account under the Federal Deposit Insurance Act, 12 U.S.C. §§ 1811, 1813(m), 1821(a), (f) (1976). Under § 1821(f), the FDIC, when a bank fails, must pay off each insured depositor in cash or by arranging another bank’s take-over of the failed bank’s accounts.

The insurance pool maintained by the FDIC, though, represents only one percent (1%) of total deposits in insured banks. Currently, the insurance fund is about $9 billion in size. The FDIC is also authorized to borrow $3 billion from the Treasury Department should the FDIC’s fund be exhausted. 12 U.S.C. § 1824 (1976). Hence, currently, in a rash of failures the FDIC would have a total of $12 billion to cover a total of $961 billion in deposits. Table 1.26, 65 FED. RES. BULL. A18 (Dec. 1979). The failure of only a few of the largest banks could disrupt the entire deposit insurance system, a contingency for which no preparation has been made legislatively. Presumably, all deposits beyond $12 billion would be uninsured and lost for their owners.

Aside from the theoretical danger of exceeding insurance fund coverage, many depositors (especially corporations) have deposits in excess of the insurance limit of $40,000. For example, when the United States National Bank of San Diego failed in 1973 over $300 million of the $930 million on deposit with the bank were uninsured. *First Empire Bank v. FDIC*, 572 F.2d 1361, 1365 (9th Cir. 1978). Had the FDIC been unable to arrange a take-over by another bank, the depositors of $300 million would have been creditors of the bank and could have lost all their money. See generally *Leff, supra* note 2.

7. The court’s administrative function and its historical basis was well delineated in *In re Home Nat'l Bank of Ellenville*, 147 F. Supp. 389 (S.D.N.Y. 1956). The case was cited with approval in *In re Franklin Nat'l Bank*, 381 F. Supp. 1390, 1393 (E.D.N.Y. 1974). However, in *Ellenville*, the judge expressed personal reservations about courts assuming such administrative roles.
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of this comment is to analyze the recent series of cases in this area and their precedential value. It argues that, in the absence of any immediate control of the bank regulators, the courts should be allowed to pierce the veil of governmental immunity presently protecting the agencies and their functionaries.

OVERVIEW AND HISTORICAL PERSPECTIVE

The Web of Regulation

Speaking of banking regulation, Representative Henry S. Reuss, Chairman of the House Banking, Currency and Housing Committee, once called it a "seamless web." He also quoted former Federal Reserve Chairman Arthur F. Burns, stating that bank regulation is a "'jurisdictional tangle that boggles the mind'"—one which essentially is a "'competition in laxity.'" The recent problems in banking have caused Congress and many commentators to advocate reform.

Much of the problem stems from the fact that the scheme of regulation evolved over the last one hundred fifty years without a unifying basis or plan. Our present system consists of a dual structure of state and federal regulation. Underlying a federal scheme of control, supervision, and insurance is a scheme of chartering, lesser controls, and supervision.

For commercial banks, four systems of regulation are possible: 1) national banks, federally chartered by the Office

12. Scott, supra note 11, at 3.
of the Comptroller of the Currency and automatically members of the FDIC and the Federal Reserve System (FRS);\(^{18}\)
2) state chartered banks subscribing to the FRS and consequently the FDIC;\(^{14}\)
3) state chartered banks choosing to skip the FRS while retaining the FDIC coverage;\(^{16}\)
4) state chartered banks functioning without federal insurance or FRS membership.\(^{16}\)
Similar schemes are found in savings and loan association regulation.\(^{17}\)
Finally, the Securities and Exchange Commission (SEC) oversees all publicly owned banks and savings and loan associations.\(^{18}\)

On the federal level, then, the OCC generally serves as the overseer of the national banks. The FRS, through its Board of Governors, serves to supervise its member banks and to formulate and implement monetary policy. Finally, the FDIC enjoys the broadest power in that it typically acts as insurer of many of the nation's banks and, when a bank under its jurisdiction fails, it acts as receiver.\(^{19}\)

**The Evolution of Bank Regulation**

To more fully consider the question of liability of bank regulators, it is necessary to have a perspective on the development of regulation, its objectives and philosophies.\(^{20}\) Our

13. As of June 30, 1978 there were 14,698 commercial banks. 5,621 of these were FRS members, of which 4,616 were national banks. The national banks' assets represented 55% of all commercial bank assets. 64 FED. RES. BULL., Dec. 1978, at A17-19. Later statistics are available, however the dates of the various financial statements are inconsistent. See 65 FED. RES. BULL., Dec. 1979, at A16-19.
14. 1005 state chartered member banks' assets represented 18% of all commercial banks' assets. 64 FED. RES. BULL., supra note 13, at A17.
15. The 8,760 FDIC insured non-member banks represented 21% of all commercial banks' assets. Id.
16. Although the lack of FDIC insurance coverage would seem to be a disadvantage competitively, the number of non-insured banks has been rapidly increasing. At the end of 1975 only 253 banks, representing 1% of all commercial banks' assets, had chosen to be noninsured non-FRS member banks. 62 FED. RES. BULL., Dec. 1976, at A14. By June 1978, this group had grown to 317 banks holding 3.5% of all commercial banks' assets. 64 FED. RES. BULL., supra note 13, at A17-19.
17. Mutual savings banks, located primarily in New England, have no federal regulatory patterns although many adopt coverage by the Federal Savings & Loan Insurance Corporation or FDIC.
18. The SEC is requiring greater and greater disclosure from banks, contrary to the bank regulators policies. See Dince, supra note 10.
20. See R. ROBINSON, THE COMPTROLLER AND BANK SUPERVISION, A HISTORICAL APPRAISAL (1968) for a long but thorough discussion of this area from the OCC perspective.
modern banking system got its start in 1782 with the establishment of the Bank of North America. Initially, the growth of banking was slow. However, in 1837, the Supreme Court opened the path for more banks by holding that states had the right to charter banks. One year later, New York followed up the Supreme Court action by enacting a “Free Banking Act” that permitted the formation of banks subject only to certain requirements. Most importantly, a legislative act was no longer required to establish each new bank. Other states followed suit and the number of state banks more than doubled from 1836 to 1863.

The federal government, in an effort to finance the Civil War, enacted the National Currency Act in 1863. This Act designated a new federal office, the Office of the Comptroller of the Currency (OCC), which originally served to supervise the establishment of a national currency. More importantly, the Act established the principle of free banking on the national level. Implicit in the free banking principle were three major public policy objectives, “[P]revention of undue concentration of economic power, protection against banking instability, and creating a system of Federally chartered and regulated banks.” Originally, a presumption underlying these objectives was that banking regulation was allowed only to the extent necessary to insure sound banking, but as the system of federal banks evolved, so did the regulator’s power. Subsequent economic crises further altered the emphasis of the original National Banking Act.

