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Financial Services Report

# THE FINANCIAL CRISIS AND INCREASED REGULATORY ENFORCEMENT: INSTITUTION-AFFILIATED PARTIES

As the financial crisis persists, banks and thrifts continue to come under intense regulatory scrutiny and more exacting oversight by way of memorandums of understanding (MOUs), cease-and-desist orders (C&Ds), formal written agreements, prompt corrective action ("PCA") and possibly receivership. In addition to regulatory actions against institutions, the bank regulatory agencies possess numerous powers to bring enforcement actions against institution-affiliated parties. This report is the second in a three-part series[1] concerning the enforcement powers of the bank regulatory agencies which will focus on enforcement actions against institution-affiliated parties. This article will concentrate on enforcement activity by the Federal Deposit Insurance Corporation (FDIC); however, all the bank regulatory authorities have similar enforcement powers.

This article reviews actions the FDIC can take against parties whether the bank fails or not. The failure of the bank is not a prerequisite to such charges being brought. The third part of this series will focus on banks that have been put into receivership and the consequences for the officers, directors and stockholders of such banks.

The present financial crisis has many characteristics not found in prior downturns. The wholesale downdraft in residential property values is unlike prior real estate bubble bursts, and the closing, or near closing, of the mortgage financing markets probably could not have been anticipated. Bank regulators, however, voiced concerns over real estate values and concentrations for several years, particularly regarding commercial real estate lending concentrations. Community bankers, stripped of almost all market opportunities save real estate lending, fought back.[2]

Financial institutions affected by the downturn are now feeling significant pain. Ultimately, the FDIC will start the slow but sure process of identifying responsible individual parties ("Targets") for enforcement action. While the affected institutions are now the subject of MOUs, formal written agreements, C&Ds and/or PCA orders, there is relatively little recent experience with enforcement actions against directors and officers because banks have been healthy for so long. The options available to the FDIC, however, are many and draconian.

One of the key questions regarding the current banking crisis is: should responsible officers and directors have reasonably foreseen the scope and breadth of the downturn and backed away from real estate lending concentrations earlier? Did they ignore the earlier regulatory warnings? If so, when does the failure to do so amount to *gross negligence*? This assumes the Targets have not engaged in

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self-dealing or other breaches of fiduciary duty.

The enforcement staff of the FDIC, acting through the Division of Supervision and Consumer Affairs, will first assess what occurred and why. Typically, the first shot is fired when an institution is tagged during an exam for a seriously unsafe or unsound practice, or a violation of law or a breach of fiduciary duty by an affiliate, or when prior examination criticisms go unheeded. Violations of law or breaches of fiduciary duty by officers or directors are a key focus. For example, a violation of Regulation O, which regulates loans to insiders, is normally a major concern, especially if it is part of a pattern. The catch-all allegation is "unsafe and unsound banking practice," which can include virtually anything that puts the institution at inordinate risk.

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The FDIC can respond to the issues pursuant to its regulatory authority, but if knowledge and intent can be proven and material loss to the FDIC deposit insurance fund can be shown, the Federal Bureau of Investigation and the U.S. Attorney's Office may become involved. Sections 1005 and 1344 of Title 18 of the U.S. Code make a number of violations of banking laws or regulations a felony. The ten-year statute of limitations makes the period of peril very lengthy. Grand juries will issue subpoenas, and indictments may follow if the loss is substantial. Criminal cases, however, almost always require the Target to have personally benefited in a material way. Assuming no criminal case can or will be brought, the FDIC will normally proceed civilly.

[1] Part I of this series, Regulatory Examination and Enforcement: What to Expect and How to Respond, cited government-sponsored entity investments as examples of investments attracting bank regulatory concern. Specifically, the article was referring to preferred stock investments in government-sponsored entities, and not to other types of government-sponsored entity investments.

