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RESPONDING TO PROPOSED ENFORCEMENT ACTIONS BY THE FEDERAL BANKING AGENCIES

This article examines, from both a legal and practical perspective, the issues presented to a FDIC-insured institution and its affiliated companies and persons, when the federal Banking Regulators initiate an enforcement action. Among other things, the author provides useful guidance on tactical considerations to successfully negotiate enforcement orders, including the resolution of underlying regulatory issues.

When FDIC-insured institutions are faced with enforcement actions by federal Banking Regulators, they often find themselves at a decided disadvantage in responding in an appropriate manner. For example, constituencies - whether it be officers, directors or employees - are concerned about personal liability, such as by the threatened or actual imposition of civil money penalties. Moreover, because in recent years the favorable economy has resulted in fewer enforcement actions, institutional memory frequently is lacking with regard to how to formulate an effective response.

Significantly, recent enforcement orders issued against financial institutions - whether by settlement or otherwise - have become unexpected sources of liability because such enforcement orders create potential “roadmaps” to class action plaintiffs' attorneys who seek damages for the violations of law, regulation, or unsafe and unsound bank practices addressed in the enforcement orders.

This article provides a framework to evaluate the various types of enforcement actions, and suggests an analytical structure for formulating an action plan to respond.

LEGAL ISSUES

The federal banking agencies possess extraordinary statutory and regulatory authority to prevent and correct unsafe and unsound banking practices, and violations of laws and regulations by a depository institution, its officers, directors and other affiliated persons and companies. While it may appear to a reasonable person that a regulatory concern could be resolved by informal negotiations between an institution and its federal banking regulator, there are numerous instances in which the federal banking agencies, as a whole, are generally inclined to initiate formal enforcement proceedings, particularly following repeated requests to a board of directors and senior management to initiate remedial action.[FN1]

This article sets forth in summary fashion several of the special legal issues that should be considered by members of a board of directors and management, following an indication by the Office of the Comptroller of the Currency (the “OCC”), the Federal Deposit Insurance Corporation (the “FDIC”), the Office of Thrift Supervision (the “OTS”), or the Federal Reserve Board (the “FRB”), that an enforcement action is being contemplated or is threatened against the institution or its officers or directors.[FN2] For purposes of this article, the analysis is divided into:

(a) a discussion of the types of enforcement actions that may be brought by the Banking Regulators;
(b) the context in which enforcement proceedings arise;
(c) negotiation and litigation strategies;
(d) an explanation of the administrative hearing process; and
(e) the role of counsel in resolving enforcement proceedings and assisting in compliance with enforcement orders.

ENFORCEMENT OPTIONS

The enforcement process by the Banking Regulators generally is initiated as a result of the ongoing examination process, which is the paper-based audit system through which the financial health of a depository institution is evaluated.

As a result of the FIRREA, the Crime Control Act, and the Federal Deposit Insurance Corporation Improvement Act (the “FDICIA”), the Banking Regulators possess extraordinary enforcement powers with which to prevent or eliminate unsafe and unsound practices or conditions and violations of laws or regulations from occurring at insured depository institutions. Moreover, the Banking Regulators' broad range of remedies available in the exercise of enforcement powers is likewise formidable.[FN3] The following are the enforcement actions that have been brought by the Banking Regulators on a regular basis:

(1) Termination of insurance actions pursuant to Section 8(a) of the FDIA;
(2) Cease and desist proceedings pursuant to Section 8(b) of the FDIA;
(3) Temporary cease and desist proceedings pursuant to Section 8(c) of the FDIA;
(4) Removal and prohibition actions pursuant to Section 8(e) of the FDIA;
(5) Assessment of civil money penalties pursuant to Section 8(i) of the FDIA;
(6) Written agreements pursuant to Section 8 of the FDIA;
(7) Prejudgment asset seizure pursuant to Section 8(i) of the FDIA;
(8) Direct intervention by the FDIC to initiate enforcement actions pursuant to Section 8(t) of the FDIA;
(9) Capital directives pursuant to the International Lending Supervision Act;
(10) Prompt corrective action orders pursuant to Section 38 of the FDIA; and
(11) Safety and soundness corrective orders pursuant to Section 39 of the FDIA

Each of these alternative enforcement actions is explained in greater detail below.

