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Insolvent Financial Institutions and The D'Oench Duhme Doctrine: The FDIC'S Avoidance Power

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Hypothetical: In 2006, a corporation takes out a loan from a federally insured bank to purchase a building for its corporate headquarters. The corporation is in the business of supplying building products to upscale home builders and in 2008 the corporation's revenues fell by sixty percent. The corporation could not make its monthly debt service payments and asked the bank for a loan modification. The bank agreed and entered into a loan modification agreement with the corporation reducing the interest rate on the note and converting the note from principal and interest to interest only payments. Six months later, the bank was placed into receivership by the FDIC and the FDIC receiver demanded payment under the original terms of the corporation's note, completely ignoring the loan modification agreement. Can the FDIC do this? Yes, it can.

In 1942, the United States Supreme Court, in the case of *D'Oench, Duhme & Co., Inc. v. FDIC*, created a doctrine of law known as the *D'Oench Duhme* (pronounced dench du mee) Doctrine. The D'Oench Duhme Doctrine allowed the Federal Deposit Insurance Corporation ("FDIC"), acting as a receiver or conservator of an insolvent federally insured depository institution, to avoid "secret" agreements between the insolvent bank and a borrower of funds from such bank. In its original form, the *D'Oench Duhme* Doctrine held that a person or entity could not rely on secret (primarily oral) side agreements modifying the terms of a promissory note to the insolvent financial institution as a defense to the FDIC's attempt to collect on the promissory note during its receivership of the financial institution.

The *D'Oench Duhme* Doctrine remained an unaltered federal common law doctrine for over forty years until Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA") in 1989 and officially codified the *D'Oench Duhme* Doctrine in 12 U.S.C. § 1823(e) and expanded its reach beyond truly secret oral agreements. The FIRREA version of *D'Oench Duhme* allows the FDIC, as the receiver of an insolvent financial institution, to ignore any agreement, written or unwritten, which "tends to diminish or defeat" any asset of the insolvent institution, as determined by the FDIC in its sole discretion, unless such agreement:

1. is in writing;
2. was executed by the depository institution and any person claiming an adverse interest thereunder, including the obligor, ***contemporaneous with the acquisition of the asset by the depository institution,***
3. was approved by the board of directors of the depository institution or its loan committee, which approval shall be reflected in the minutes of said board or committee, and
4. has been, continuously, from the time of its execution, an official record of the depository institution.

The most significant issue argued in Federal Courts with respect to the four requirements for agreements excluded from *D'Oench Duhme's* reach has been whether the agreement the FDIC is disregarding was executed contemporaneous with the promissory note or other document giving rise to the debtor's obligation to the insolvent institution. Federal Courts have consistently determined that any agreement executed before or after the promissory note is executed are subject to avoidance under the *D'Oench Duhme* Doctrine. The courts have been strict in interpreting the "contemporaneous" requirement of *D'Oench Duhme*, finding that, without exception, an agreement not executed contemporaneous with the promissory note is void as against the FDIC. Some courts have even gone as far as to say that the intent of the bank and borrower is irrelevant to *D'Oench Duhme's* application.

The reach of the *D'Oench Duhme* Doctrine was clearly expanded with the enactment of FIRREA and Federal Courts have continued to broaden its reach over the years. The concern for a borrower is that an agreement, such as a forbearance agreement or modification agreement, executed some time after the original loan documents, could be ignored and the original loan terms restored if its lender goes into an FDIC receivership. This could also have a significant impact on a guarantor who may renegotiate a reduction of the guarantee obligations, only to have the original obligations restored by the FDIC under the *D'Oench Duhme* Doctrine. If this happens, the borrower is essentially powerless against the FDIC to stop it. The best advice for any borrower is to examine the financial health and stability of the lender from which they are considering borrowing funds.