[2] Developing Concern: Bankers and Regulators Clash over Surge in Real-Estate Loans; Commercial-Property Focus Worries Federal Agencies; Executives Resist Curbs; A Thousand Protest Letters, WALL ST. J., Sept. 11, 2006, at A1.

## CIVIL MONEY PENALTIES

The FDIC typically begins a civil money penalty enforcement action by sending out a notification letter, giving the Target an opportunity to respond and stating that the regional office is considering a recommendation that an enforcement action be initiated by Washington. The response time has been increased slightly, to 15 days, replacing the prior "10-day letter." Accordingly, the Target must address the notification letters seriously and promptly.

The written response should dissect the FDIC's claim, demonstrate applicable extenuating circumstances, and explain why no further action by the FDIC is warranted. The FDIC, assuming it is willing, will respond by stating that it will settle on terms it proposes, typically a civil money penalty of a certain dollar amount. Requested amounts vary widely from a few thousand to a few hundred thousand dollars, depending on the severity of the charges and whether such charges have been brought before. After the written response, negotiations by the Target typically occur either directly or through counsel.

### *Civil Money Penalty Authority*

Section 1818 of the FDIA Act gives the FDIC, and the other banking regulators, authority to issue three tiers of civil money penalties, each representing a different level of culpability and fine. Tier I penalties, the least severe, are reserved for violations of laws or regulations, violations of C&Ds, violations of written conditions in connection with a grant of any application or other request, or violations of formal written agreements with the banking regulator. Tier I fines are as high as $6,500 per day for each day of a continuing violation.

Tier II penalties are reserved for more egregious misconduct or harm. If the FDIC believes that the allegations of misconduct relate to Tier II misconduct, the penalty becomes quite severe—up to $37,500 per day. In order to levy Tier II penalties, the FDIC must make two findings, the first as to the nature of the misconduct and the second as to the gravity of the misconduct.

If the FDIC believes that the allegations of misconduct relate to Tier II misconduct, the penalty becomes quite severe—up to $37,500 per day.

With respect to the nature of the misconduct, Tier II penalties may be assessed if an institution-affiliated party:

1. commits any Tier I violation;
2. recklessly engages in an unsafe or unsound practice in conducting the affairs of an insured depository institution; or
3. breaches any fiduciary duty.

Tier II penalties are the first level at which unsafe or unsound practices and breaches of fiduciary duty become subject to civil money penalties. As for unsafe or unsound practices as alleged by the agency, only reckless or knowing conduct will be sufficient. Congress imposed this threshold because of the inherently vague nature of the concept of unsafe or unsound practices. For Tier II penalties predicated on an unsafe or unsound practice, at least one commentator has suggested that the respondent must have had advice or notice that the practice was unsafe or unsound in order to be guilty of recklessness.

The second finding, with respect to gravity, requires proof that the violation, practice or breach:

1. was part of a pattern of misconduct;
2. caused or was likely to cause more than a minimal loss to such depository institution; or
3. resulted in pecuniary gain or other benefit to the respondent.

There is relatively little case law on what constitutes a "pattern of misconduct" for purposes of Tier II penalties. In one of the few cases on point, *Rapp v. United States Department of Treasury*, the Tenth Circuit ruled that repeated efforts to conceal Change of Bank Control Act violations, together with a continuing refusal to comply with the applicable regulations, rose to the level of a "pattern of misconduct."

Tier III penalties are assessed for knowingly committing a Tier I violation or engaging in unsafe or unsound practices or breaking a fiduciary duty. Fines can be as high as $1,250,000 per day.

### *Responding to a 15-Day Letter*

In response to a 15-day letter, the FDIC asks the Target to set forth a response by way of defenses for a number of factors. Targets should try to show that they acted in good faith and, if the facts warrant, in reliance on advice of counsel.

***Duration, Frequency and Continuation of the Purported Violations.*** Targets should show that the allegations involve only a single or infrequent violation.