Financial panics in the 1890’s and in 1907 led to the enactment of the Federal Reserve Act in 1913. The Act established the Federal Reserve System requiring each national bank to be approved by the Federal Reserve Board. 21

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21. Chartering at that time required a legislative enactment, thus making entry into the banking market difficult. The lack of a unified currency and the concept of deposit banking (mostly banks operated by issuing notes) also dampened growth.
24. 713 state banks existed in 1836; 1466 in 1863. Hackley, supra note 11, at 570 n.19.
25. The original act was revised and enacted as the National Bank Act in 1864. National Banking Act, ch. 106, 13 Stat. 99 (1864).
27. Id. at B-7.
bank to join the system in order to support twelve regional Federal Reserve Banks. The FRS had three stated objectives: 1) to circulate a new form of currency, Federal Reserve Notes; 2) to provide an agency where member banks could rediscount commercial paper; and 3) "to establish a more effective supervision of banking."99 Basically, the FRS was to function as a central bank.

Establishing the FRS buoyed the banking system temporarily, but banking practices and bank failures in the 1920's and 1930's produced a clamor for more supervision and regulation.30 The concept of true competition in the banking industry faded as the government imposed controls on bank entry, deposit interest rates, and other bank activities.31 Compared to the pre-Depression regulation, the post-Depression era was characterized by extreme conservatism. Regulatory conservatism arose in the wake of the Depression then waned gradually. By the 1960's, Congress was again seeking to stimulate competition in banking32 even though it maintained a more pervasive system of regulation than that contained in the 1863 Act.33 This was necessary in light of the fact that banking in general and assets in particular were becoming more concentrated. Nonetheless, the period of aggressive bank management and risk-taking in the late 1960's and early 1970's proved to be short-lived. The advent of branch banking, electronic fund transfers, concerns about privacy, and recent bank failures have prompted a great deal of legislative interest in restructuring and tightening the reins of control again. This tightening is evident in the Financial Institutions

29. Ch. 6, § 1, 38 Stat. 251.
30. The 1920's saw a period of rapid growth and involvement in speculative ventures. Combined with the still relatively "free" bank structure many banks were formed and promptly failed as a result of poor management, too rapid growth, undercapitalization, and the like. An overwhelming proportion of these failures were of small, individual, midwestern banks. For example, 79.1% of the failures occurred in towns with less than 2500 residents. Compendium supra note 1, at 542. In 1920 there were 30,921 banks of all types (national and state). Between 1920 and 1929, 5411 banks failed. In 1930, 23,679 banks remained with 3,505 failing in 1930 and 1931. Id. at 542-49.
32. The number of banks in the country ebbed to a low of 13,140 banks in 1960. By 1970, this number had grown to 13,678. It now stands at about 15,000. Compendium, supra note 1, at 347.
Regulatory and Interest Rate Control Act of 1978 (FIRA).  

FIRA is an omnibus provision that was passed in the closing minutes of the Ninety-Fifth Congress in October 1978. Generally, FIRA clarifies and sharpens the guidelines for identifying both sound and unsafe banking practices. Title I of FIRA toughens the regulatory powers of the OCC, FRS, and FDIC. For example, under FIRA, the agencies now have the power to issue cease and desist orders, levy fines of up to $1000 a day, and remove bank officials and employees.

Title VIII of FIRA seeks to regulate insider transactions and to prevent the abuse of correspondent banking. Considering that many bank insolvencies are caused by insider abuses, this provision potentially may be the most effective measure in the Act. As detailed below, however, efficient and proper use of regulatory power remains an ideal. Congress, in FIRA, gave the regulators great power but did little to encourage improvement of the regulators’ efficiency and record of success.

FIRA prevents interlocking directorates and management of financial depository institutions (commercial banks, savings banks, savings and loans, and credit unions). It also provides for a bank regulatory oversight council, government

35. In past legislation, the finer aspects of defining unsafe and unsound were left to be defined by banks, banking associations, and bank examiners.
36. Title I is a series of amendments to previous acts. It provides, inter alia, that agencies may issue cease and desist orders for anticipated, as well as past and present violations or unsafe and unsound banking practices. The orders may be applied directly to the violator or instigator, including the bank, its directors, officers, employees, agents, or anyone involved in the bank’s affairs. FIRA’s Title I also provides for tough civil penalties. Violators may be fined up to $1000 per day for violations. A third enforcement device is especially tough. An agency or regulator has the power to remove a violator upon a finding of dishonesty, breach of fiduciary duty, disregard for the bank’s soundness and safety, and even unfitness for management of a bank. Suspension is possible, especially while the agency completes an investigation to help decide whether to make a suspension a permanent removal. Of course, all of these steps are accompanied by due process provisions.
37. Id. 3690-93.
38. Id. at 3672-75.
39. Id. at 3694-96.
approval or disapproval of bank acquisitions,\textsuperscript{40} protection against financial privacy,\textsuperscript{41} and electronic fund transfer regulations.\textsuperscript{42}

Given the government’s ever increasing presence in the banking industry, an important issue arises: Precisely what are the government’s duties and liabilities? Arguably, the government owes a duty and is liable to everyone for the maintenance of a safe and viable banking system. The concern of this comment is narrower, liability of the regulators \textit{vis à vis} a bank’s depositors, borrowers, creditors, and shareholders. This requires consideration of the doctrine of sovereign immunity, the Federal Tort Claims Act, and related case law.

THE QUESTION OF LIABILITY

Aware of the government’s increasingly pervasive regulation of banking and the growing strength of the bank regulators, one wonders who is responsible when the regulators act negligently, make a mistake, or are misfeasant. As detailed below, the Federal Tort Claims Act,\textsuperscript{43} while lifting the veil of general government immunity,\textsuperscript{44} has exceptions that cover otherwise culpable bank regulators.

\textit{Federal Tort Claims Act}

Prior to enactment in 1946 of the Federal Tort Claims Act (FTCA), a claimant had little recourse against the government for tortious wrongs. Since the federal government had not given general consent to be sued for the tortious acts of its agents, a claimant had to seek specific, private congressional

\begin{itemize}
\item \textsuperscript{40} Id. at 3683-90.
\item \textsuperscript{41} Id. at 3697-3710.
\item \textsuperscript{42} Id. at 3728-41.
\item \textsuperscript{43} 28 U.S.C. §§ 2671-2680 (1976).
\item \textsuperscript{44} Government and official immunity has frequently been discussed because litigants are often estopped from seeking redress for perceived wrongs committed by government or public officials. See Freed, \textit{Executive Official Immunity for Constitutional Violations: An Analysis and a Critique}, 72 Nw. L. Rev. 526 (1977), where Professor Freed concludes "that immunity from liability for any public official is intolerable in a free society." \textit{Id.} at 565. He asserts that courts at the very least should draw a line somewhere if not abandoning the immunities totally. A qualified immunity, he concludes, would protect innocent officials while compensating victims of official misfeasance and incompetence and deterring such conduct in the future. See also Aibel, \textit{Federal Officers—Scope of Immunity from Damage Actions Available to Administrative Agency Officials—Economou v. United States Department of Agriculture}, 30 Rut. L. Rev. 209 (1976).}
\end{itemize}
action as relief. Realizing that government was getting more and more complex, and that private legislation was affordable only to the well-to-do, Congress enacted the FTCA. 45