TERMINATION OF INSURANCE

An administrative action to terminate deposit insurance may be brought by the FDIC against any insured institution, and must be *immediately* addressed by a board of directors and management. Unless quickly halted, a termination of insurance proceeding almost always results in the seizure of the institution, whether through action taken by the applicable Banking Regulator or through the state licensing authority. (Although technically brought by the FDIC, these so-called “8(a)” actions are used frequently by the FDIC as a threat to force another state or federal regulator to seize or otherwise take a strong enforcement posture against a financial institution.)[FN4]

The only cure for an 8(a) action is the recapitalization of the institution, either through a capital infusion by the institution's shareholders, the identification of a new investor, or a merger or similar transaction that restores the institution's capital to a level above the regulatory minimum.[FN5] Should improvement to the institution's capital prove to be impossible, the board of directors and management must consider taking immediate action to limit their personal liability in light of the probability that the institution may fail.[FN6]

CEASE AND DESIST ORDERS

The Banking Regulators have favored the use of cease and desist (“C&D”) authority under Section 8(b) of the FDIA to cure a host of regulatory concerns. Under the Section 8(b) authority, a Banking Regulator can issue a C&D order to correct or eliminate a violation of a statute, rule, regulation, or unsafe or unsound practice at a financial institution. The issuance of a C&D order (which is frequently agreed to by a financial institution by means of a consent stipulation) subjects the institution to a panoply of regulatory restrictions and reporting requirements, as well as significant additional liability if the corrective measures required by the C&D order are not properly implemented. Further, as noted below, the C&D authority is now a tool utilized by the Banking Regulators to order financial institutions to increase their capital base, and has become the favored means of issuing capital directives against a financial institution.[FN7]

TEMPORARY CEASE AND DESIST ORDERS

In cases deemed particularly urgent and threatening to an institution's continued existence, the Banking Regulators may issue a temporary C&D order, and immediately impose corrective measures on the institution and its related persons and entities. A temporary C&D order is effective upon issuance, and can only be challenged by an action in federal district court seeking an injunction for relief from the temporary C&D order. This extraordinary remedy has been used by the Banking Regulators principally against institution-affiliated parties to prevent the dissipation or transfer of assets deemed by the government to belong or relate to the insured institution. When used in this manner, a temporary C&D is, in effect, a prejudgment asset seizure tool that requires no prior review by a court in order to be effective.

REMOVAL AND PROHIBITION ORDERS

Under Section 8(e) of the FDIA, the Banking Regulators can issue orders against an institution's officers and directors, removing such individuals from their positions with the institution and prohibiting further contact. (This authority to remove a member of the board or management continues following the date the individual severs his or her relationship with the financial institution.) Upon the issuance of a removal and prohibition order, the officer or director is also prohibited from being associated with another regulated depository institution (including a holding company), until such time as permission is received from a Banking Regulator. The use of the removal and prohibition authority, therefore, can effectively prohibit an officer or director from ever being employed in the financial services industry in the future.[FN8]

CIVIL MONEY PENALTIES

The Banking Regulators may assess civil money penalties against an insured financial institution and its officers and directors for any alleged violation of law, regulation, agreement between an institution and its Banking Regulator, or unsafe or unsound practice. For basic violations (i.e., regardless of fault), the Banking Regulators may assess a penalty in the amount of $5,500 for each day an alleged violation continues; for reckless violations that result in harm to the institution, the maximum penalty rises to $27,500 a day per officer and director; and for violations that indicate criminal or quasi-criminal activity, violations carry a punitive penalty as high as $1,100,000 per day for each officer and director of the institution and the insured depository institution itself.[FN9]

The civil money penalty authority is frequently utilized by the Banking Regulators because of its impact on the leadership of the institution. Because civil money penalties are typically imposed individually on officers and directors, the mere threat of a proposed assessment requires the immediate attention of those individuals, and may result in a financial institution capitulating to whatever remedial action has been requested by the Banking Regulators. Further, as discussed below, because civil money penalties are frequently threatened for the violation of a C&D order or a memorandum of understanding, the risk to an officer or director becomes exceptionally high subsequent to the date the institution becomes subject to the terms of one of those enforcement documents.