***Cooperation with Banking Regulators.*** Targets should show that they have been forthright in their dealings with the FDIC regarding the allegations.

***Potential Loss or Harm to Financial Institutions.*** Targets should try to show that the bank was never at risk of loss.

***Financial Gain.*** Targets need to show that they had no "improper financial gain," i.e., one that did not occur due to the wrongdoing alleged.

***Prior History.*** Targets should show that this is (hopefully) their first alleged offense.

***Financial Capacity.*** Targets should plead financial hardship if appropriate. Capacity to pay is definitely a factor.

## REMOVAL

Formal removal proceedings are rare, but serious violations can bring swift and severe enforcement actions. Virtually all removal cases are settled by agreement; hearings are exceedingly unusual. A major obstacle for Targets interested in pursuing a hearing is that they have very limited discovery power; there is discovery generally by document production only. Hearings are

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held before an administrative law judge, whose advisory ruling is submitted to the FDIC Board of Directors, which ultimately decides the case. Their decision is appealable to the U.S. Court of Appeals. Perhaps the biggest obstacle, however, is the disparity in resources between the individual and the federal government. The Target may be facing a large fine or perhaps removal from banking, or both. The decision tree is simple: Do you challenge the allegations, or do you pay and leave the industry?

### *FDIC Removal & Prohibition Authority*

Pursuant to 12 U.S.C. § 1818(e), the FDIC is granted the very narrow power to remove and prohibit individuals from working in the banking industry for only the most serious offenses. When granting suspension and removal powers, well aware of the dangers that could result from granting the FDIC unfettered discretion to wield such potentially devastating power, Congress purposefully limited the circumstances under which these powers could be used. The Senate committee report states that "the power to suspend or remove an officer or director of a bank or savings and loan association is an extraordinary power, which can do great harm to the individual affected and to his institution and to the financial system as a whole. It must be strictly limited and carefully guarded."

Only after the FDIC meets its high statutory burden may it remove individuals from banking. To prohibit and remove a party from participation in the affairs of a financial institution, the FDIC must find that each of the elements of 12 U.S.C. § 1818(e) has occurred. The FDIC must first establish the following:

1. a specified type of misconduct;

2. such misconduct led to a particular effect; and

3. a certain degree of culpability exists on the part of the potentially offending party.

Most of the phrases and terms that are embodied in these rather succinct elements are not defined in the FDIA Act. How these terms are defined, however, is vitally important to the outcome of removal and prohibition proceedings. Below is a discussion of each of these elements and how the terms that make up the elements have been defined by the FDIC and other banking regulators.

### *Misconduct*

The first finding for removal and prohibition concerns misconduct. The FDIC must show that an institution-affiliated party committed one or more of the following acts, either directly or indirectly:

1. violation of a law, regulation, C&D, any condition imposed in writing by a federal banking agency in connection with any application or other request or any written agreement with a depository institution in question;

2. engaging or participating in any unsafe or unsound practice in connection with any insured depository institution or business institution; or

3. committing or engaging in any act, omission or practice that constitutes a breach of the party's fiduciary duty.

Concerns about agency overreaching, as well as about the severity of removal and prohibition, have caused a number of courts to construe narrowly the requisite grounds for misconduct. "Unsafe or unsound practice" is generally understood to mean "any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds." "Fiduciary duty" involves acting diligently, prudently, honestly and carefully in carrying out responsibilities.

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### *Effect*

To order removal and prohibition, a second finding must be made as to the effect(s) of the misconduct. The FDIC must determine that by reason of the conduct alleged:

1. the insured depository or other business institution has suffered or will probably suffer financial loss or other damage;

2. the interests of the depository institution's depositors have been or could be prejudiced; or

3. the potentially offending party has received financial gain or other benefit by reason of the violation, practice or breach.