The FTCA embodies a general waiver of the immunity privilege of the government for liability in tort. Two sections, 1346(b) and 2674, waive governmental immunity. Section 1346(b) provides, in part:

the district courts . . . shall have jurisdiction of civil actions on claims against the United States, for money damages, accruing on or after January 1, 1945, for injury or loss of property, or personal injury or death caused by the negligent or wrongful act or omission of any employee of the Government while acting within the scope of his office of employment, under circumstances where the United States, if a private person would be liable to the claimant, in accordance with the law of the place where the act or omission occurred. 46

Section 2674 states:

The United States shall be liable, respecting the provisions of this title relating to tort claims, in the same manner and to the same extent as a private individual under like circumstances, but shall not be liable for interest prior to judgement or for punitive damages. 47

Section 2680 includes several relevant exceptions to the general rules cited above. First, it stipulates that the government will not be liable for acts done with due care "in the execution of a regulation or statute, whether or not such statute or regulation be valid," or for acts or omissions that are within the realm of "discretionary function or duty" of any federal agency or employee. 48 Second, claims arising out of

45. The private claim bill, as the private legislation was called, numbered in the thousands. From the 68th Congress through the 78th the claim bills averaged around 2000 per session. For example, 593 out of 1829 private claim bills introduced in the 77th Congress were approved. Total damages awarded for these 593 claims were $1,000,253.30. Note that this was during World War II. Before the War, settled claims of $2-3 million were not unusual. Often total claims introduced exceeded $100 million. Dalehite v. United States, 346 U.S. 15, 25 n.9 (1953).
48. 28 U.S.C. § 2680 (1976) states:

The provisions of this chapter and section 1346(b) of this title shall not apply to—

(a) Any claim based upon an act or omission of an employee of the
misrepresentation and interference with contract rights are also estopped. Finally, the section bars “any claim for damages caused by the fiscal operations of the Treasury or by the regulation of the monetary system.”

As applied to bank examination and regulation, the FTCA is subject to varying interpretations. Nevertheless, in a Government, exercising due care, in the execution of a statute or regulation, whether or not such statute or regulation be valid, or based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a federal agency or an employee of the Government, whether or not the discretion involved be abused.

(b) Any claim arising out of the loss, miscarriage, or negligent transmission of letters or postal matter.

(c) Any claim arising in respect of the assessment or collection of any tax or customs duty, or the detention of any goods or merchandise by any officer of customs or excise or any other law-enforcement officer.

(d) Any claim for which a remedy is provided by sections 741-752, 781-790 of Title 46, relating to claims or suits in admiralty against the United States.

(e) Any claim arising out of an act or omission of any employee of the Government in administering the provisions of sections 1-31 of Title 50, Appendix.

(f) Any claim for damages caused by the imposition or establishment of a quarantine by the United States.

(h) Any claim arising out of assault, battery, false imprisonment, false arrest, malicious prosecution, abuse of process, libel, slander, misrepresentation, deceit, or interference with contract rights: Provided, That, with regard to acts or omissions of investigative or law enforcement officers of the United States Government, the provisions of this chapter and section 1346(b) of this title shall apply to any claim arising, on or after the date of the enactment of this proviso, out of assault, battery, false imprisonment, false arrest, abuse of process, or malicious prosecution. For the purpose of this subsection, “investigative or law enforcement officer” means any officer of the United States who is empowered by law to execute searches, to seize evidence, or to make arrests for violations of Federal law.

(i) Any claim for damages caused by the fiscal operations of the Treasury or by the regulation of the monetary system.

(j) Any claim arising out of the combattant activities of the military or naval forces, or the Coast Guard, during time of war.

(k) Any claim arising in a foreign country.

(l) Any claim arising from the activities of the Tennessee Valley Authority.

(m) Any claim arising from the activities of the Panama Canal Company.

(n) Any claim arising from the activities of a Federal land bank, a Federal intermediate credit bank, or a bank for cooperatives.

49. Id.
50. Id.
great majority of cases, two of the section 2680 liability exemptions, subsections (a) and (h), have been used to provide the government and its agents immunity from tort actions. Section 2680 (i), relating to "regulation of the monetary system," has rarely been used in bank examination and regulation cases. Where it has been used to defend against tort liability, the courts have tersely noted its inapplicability.

Cases involving discretion and assumption of duty. A key inquiry in any FTCA tort claim is whether the complained of action or omission was a discretionary act. Dalehite v. United States is one of the leading cases in this area.

Dalehite arose on claims alleging negligence by government officials in planning and implementing a fertilizer export program. By failing to notify all concerned of the potentially great danger of the chemicals involved, plaintiffs contended the government should be liable for the deaths in the explosion that nearly destroyed Texas City, Texas. The Supreme Court, finding governmental immunity by section 2680(a), made a thorough exploration of the intent of the FTCA.

The Court found that the FTCA culminated eighty-five years of "steady encroachment upon the originally unbroken domain of sovereign immunity from legal process for the delects of its agents." The Court also found that the section 2680(a) exemption from liability was drafted to "assure protection for the Government against tort liability for errors in administration or in exercise of discretionary functions." The Court quoted extensively the testimony of an Assistant Attorney General who appeared before Congress to explain the exemption. The exception precludes, he explained,

"any possibility that the act may be construed to authorize damage suits against the Government growing out of a legally authorized activity," merely because "the same conduct by a private individual would be tortious." It was not "intended that the constitutionality of legislation, the legality of regulations, or the propriety of a discretionary act, should be tested through the medium of a damage

51. See note 48 supra.
54. Id. at 25 n.10.
55. Id. at 26-27.
suit for tort." 56

The witness also explained that although previous bills did not contain the "discretionary function" exception, it would have been exempted by judicial construction. "It is not probable that the courts would extend a Torts Claims Act into the realm of the validity of legislation or discretionary administrative action . . . ." 57 Hence, "it was not contemplated that the Government should be subject to liability arising from acts of a governmental nature or function." 58

Having analyzed the intent and nature of the section 2680(a) exception, the Court ruled on the specifics of the case. The Court looked to the committee reports on the original bill, finding that the intent of section 2680(a) "is to preclude action for 'abuse of discretionary authority . . . whether or not negligence is alleged to have been involved.'" 59 Thus, while liability will exist if a government agent negligently causes a car collision, the same employee will not incur liability for negligence in performing a discretionary act within the scope of his governmental authority.

The Court in Dalehite held that it was unnecessary to define exactly where discretion ended. Discretionary duty or function, in the case of establishing and implementing a fertilizer program included not only initiation of programs and activities, it also included

determinations made by executives or administrators in establishing plans, specifications or schedules of operations. Where there is room for policy judgment and decision there is discretion. 60

The Court further stated that subordinates operating in accordance with official government directives are also immune. The Dalehite ruling has served to foreclose many tort actions against the government. Several subsequent cases have carved distinctions from Dalehite. For example, with respect to low level administrators (in bank insolvency cases the crucial decisions at issue are made at high levels of administration), the

56. Id. at 27 (quoting Hearings on H.R. 5373 and H.R. 6493 Before the House Comm. on the Judiciary, 77th Cong., 2nd Sess. 6 (1941)).
57. Id.
58. Id. at 28.
59. Id. at 33.
60. Id. at 35-36 (emphasis added).
Second Circuit Court of Appeals recently held that the administrators, individually, do not require the same protection of absolute immunity as do legislators, judges, and high level administrators. Rather, a defense of “qualified good faith, reasonable grounds” immunity is available.61

A second important case, Indian Towing Co. v. United States,62 distinguishes from Dalehite the situation where a regulatory or governmental agency participates so actively or extensively in its regulated domain that it engenders reliance by the public or those regulated. This constitutes an assumption of duty theory.