An institution-affiliated party receiving a notice by a Banking Regulator of the intention to assess civil money penalties cannot take the matter lightly. The few judicial decisions in the area suggest that culpability is based upon a virtual strict liability standard, which means that exoneration from liability lies solely within the discretion of the Banking Regulator following a review of a written submission from the officer or director opposing the proposed assessment of a civil money penalty. Several of the Banking Regulators have adopted a “matrix” to evaluate personal culpability, and it is therefore important in any written response to a proposed assessment of civil money penalties to address the factors in the applicable matrix to minimize or eliminate an assessment of a proposed penalty.

FORMAL AND INFORMAL AGREEMENTS WITH THE BANKING REGULATORS

It was once thought that the least onerous enforcement action taken by a Banking Regulator was the execution of a written agreement by which the financial institution agreed to take corrective action. Such a written agreement, commonly called a “memorandum of understanding” or “MOU,” typically contains the same language and requirements as a C&D order.

Thus, while MOUs formerly were considered far less onerous than a C&D order, the FIRREA increased the liability of an institution and its officers and directors when signing a MOU. This is because a MOU now is enforceable in the same manner as a C&D order, and the violation of the terms of a MOU carries the same penalties, such as civil money penalties, as a C&D order. In fact, in a manner identical to that of C&D orders, MOUs and similar documents are announced publicly by the Banking Regulators upon execution. For publicly traded companies, a MOU generally requires the same degree of securities disclosure as a C&D order, and for non-registered companies, the Banking Regulators frequently require that the institution provide its shareholders with a complete description of the MOU's contents. (In many ways, a MOU could be viewed as a stipulated C&D order, particularly if the Banking Regulator requires that some form of disclosure of the MOU be provided to the public and/or to the institution's shareholders.)

Notwithstanding the foregoing, it is frequently the strategy of choice for an institution to attempt to negotiate with a Banking Regulator to sign a MOU rather than a C&D order, because, in part, of a perception that the public and investors view a MOU as being less serious than a C&D order. While this strategy has definite benefits, it often results in the institution agreeing to a list of expansive remedial actions demanded by a Banking Regulator, in exchange for which the enforcement document is termed a MOU. Further (and more importantly for officers and directors), the same significant liabilities arise when a MOU is executed as when a C&D order is consented to by an insured institution.[FN10]

PREJUDGMENT ASSET SEIZURE POWERS

The Crime Control Act provided the Banking Regulators with additional quasi-criminal enforcement powers, including prejudgment asset seizure authority. As set forth in Section 8(i) of the FDIA, the Banking Regulators may obtain a court order enjoining the transfer of an individual's personal assets, including the appointment of a receiver to administer the same. This asset seizure power, which to date has been used sparingly, is very similar to the civil money penalty authority in that it is intended to be directed at individuals associated with an institution.

INTERVENTION BY THE FDIC IN ENFORCEMENT SITUATIONS

As a result of the FDICIA, the FDIC received “back-up” enforcement authority it had been seeking for many years. Under the terms of Section 8(t) of the FDIA, the FDIC may place any other Banking Regulators on notice of its intention to take enforcement action if the notified Banking Regulator fails to take enforcement action within a 60-day period. From an institution's perspective, because the FDIC in this role is second-guessing the primary Banking Regulator, the institution can be placed in the position in which its own regulator may be satisfied with corrective efforts being made, yet is forced to take formal enforcement action to avoid inter-agency criticism.

CAPITAL DIRECTIVES

The Banking Regulators have the authority to issue capital orders that are focused on the particular needs of an institution. Unlike other enforcement authority, however, judicial precedent strongly suggests that there is virtually no right to an administrative review of the determination to issue a capital directive, and that any subsequent judicial review is limited as well.[FN11]

The failure to comply with a capital directive may be enforced in the same manner as a cease and desist order.

PROMPT CORRECTIVE ACTION

The FDICIA provided the Banking Regulators the authority to avoid risk to the FDIC insurance funds by mandating capital compliance with capital categories. Depending upon the level of capital deterioration, an institution may be subjected to a range of requirements, including:

(a) restoration of capital;
(b) improving management;
(c) electing a new board of directors;
(d) removing specified officers and directors;
(e) asset growth and activities restrictions; and
(f) capital distributions limitations.