The law requires more than just a loss or benefit resulting from a transaction. Losses and benefits result from proper conduct in a business context every day. Instead, it is important to note that the law specifically references the misconduct alleged and states that "by reason of" that misconduct—i.e., violation of law, regulation or order; unsafe and unsound practice; or breach of fiduciary duty—a loss, potential loss or benefit resulted. Thus, even though a bank experienced a loss or a party benefited from the transaction, that loss or benefit must be the result of actual misconduct—i.e., the benefit must be improper.

### *Culpability*

Finally, the FDIC must find that the respondent had the requisite culpability before the FDIC can order removal and prohibition. The FDIC must determine that the violation, practice or breach either:

1. involved personal dishonesty on the part of the respondent; or

2. demonstrated willful or continuing disregard by the respondent for the safety or soundness of the insured depository or other business.

The term "dishonesty" has been referred to as embracing, among other things, misrepresentation of the facts and deliberate deception by pretense and stealth, as well as want of straightforwardness. The FDIC has defined it as "a disposition to lie, cheat, defraud, misrepresent or deceive." Similar to personal dishonesty, the willfulness standard requires knowing or intentional misconduct. Courts have deferred to the Office of the Comptroller of the Currency's definition of "willfulness" as "deliberately and consciously tak[ing] part in an action that evidences utter lack of attention to an institution's safety and soundness." Alternatively, the FDIC can rely on evidence of "continuing disregard," which can extend even to recklessness if the individual's indifference to the consequences spanned some period of time. The Tenth Circuit has defined "continuing disregard" as "conduct which has been 'voluntarily engaged in over a period of time with heedless indifference to the prospective consequences.'"

As the law above sets forth, proof of scienter is needed to show culpability—negligence alone will not suffice. If the FDIC cannot demonstrate the necessary scienter to show personal dishonesty or willful or continuing disregard, removal and prohibition must not be recommended.

## CHALLENGING THE FDIC

Very few Targets challenge the FDIC or other banking enforcement agencies at a hearing—consent dispositions are common—because challenging removal or a large civil monetary penalty can be both costly and personally disruptive. It exacts a huge toll merely to challenge the allegations, and winning may be pyrrhic, because Targets must still interact with the regulators post-hearing. So, what should the Target do? Compromise and settle? Our advice is to pick your battles only after a careful evaluation of the case with experienced counsel.

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The forthcoming article on bank failure and its consequences for bank affiliates will show that the FDIC will: (1) determine how, why and by whose fault the failure occurred, as required by law and (2) decide to pursue those responsible through monetary damages.

If you have any questions, please contact **Daniel O'Rourke** (312-609-7669), **Timothy L. Cox** (312-609-7527) or any other Vedder Price attorney with whom you have worked. ■

Daniel O'Rourke

Timothy L. Cox

## BANK DIRECTORS' AND OFFICERS' GUIDE TO AVOIDING REGULATORY DURESS

### *Pre-Joining the Institution*

1. Join only well-managed institutions;
2. Make sure the bank has charter and bylaw provisions exculpating you for ordinary negligence and indemnifying you as fully permitted by law;
3. Make sure the bank has D&O insurance that covers enforcement issues; and
4. Have an indemnification agreement that guarantees legal representation.

### *Pre-Examination*

1. Do your job carefully, and document the care taken;
2. Stay current on regulatory developments; and
3. If involved in the examination process, get prepared well in advance.

### *During the Exam*

1. Manage the exam. Know what the hot buttons are before the examiners show up. Have a written analysis of issues, e.g., commercial real estate exposure. Meet regularly with the examiners during the exam. No surprises are allowed. Resolve the issues as they arise.
2. Be ready to answer questions about your responsibilities and activities—answer examination questions truthfully the first time.
3. Be careful what you say—regulators do not need long memories; they write everything down. Ideally, have all conversations witnessed by another officer. Keep good notes yourself.

### *After the Exam*

Follow up on all criticisms found, and live up to commitments to remediate problems. Little problems become big problems if repeated on the next exam.

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