In Indian Towing, plaintiffs alleged that because the Coast Guard was negligent in maintaining a lighthouse, it should be liable for damages incurred when one of Indian Towing Company's tugs went aground in the area served by the light. The government and lower courts looked to the FTCA exemptions and to Dalehite for the answer in denying the plaintiff's claim.63 Rather than “discretionary function,” the issue in Indian Towing was whether there is liability for assumption of duty and “for negligent performance of 'uniquely governmental functions.'”64

The Supreme Court first found that “all Government activity is inescapably ‘uniquely governmental’ in that it is performed by the Government.”65 However, the Court also held that it was not the intent of Congress to draw distinctions so finespun and capricious as to be almost incapable of being held in the mind for adequate

61. Economou v. United States Dep't of Agriculture, 535 F.2d 688 (2nd Cir. 1976), cert. granted, 429 U.S. 1089 (1977). An appeal of a dismissal by plaintiffs, the case originated as a suit by a registered commodity futures merchant against the Dep't of Agriculture and its agents for initiating a wrongful administrative proceeding against the merchant. With respect to the individual agents, the court first noted that the concept of absolute immunity for administrative officials was clouded and hinged on “distinctions in the character of their respective functions.” Id. at 695. Lower level administrators may “avail themselves of the defense of qualified 'good faith, reasonable grounds immunity,' ” which the court felt was the general trend in cases of this sort. Id. at 696. Thus, subordinate officials, at least in the Second Circuit, must defend tort suits by “demonstrating the reasonableness of their actions, buttressed by affidavits of good faith.” Id. See also Aibel, supra note 44.
63. Id. at 64.
64. Id. The issue of governmental functions appears in Dalehite as a subissue, see text accompanying note 58 supra.
65. Id. at 67.
formulation. . . . [I]t is hard to think of any government-
tal activity which is 'uniquely government,' in the sense
that its kind has not at one time or another been, or could
not conceivably be, privately performed.66

Hence, to deny liability for negligence in uniquely government-
tal functions would be tantamount to the Court's importing
immunity back into legislation designed to limit it.

The Court held the Coast Guard liable on the grounds
that while it had discretion in deciding whether to build and
operate a lighthouse or not, once it decided to operate the
lighthouse it was obligated to use due care to keep the facility
in proper working order.67

Dissenting Justices Reed, Barton, Clark, and Minton ob-
served that the "overall impression from the majority opinion
is that it makes the Government liable under the Act [FTCA]
for negligence in the conduct of any governmental activity on
the 'operational level.'"68 The Justices felt that the holdings
and dicta of the case were too broad as they could conceivably
extend to almost all governmental activities.

In the few (mostly recent) cases where insurers, borrowers,
directors, or shareholders connected with insolvent depos-
itory institutions have sought to hold government examiners
and regulators liable for tortious acts or omissions, Dalehite
and Indian Towing have played important roles. As discussed
below, courts have usually held examiners and regulators im-
une in tort claims, "absent clear evidence of grossly arbi-
trary or capricious action . . . ."69 or assumption of duty.
These decisions will be explored.

Following a discussion of these decisions, a recent Illinois
case, Tcherepnin v. Franz,70 that imposed a qualified immu-
nity for state regulatory officers71 in a savings and loan associ-

66. Id. at 68.
67. Id. at 69.
68. Id. at 76.
70. 570 F.2d 187 (1978).
71. Some states, e.g., Arizona, have totally eliminated the concept of sovereign
immunity for tort liability. Stone v. Arizona Highway Comm'n, 93 Ariz. 384, 381 P.2d
107 (1963); State of Arizona v. Superior Court, 123 Ariz. 324, 599 P.2d 777 (1979). In
the latter case, the Arizona Supreme Court found that pleadings alleging fraud and
conspiracy by state officials did not adequately state claims for which relief can be
granted. The Officials' actions were supposed to have helped two thrift associations
fail and cause the loss of much money to investors. The court noted that because
ation case, will be analyzed in suggesting reform. The Illinois standard may well be the next step in the century-long process of encroachment upon sovereign immunity. Such strongly qualified immunity may be warranted, especially in bank regulation where Congress itself has found a great deal of error and negligence. The 1974 failure of the Franklin National Bank, a $5 billion institution, offers a prime example of the problems which such negligent regulation can produce.

Franklin National Bank

On October 8, 1974, the Comptroller of the Currency, James E. Smith, declared Franklin National Bank, a $5 billion international bank ranked 19th in the Nation, to be insolvent. This insolvency declaration established Franklin as the largest bank failure in U.S. history and brought to a conclusion half a decade of financial mis-management and regulatory neglect.

Thus begins a highly critical report entitled Adequacy of the Office of the Comptroller of the Currency's Supervision of Franklin National Bank. The House Committee on Government Operations that made the study concluded that the OCC had seriously bungled its job. The Committee reached several important conclusions including that the OCC failed to utilize fully its supervisory options to correct problems uncovered by examiners. Although examiners ascertained most

Arizona had eliminated immunity for tort liability, a simple negligence allegation would have been sufficient to state a claim upon which relief could be granted.

72. See generally notes 1-4, 9, 10, and 17 supra; Failure of the U.S. National Bank of San Diego: Subcomm. on Bank Supervision and Insurance, House of Reps., 93d Cong., 2d Sess. (1975) [hereinafter cited as Failure]; The Failure of Citizens State Bank of Carrizo Springs, Texas and Related Problems, Parts 1 & 2, Subcomm. on Financial Institutions Supervision, Regulation and Insurance, 94th Cong., 2d Sess. (1977). The apparent deficiencies of the examination process were noted by Rep. St. Germain in the Carrizo Springs hearings. He poignantly pointed out that "[o]f the 56 banks that failed in the United States between 1959 and 1971, 34 had passed their most recent examination in a "no problem" category, and 17 out of the 34 had been given an 'excellent' rating." Id. at 2.