SAFETY AND SOUNDNESS PLANS

Section 39 of the FDIA established the requirement for the Banking Regulators to promulgate standards for the safe and sound operation of an insured institution. Joint agency guidelines require an insured institution to adopt a laundry list of required policies and procedures addressing various components of the institution's operations.

The Banking Regulators are authorized to issue a directive to an institution to develop a plan to correct weaknesses in the institution's operations and to take other corrective action. Because the nature of an alleged violation of Section 39 is, per se, an unsafe and unsound condition, the requirement of submitting a safety and soundness plan is frequently included as part of a cease and desist order.[FN12]

THE CONTEXT IN WHICH ENFORCEMENT ACTIONS ARISE

Enforcement actions usually occur during difficult moments in a financial institution's corporate existence, and almost always result in the diversion of management's time and the reallocation of the institution's resources away from the institution's actual concerns.[FN13] Enforcement actions arise in the following situations:

(1) immediately following examinations;
(2) following the failure to implement informal recommendations of the Banking Regulators; and
(3) following the settlement of other enforcement actions.

Each will be considered separately.

ENFORCEMENT FOLLOWING EXAMINATIONS

The most frequent use of formal enforcement authority occurs immediately following completion of an examination by one of the Banking Regulators. In this situation, the Banking Regulator utilizes the enforcement option in an attempt to remedy the regulatory criticisms set forth in the report of examination, including violations of law and regulations, classification of assets, adequacy of capital and loan loss reserves, maintenance of books and records, supervision of lending operations, and similar matters.

Several of the Banking Regulators have adopted internal review policies following an examination to determine whether an enforcement action should be initiated. For example, this review process is initiated by a finding by the examination team of serious violations of laws or regulations, whereupon the severity of the alleged violations from a safety and soundness perspective is evaluated by the senior staff of the Banking Regulator. In such cases, the recurrence of violations raised by previous examinations is a significant factor when determining whether enforcement action should be initiated.[FN14] In certain instances in which a sufficient degree of non-compliance is found following an examination, agency policy may dictate the initiation of immediate and severe enforcement action.

RECEIPT OF INFORMATION BY THE BANKING REGULATORS

Enforcement actions also arise following the receipt of information by the Banking Regulators from various sources, including quarterly reports of condition and income, limited examinations or visitations, and informal sources. In such cases, the Banking Regulators may feel compelled to act in an expeditious manner to avoid an imminent loss and may utilize a temporary C&D order to stabilize the situation. In cases not involving immediate loss, an enforcement action may be preceded by a letter directive or order requiring the institution to take some type of corrective action.[FN15]

FOLLOW-UP ENFORCEMENT TO OTHER FORMAL ENFORCEMENT PROCEEDINGS

The Banking Regulators frequently use removal and prohibition actions, as well as the assessment of civil money penalties, against individual officers and directors as a follow-up to other enforcement actions, such as a C&D proceeding against the institution itself. After the board of directors and management believe they have resolved a crisis with their Banking Regulator, they may be confronted with additional enforcement actions that are directed to the individuals at the institution, and result in further diversion of resources. Because such follow-up enforcement actions are usually aimed at senior personnel at the institution, the same individuals who are primarily responsible for curing the regulatory concerns at the targeted institution must instead focus on their individual liability. Depending upon the nature of the regulatory difficulties, a prudent strategy to pursue by a board of directors may be to have separate counsel representing the board and the institution during the period of time that an enforcement action is threatened.

Of particular note to management and directors is a practice employed by the Banking Regulators of pursuing civil money penalties against individual members of management and the directorate following an examination conducted to determine the level of compliance with a previously executed MOU or a C&D order. It is therefore *crucial* that board members and management obtain a clear understanding of the scope of personal responsibility that is being assumed when an enforcement order or written agreement is entered. (Similarly, the implementation of a robust compliance program is strongly urged to avoid subsequent liability.) FN16

PRACTICAL CONSIDERATIONS FOR OFFICERS AND DIRECTORS WHEN CONSIDERING ENFORCEMENT PROCEEDINGS

Today's regulatory environment involves a combination of cooperative interaction mixed with a healthy dose of arm's-length caution between institutions and the Banking Regulators. Thus, a depository institution must always consider the possibility that the Banking Regulators may be potential litigants that possess extraordinary civil and quasi-criminal enforcement authority. Further, the board of directors and management of a financial institution should never deem any written correspondence with its Banking Regulator to be innocent or on a friendly basis.