73. COMM. ON GOVERNMENTAL OPERATIONS, supra note 2, at 1.

74. Id. at 6. Franklin's troubled status first became apparent when, after one of its rare examinations, the OCC rated the Bank's condition a 3 on a scale of 1 to 4 (1 being best; 3 and 4 requiring special attention). However, not only did the OCC not pay special attention, it also failed to fully utilize its corrective powers. Id. at 14. For example, special one day visitations to review Franklin's foreign exchange operations (where many of its problems lurked) were insufficient to make an adequate evaluation of these operations. Id. at 17. Also, the OCC failed to use cease and desist powers, it
of Franklin National Bank's (hereinafter Franklin or the Bank) problems, these were inadequately pointed out to Franklin or the regulators.\textsuperscript{76}

There was strong evidence in May 1974 that Franklin could not survive as a viable independent entity. Consequently, there is serious debate as to the propriety of the Comptroller's decision at that time to declare the bank solvent.\textsuperscript{76} The Comptroller's declaration allowed other banking agencies to engage in costly and ultimately fruitless efforts to save the bank.\textsuperscript{77} The OCC is required by federal law to examine a bank twice yearly, but for good cause may reduce examinations to no less than three in two years\textsuperscript{78} but

\begin{quote}
[t]he OCC failed to conduct the required number of examinations of Franklin during the crucial years of 1969 through 1971 when some of the banking practices which later proved fatal to Franklin were in full use.\textsuperscript{79}
\end{quote}

The OCC did not satisfactorily document why it deliberately skipped required examinations.\textsuperscript{80} Finally, the Committee criti-
cized the Federal Reserve System for violating its own policies with regard to extending credit to troubled banks. As for the OCC's overall accountability, the Committee found that the OCC was "lax in enforcing bank agreements and commitments to improve soundness" and that even in large bank failures—involving "huge Federal Reserve loans, large stockholder and even depositor losses, major market disruptions, etc.—the bank regulators are no more accountable to the Congress than under normal day-to-day regulatory operations." Given the OCC's related agencies' independence from direct supervision and the congressional findings of neglect of ministerial or statutory duty and lax enforcement of regulations, a strong argument can be mustered that liability for the failure should attach.

The Comptroller did not observe the statutorily required examination frequency in regards to Franklin, and, in addition, ignored the formal statutory waiver provisions. From 1969-71 only three reports of examination were prepared on Franklin. Furthermore, from 1969 through 1973, the Comptroller also failed specifically to waive any examination of the bank although he did not conduct at least two examinations per calendar year.

... The Comptroller's response that the statutory requirements are unduly burdensome cannot be justified in the case of Franklin. The reported condition of Franklin certainly would have justified meeting or exceeding the statutory required number of examinations. If the Comptroller believed the statute too burdensome and imprecise, he should have requested Congress to amend it accordingly.

Id. at 12-13.

81. Id. at 6. The Committee also found that:

It is not the Federal Reserve's practice or policy to rely on the sale of the loan collateral, with its attenuate uncertainties and delays, to recover the funds it advances. When the Federal Reserve Bank of New York asked how Franklin could repay loans from the Federal Reserve, necessary to Franklin's survival, the bank's senior management replied "there was no way to repay it." The Federal Reserve pursued the charade to justify making a loan to Franklin and insisted that Franklin's officers "give us your ideas any [sic] on how to pay us back." Franklin's president said that any response would have been little more than a "comic letter." Nevertheless, the Federal Reserve Bank of New York loaned an unprecedented $1.7 billion to Franklin.

Id. at 35.

82. Id. at 7. While Congress is the ultimate watchdog over the regulators, such supervision is extremely loose due to its very nature: Congress doesn't have the expertise, manpower, nor interest to constantly supervise the bank agencies. Adding to the agencies' independence is the fact that they derive all of their funding from the banks they regulate—Congress cannot pull financial strings to control the agencies. This argues strongly for allowing greater judicial review and limitation of the discretion rules of the FTCA exceptions.
Much litigation followed FNB's failure; two cases were preeminent: *In re Franklin National Bank Securities Litigation* and *Huntington Tower, Ltd. v. Franklin National Bank*. The two cases will be discussed jointly.

*FNB Securities* was a consolidation of several cases originally generated by the FDIC's suit against several insurers supplying Bankers' Blanket Bonds. Other actions targeted Franklin's auditor, Ernst & Ernst, and Continental Bank International (Continental). Many of the parties initiated third-party complaints against the United States and cross- and counter-claims against each other, creating a very complex case.

The insurance companies in their third-party complaints against the United States basically alleged that government bank examiners and regulators were negligent, thereby contributing to Franklin's losses. Continental and Ernst & Ernst made similar allegations in their defenses and cross-claims. The insurers also suggested that the government, through its bank regulatory agencies, overstepped its normal regulatory functions and actually participated in the management of Franklin. By so doing, it was argued, the government should be liable for some losses under the *Indian Towing* theory of assumption of duty. The government sought to end the action quickly by moving to dismiss the counter-charges on the grounds of lack of subject matter jurisdiction and failure to state a claim upon which relief can be granted.

The District Court for the Eastern District of New York held, and subsequently affirmed its holding, that: 1) the United States owed no duty to the Bank by virtue of statutes requiring government agencies to examine and regulate banks; 2) by regulating a bank, the government usually did not assume a duty to the bank such that negligent regulation could give rise to tort liability; 3) a cause of action was stated in a complaint alleging governmental assumption of duty by ex-

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84. 559 F.2d 863 (2d Cir. 1977), cert. denied, 434 U.S. 1012 (1978).
86. These bonds insured Franklin and its parent company, Franklin New York Corporation, against the losses perpetrated through dishonesty or fraud by the employees of either firm.
ceeding normal regulatory activities; and 4) by suing, the FDIC did not waive sovereign immunity.

The district court bisected its discussion of governmental duty into statutory duty and assumption of duty. With respect to statutory duty the insurance companies principally asserted that the OCC had failed to fulfill its statutory obligations under section 481 of Title XII of the United States Code that requires examiners to examine every national bank at least twice annually. Section 481 also states that the Comptroller, at his discretion, may waive examinations, but not more than one examination in any two year period. Finally, the examiners are required to make a "full and detailed report of the condition of said bank to the Comptroller of the Currency . . . ." The insurance companies alleged, and as discussed above, congressional hearings subsequently revealed, that the OCC and examiners "conducted these bank examinations negligently and thus caused the losses at FNB by failing to discover wrongdoing by the FNB employees." Complainants also alleged that the government negligently failed to act and use its statutory powers with respect to facts it did know about the Bank. The insurance companies argued that such negligence gives rise to liability because statutes giving the United States regulatory authority impose a duty in favor of the banks under federal regulation.

It is indicative of the lack of authority in this area that the main cases discussed in the court's opinion, Harmsen v. Smith and Kaufman v. Evans were being argued simultaneously. The California district court opinion in Harmsen came down before FNB Securities. The Harmsen appellate decision affirming the district court's decision came down after FNB Securities. The FNB Securities court agreed with the courts in Kaufman and Harmsen that the examinations are "not intended to create an actionable duty to the examined banks." The FNB Securities court interpreted the

87. 445 F. Supp. at 730-34.
89. Id.
90. 445 F. Supp. at 730.
reasoning of the other courts as indicating that the statutes requiring examinations were primarily designed to assist the regulators in regulating. It admitted that incidental benefits accrue to the banks under such a scheme. However, absent a clearer Congressional expression of intent, the FNB Securities court felt it would be foolish to read into the statute protection of shareholders, officers, or directors by the government. As such, then, the statute imposed no duty on the government vis à vis those parties.94

Noting that FTCA section 1346(b) allows liability only if it is based on “the law of the place where the act or omission occurred,” the parties and court utilized New York law that recognizes an assumption of duty theory of liability.95 Some of the insurance companies argued that regulation is an assumption of duty such that negligent regulation gives rise to tort liability. This issue can be bifurcated. The first question is whether assumption of duty can be found in normal day-to-day examination and regulation. The second is whether assumption of duty exists when, as alleged in the cases the government over-regulates and becomes involved in the operation of the bank.

With regard to the first question mentioned above, the FNB Securities court, relying on the district court opinion in Harmsen, held that the United States owed no duty to the banks by examining and regulating them. Harmsen distinguished Indian Towing and related cases.97 In Harmsen, the district court ruled that the crucial difference or test is the purpose for which such task is performed.98 In Indian Towing,

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94. Id. at 731.
95. See note 46 and accompanying text supra.
96. 445 F. Supp. at 731 (1978). The court explained the assumption of duty theory as follows: “Some of the Insurance Companies argue that even if there is no statutory duty, the Government’s involvement in the operation of FNB was so extensive that it was reasonable for the bank and its directors, officers and shareholders to rely on the United States to protect against fraud, and thus the United States thereby assumed a duty to these parties.” Id.
97. See, e.g., Ingham v. Eastern Air Lines, Inc., 373 F.2d 227 (2nd Cir.), cert. denied, 389 U.S. 931 (1967). In this case the court ruled that victims of a crash, which resulted from the negligent failure of a Federal Aviation Agency approach controller to warn incoming aircraft of lessened visibility, were entitled to damages. The court stated that “[i]t is now well established that when the government undertakes to perform services, which in the absence of specific legislation would not be required, it will, nevertheless, be liable if these activities are performed negligently.” Id. 236.
98. The court of appeals upheld the decision of the district court that the Comptroller owed no duty to the shareholders or to the directors of USNB. The court
the lighthouse existed to warn the public. However, the examinations the OCC is required to make are designed essentially to aid the government in regulating the banks, not to provide the banks with warnings or service. Ergo, the examinations are not intended to engender reliance by the banks, nor does the government assume any duty by its actions.

The court in *FNB Securities* found that the second prong of the assumption of duty theory was actionable. "[I]f the activities of the Government were so extensive that the directors or officers reasonably relied on the government to prevent fraud, then the United States could be held liable . . . ." Underlying and potentially estopping the liability are the notions of the FTCA exceptions under section 2680. In analyzing this issue, the *FNB Securities* court first turned to the court of appeals' opinion in *Huntington Towers, Ltd. v. Franklin National Bank*. 100

*Huntington Towers* was a borrower's suit brought by real estate developers who sought to recover a loss of $8 million suffered because of the failure of Franklin. The plaintiffs alleged that more than $3 million of their losses stemmed directly from the late declaration of the Bank's insolvency. It was during the period from May 13, 1974 to October 8, 1974 when the FRB made large loans to Franklin that the plaintiffs gave $3 million in additional security for their loans. Thus, the developers argued, but for the improper actions of the government agencies, the losses would not have occurred because Franklin was insolvent in May 1974.

The essence of the developers' first claim against the Federal Reserve Bank was that it should not have supported Franklin in light of its "hopeless financial situation throughout that period and that failure to disclose the insolvency to

wrote: "All that the Comptroller did was to perform his statutory duty of examination. In performing those statutory tasks, the Comptroller assumes no special relationship to the stockholders or to the directors who claim reliance on the results of the examination." 586 F.2d at 158.

99. 445 F. Supp. at 733. The conclusion was deduced from the dicta of Social Security Administration Baltimore Federal Credit Union v. United States, 138 F. Supp. 639 (D. Md. 1956). The case, which is the foundation for the *Harmsen* opinion, entailed a FTCA action by a federal credit union against the government on the grounds that the government had been negligent in examining the credit union's records. The court in *SSA Credit Union* held that it was the duty of the credit union itself (primarily its accountants) to detect internal fraud. The government had no statutory duty and assumed no duty in this regard.

100. 559 F.2d 863 (2d Cir. 1977).
appellants constituted an actionable tort." The court reasoned that "absent clear evidence of grossly arbitrary or capricious action on the part of either [the OCC or the FRB]," the fixing of the date of insolvency and the decision to support Franklin with FRB funds were within the realm of the agency's discretion. No evidence of grossly arbitrary or capricious action was presented. The court commented that:

It is not for the courts to say whether or not the actions taken were justified in the public interest, particularly where it virtually concerned the operation and stability of the nation's banking system . . . . In short, the FRB . . . was doing, for better or worse, what Congress expected it to do . . . .

Interestingly, the court in Huntington Towers dismissed the plaintiff's claim on the grounds of "lack of subject matter jurisdiction" and not the FTCA "discretion" exemptions. Additionally, the plaintiffs in Huntington Towers claimed that the Comptroller should be liable individually and officially because:

(1) he failed to declare an insolvent bank insolvent; (2) he declared an insolvent bank solvent; (3) he kept an insolvent bank open; (4) he consented to an unlawful preference among creditors in violation of 12 U.S.C. §194; and (5) he failed to take action to have . . . preferential liens declared null and void.

Citing Hawaii v. Gordon and Dalehite the court suggested that section 2680(a) relating to discretionary functions precluded the claim.

In FNB Securities, the court cited as one possible source of liability the Huntington Towers test of "clear evidence of

101. Id. at 867.
102. Id. at 868 (emphasis added). But see note 114 infra.
103. Id.
104. Ostensibly, the holding was based on several old cases. Id. at 868-69. In FNB Securities the court read the dismissal as being based "apparently on the ground that as long as the FRB acted within its statutory authorization, the decisions of the FRB are immune from judicial scrutiny." 445 F. Supp. at 733.
105. 559 F.2d at 869.
106. 373 U.S. 57 (1963). The case entailed a suit by the State of Hawaii against the Director of the Bureau of the Budget. The court held the case was one against the United States and as such could not be maintained without the consent of the United States.
grossly arbitrary or capricious action." The insurance company strongly asserted that the government's actions with regard to Franklin met this test. On the basis of these assertions, the court denied a motion to dismiss.

The government in FNB Securities tried to use the FTCA exceptions to foreclose the insurance companies' claims. Relying on section 2680(h) and United States v. Neustadt, the government argued that while its actions were willful, they still fell within the Neustadt standard which includes both negligent and willful misrepresentation under the section 2680(h) exception. Thus, claimed the government, their actions were exempted from FTCA liability. The court disagreed, quoting United Air Lines, Inc. v. Wiener:

Here, the gravamen of the action is not misrepresentation but the negligent performance of operational tasks, although such negligence consisted partly of a failure of a duty to warn.

Thus, under these circumstances, section 2680(h) does not protect the government. However, the court went on to point out that it had held that the OCC, FDIC, and FRB held no duty to the bank even for negligent regulation, thus the question was moot.

Finally, the United States sought to invoke the section 2680(a) "discretionary function" exception. The court refuted the government's argument by making an analogy based on Indian Towing:

By analogy, while the chartering of a national bank by the United States is a discretionary decision exempt

107. 559 F.2d at 868.
108. 366 U.S. 696 (1961). Neustadt was a suit brought under the FTCA against the United States by purchasers of residential property seeking to recover the difference between the purchase price of the property and its fair market value alleging that they would not have purchased the property if they had not relied on a negligent inspection and appraisal made by the Federal Housing Administration. The Court held that the plaintiffs' claims were based on negligent misrepresentation which is not actionable under section 2680(h). The section 2680(h) exception for misrepresentation includes both willful and negligent actions the Court concluded.
109. 335 F.2d 379 (9th Cir.), cert. dismissed, 379 U.S. 951 (1964). The case involved 31 claims arising out of a mid-air collision between an Air Force fighter and a commercial airliner. The court held that the United States was liable because the Air Force was negligent and thus must indemnify the airline. The suit was not precluded by the FTCA exceptions.
110. 335 F.2d at 398.
from scrutiny [similar to the Coast Guard's decision whether or not to build a lighthouse], as is the fixing of the date of declaration of insolvency, however, once having taken control of a bank, as it is alleged to have done here, it could not operate it in a negligent manner without being subject to liability.\textsuperscript{118}

In other words, once the government exceeded its normal function and basically managed the bank, it stepped into the shoes of the directors and was held to the same standards as they were. In a sense, the court implies that when the government exceeds or abuses its discretionary power, it cannot use the FTCA exception as a shield.

What finally emerges is a doctrine of mildly qualified immunity for federal agents and agencies. As the courts point out, there are potentially two sources of liability on these facts. First, a case may be based on a theory of assumption of duty where the regulators have exceeded their legal powers and have actually participated in the operation of the bank. Second, a case may be built on grounds of grossly arbitrary or capricious actions by federal regulators.

The New York district court in \textit{FNB Securities} depended heavily on the analysis and holding of the California district court in \textit{Harmsen}. The Ninth Circuit Court of Appeals decision in \textit{Harmsen v. Smith},\textsuperscript{118} in turn, repeatedly cited \textit{FNB Securities}. Despite this inherent weakness, \textit{Harmsen} does merit inspection as it addresses some questions not raised in the Franklin Bank cases.

\textbf{United States National Bank}

\textit{Harmsen v. Smith} arose from the failure of the U.S. National Bank of San Diego.\textsuperscript{114} While factually the failures of Franklin and U.S. National Bank differed,\textsuperscript{115} the pattern of

\begin{thebibliography}{99}
\bibitem{112} 445 F. Supp. at 735.
\bibitem{113} 586 F.2d 156 (9th Cir. 1978).
\bibitem{114} Another case, First Empire Bank v. FDIC, 572 F.2d 1361 (9th Cir.), \textit{cert. denied}, 439 U.S. 919 (1978), involved the bank regulatory process in terms of disposing of an insolvent bank's assets by the FDIC. Creditors sued the FDIC alleging that their claims to San Diego had been improperly disposed of and that, as such, the FDIC should be liable. Finding the FDIC had erred in its handling of the bank, the Court of Appeals held that the FDIC had the responsibility to compensate creditors for its failure.
\bibitem{115} Franklin failed because of fraud and excessive losses in its foreign currency and real estate divisions. U.S. National Bank failed primarily because of a loan pyra-
\end{thebibliography}
regulatory neglect and abuse was similar.

When it failed on October 18, 1973, U.S. National Bank was among the 100 largest banks in the country with total assets exceeding $1.2 billion. As early as 1962, the problems that ultimately caused the bank to fail were known to examiners.\textsuperscript{116} Had action been taken to stop the loans to corporations controlled by C. Arnholt Smith, Chairman of U.S. National Bank, the bank might have been saved.\textsuperscript{117} The examiner who discovered the discrepancies, however, was reprimanded and taken off the case by the Comptroller of the Currency.\textsuperscript{118} Furthermore, the OCC stood by and allowed the unsound banking practices at the bank to continue for the next ten years.\textsuperscript{119}

In \textit{Harmsen}, the court addressed the “novel” question whether directors of a defunct national bank may maintain actions for indemnity against the United States for alleged negligence of the Comptroller of the Currency in conducting bank examinations.\textsuperscript{120}

The case had originated as a shareholder class action suit against the directors for various breaches of fiduciary duty. The FDIC intervened, acting as the bank's receiver, on behalf of the shareholders. The directors thereafter filed third-party complaints seeking indemnity under the FTCA.

The directors' complaints alleged that the OCC "was negligent in performing bank examinations, in supervising employees who performed the examinations, and in failing to discover illegal or unsound banking practices of USNB."\textsuperscript{121} To support the directors' argument for equitable indemnity, the court required the showing of a duty owed the original plaintiff (the bank's shareholders) by the United States.\textsuperscript{122} Citing mid scheme run by its Chairman of the Board, C. Arnholt Smith. In the scheme a series of companies controlled by Smith, including the San Diego Padres baseball team, shifted their books and assets in order to get hundreds of millions of dollars in loans and loan guarantees from the bank. The loans far exceeded the legal lending limits of the bank. Ultimately, the loans based on and secured by sham assets so impaired U.S. National Bank's capital structure that the bank was declared insolvent. See generally \textit{Failure}, note 72 supra.

\textsuperscript{116} See testimony of Jack Baker, \textit{id.} at 161.
\textsuperscript{117} \textit{Id.} at 162.
\textsuperscript{118} \textit{Id.} at 162-63.
\textsuperscript{119} \textit{Id.}
\textsuperscript{120} 586 F.2d at 156.
\textsuperscript{121} \textit{Id.} at 157.
\textsuperscript{122} The district court also required a showing "that the negligence of the original defendant was of a different character than that of the party from whom indem-
FNB Securities, the court found there is no "duty on the Comptroller to protect shareholders [and that] [n]othing in the statutory scheme suggests that any such duty should be implied." The Harmsen court appears not to have totally perceived the implications of the ruling and language of FNB Securities. It is conceivable, in New York and the Second Circuit, that the government might regulate in such a manner that it negligently assumed duties running to the bank by either engaging in grossly arbitrary and capricious actions or by participating beyond the scope of its statutory powers. It is not clear under Harmsen in California if this "negligent assumption of duty" theory could exist. Since the case involved mere fulfillment by the Comptroller of his statutory duties, the court did not address the question of more flagrant governmental actions.

In response to the directors' contention that submission of the OCC's examination reports to them engendered reliance, the court attempted to distinguish the Indian Towing case. The court asserted that bank examination bore no resemblance to the Coast Guard's duties to maintain lighthouses stating, "Bank examinations are not beacons to light the path of erring directors or gulled stockholders." The court admitted arguendo however, that it is possible that a case could occur where the OCC so heavily participated in management of a bank that the conduct created a duty to the bank and its shareholders.

Finally, the court refuted the directors' arguments, based on a series of early cases, that among the purposes of federal banking regulation was the protection of creditors and depositors. The court posited that "from the fact of congressional intent to protect creditors and depositors of national banks, no inference arises of any congressional intent to protect stockholders and directors of national banks." Essentially, then, Harmsen rests on a lack of standing for shareholders and directors. No matter how shoddy the gov-

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123. Id. at 157 n.1. The court of appeals' decision on the first requirement allowed it to sidestep this issue.
124. Id. at 157.
125. Id. at 158.
ernment's actions, shareholders and directors have no cause of action because no duty is owed them by bank regulators. The Harmsen court did not even have to consider the discretionary exception of the FTCA.

While the Franklin and U.S. National Bank have circumscribed the law in this area, courts in state jurisdictions have generally found only a qualified immunity for bank regulators, holding that such regulators do owe a duty to shareholders of a depository institution. The seemingly unending litigation surrounding the 1964 collapse of a Chicago savings and loan represents the leading case in the area of broad qualification of official immunity—Tcherepnin v. Franz.

City Savings Association of Chicago

The Illinois standards set forth in Franz basically extend the liability of depository institution regulators to depositor/shareholders and qualify the immunity of public officials. Franz arose out of a claim by depositors of City Savings Association of Chicago that several state officials, including Joseph Knight (the later retired and deceased Director of the Department of Financial Institutions), had breached their statutory duties to City Savings. City Savings' receiver interceded, seeking to hold the officials and the State of Illinois liable for damages to the depositors. The state settled, appropriating over $12 million for reimbursements to depositors. The officials did not settle and district court subsequently found against the estate of Joseph Knight. The district court found that Knight had maliciously breached a statutory duty to supervise the affairs of City Savings and that he

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128. 393 F. Supp. 1197 (N.D. Ill. 1975), aff'd, 570 F.2d 187 (7th Cir. 1978).
129. 570 F.2d at 191.
130. As is the case with many savings institutions, depositors technically are holders of withdrawable capital shares. Thus, one is both a depositor and shareholder simultaneously. See Tcherepnin v. Knight, 389 U.S. 332 (1967) where the Court held the depositor's interests to be securities for purposes of SEC regulation.
132. Specifically, the district court found that Knight breached his statutory duty to supervise CSA by intentionally ignoring or concealing examinations and by delaying action for four months after he ascertained CSA's impaired financial condition. Id. at 1216.
had either fraudulently or negligently participated in foisting an illegal plan of voluntary liquidation upon its depositors.

On appeal, Knight’s estate sought to invoke official immunity with respect to the district court’s finding. The appellate court noted that, while under common law public officials were immune from errors in discretion and judgment, this was not true of Illinois and other jurisdictions. Citing an old Illinois case, the court held that

the immunity conferred on public officials is a qualified one, one that is displaced by an official’s negligent conduct in the performance of ministerial duties or malicious and corrupt conduct in the performance of discretionary duties . . . .

The essential inquiry of this “statutory violation theory,” as the district court termed it, was ascertaining which parties were owed what duties by the regulator. In this regard, Knight, subject to the terms of the Illinois Savings and Loan Act, was responsible for the “protection of the Association.” This language was broad enough that City Savings and its depositors had “a vested right in the duties therein prescribed.” The court deemed such responsibility sufficient to create liability. Knight was found to have been malicious and willful in the dereliction of his duties. Such extreme conduct might fit the “grossly arbitrary or capricious” test for liability on the federal level. Note that Illinois law, as interpreted in this case, extends liability against an official not only in his official capacity, but personally as well—a significant qualification of immunity.

Briefly, then, Illinois in the absence of the FTCA or similar act, has evolved a standard of strongly qualified immunity for public officials. In depository failure cases the regulators owe a duty to the institution as well as to creditors and depositors. In a savings and loan situation, and perhaps in other situations, a duty is owed the shareholders as well. Duty may be breached and liability incurred by negligence in the performance of ministerial functions. With discretionary functions, duty is breached by corrupt and malicious conduct.

134. 570 F.2d et 191.
135. Id.
136. Id.
Most importantly, with respect to the rights of shareholders and other claimants, the lower standards of Illinois' qualified immunity offers far greater protection.

Summary of Standards

At the federal level, the *Franklin* and *U.S. National Bank* decisions helped establish the concept of mildly qualified immunity of federal bank examiners and regulators. Note that neither case made a determination for liability on the facts presented; consequently, the concept is still theoretical. Only two methods exist to circumvent FTCA immunity. First, the assumption of duty theory may be invoked where the government actually participated in managing the affairs of the bank. Second, liability may be implied where there is clear evidence of gross arbitrary or capricious actions by the regulators in the course of their duty. Underlying these exceptions is the question of duty: what duty is required and to whom is it owed? In the federal cases, creditors and depositors are owed a duty of fairness and propriety by regulators. Shareholders and directors of a bank, in other words, the banks themselves, are left without recourse in cases of negligent government regulation and administration and less than grossly arbitrary or capricious federal conduct.

In Illinois, shareholders and directors also have rights *vis à vis* regulators. The standard of immunity from tort action is broadly qualified and may be displaced by an official's negligent conduct in performing statutory duties or by malicious and corrupt conduct in performing discretionary duties. Such an official may be found liable personally as well as officially.

Conclusion

Traditional policy arguments appear to be strong for maintaining almost absolute immunity for federal depository institution examiners and regulators. One often reads or hears that public policy dictates that we should protect those who must act decisively in a sensitive and complex area such as banking. Present trends, however, call for some rethinking of this policy.

The primary issue is whether there should be a duty owed to banks, shareholders, and directors. In Illinois, the courts have read the laws on examination and supervision as being
enacted for the protection of the depository institution. The federal courts, however, as seen in SSA Credit Union, Harmsen, and the Franklin Bank cases, read the law as protecting only the public.

Even when there is a duty, the courts have granted significant immunity. For example, in distinguishing a recent case, Economou, the Huntington Towers court stated that the breadth and character of the OCC’s role required absolute immunity so that the OCC may work without the threat of supervision and suit.

These arguments, however, are flawed when viewed in context. Banking is the subject of more and more regulation. FIRA, passed recently, gives new powers and thus heightens the potential for abuses by banking regulators. And this new power was granted despite recent congressional investigations that chronicled a history of OCC, FDIC, and FRB negligence and malfeasance.

There is clear danger from abuse of power and negligence by regulators. Consider, for example, $8 million in losses to Franklin’s borrowers and potentially millions lost to the shareholders of U.S. National Bank. Given these facts and the express congressional purpose of protecting the public and maintaining a safe and sound banking system, it is logical to impose more judicial supervision and review in these cases and less absolute immunity.

As noted by this comment, one of the purposes of absolute or mildly qualified immunity has been to encourage the regulator to act decisively. Nonetheless, as the Franklin and U.S. National Bank cases demonstrate, the regulators either did not act or acted very slowly. A standard of strongly qualified immunity, rather than shackling a regulator with fear of liability, would encourage him to act reasonably and prudently—ideals that are to the greatest public benefit. Standards of reasonableness can be applied to discretionary situations. It is time for Congress to look not at how the powers and regulations have failed; but rather how to make its regulators more accountable and efficient. To this purpose the

137. See note 99 supra.
139. 559 F.2d at 870 n.2.
enlightened Illinois perspective may find a useful federal application.

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