The following are practical considerations for officers and directors when considering actual or threatened enforcement actions:

THE REQUIREMENT OF MAKING A RECORD

It is fundamental that management and the board of directors of a financial institution understand that the institution must constantly create a written record of the reasonable steps it has taken to respond to regulatory concerns, and formally place on the *administrative record* (i.e., before the Banking Regulator in writing) its position on all regulatory issues. This is because the courts have clearly stated in recent decisions that it is only those facts that the Banking Regulator has before it (i.e., on the written administrative record) that are germane to a Banking Regulator's determination in any current or future enforcement proceeding. In other words, if the institution possesses information that is favorable to it and such information is not before the Banking Regulator in writing, neither the institution itself nor its officers or directors can offer that information in defense of an enforcement proceeding brought by the Banking Regulator at a later date.

For example, it is typical as part of the examination process to have numerous informal conversations between management and the examination staff. Frequently, such conversations involve issues of concern between the Banking Regulator and the institution, with the examiners informally telling management that an area of disagreement has been resolved favorably, or that no culpability for a potential loss would be attributed to the board or management. In the written examination report itself, however, the Banking Regulator excoriates both management and the board for a lack of oversight and internal controls, and sets forth the Banking Regulator's version of the facts it will rely upon to justify taking enforcement action. In the enforcement proceeding itself, if the institution has failed to disagree with the examination report's findings in a manner that placed on the administrative record the institution's position on the relevant facts, only the written examination report is reviewable by an administrative hearing officer or court.

Accordingly, we strongly recommend that an institution experiencing disagreements with its Banking Regulator place on the administrative record its views of contested facts and circumstances that give rise to regulatory concerns and possible enforcement action, or else risk losing the ability to defend itself and incur liability for its officers and directors. This is a critical legal document and requires the attention of experienced legal counsel. In the context of the examination process, among other things, this means: (a) setting forth the institution's positions on matters of disagreement between itself and the Banking Regulator; and (b) clearly indicating the reasonable steps taken by the board and management to investigate and correct perceived regulatory deficiencies as noted in the examination report.[FN17] Depending upon the situation, it may also be necessary to take advantage of the informal and formal agency review procedures recently adopted by the Banking Regulators.

PUBLICITY REGARDING ENFORCEMENT PROCEEDINGS

The FIRREA and the FDICIA radically altered the enforcement landscape by requiring that notice of the issuance of final C&D orders and MOU be published by the Banking Regulators, regardless of whether the particular C&D order or MOU is entered into by means of an administrative decision or a stipulation. As a result, the local media now receives notice that a C&D order or MOU has been issued against an institution, and the resultant publicity frequently may result in an increase in the institution's cost of funds, deposit withdrawals, or shareholder litigation (or in the least, very adverse publicity). The issue of publicity is further complicated because applicable federal securities disclosure rules for registered companies may require disclosure of the pendency of an enforcement proceeding, as well as the contents of a C&D order or MOU that is eventually entered. Further, the Banking Regulators now generally require that institutions or their holding companies that are not registered companies provide extensive disclosure to their shareholders regarding the contents of a MOU or a C&D order.[FN18]

In light of the likelihood that adverse publicity will arise upon the execution of a C&D order or a MOU, institutions from time to time have adopted the strategy of using the administrative hearing process as a vehicle to clarify and limit the eventual enforcement order that is issued. When the Banking Regulators are wrong as to their facts - or else are excessive in the remedial action requested - many institutions find that the administrative hearing process may be a valuable tool in that it forces a Banking Regulator to evaluate the accuracy of its claims before a neutral hearing officer, which can result in a much narrower - and more favorable - settlement than might be negotiated between the institution and its Banking Regulator had the matter not proceeded through the initial stages of the administrative hearing process.

A brief description of the administrative process that governs enforcement actions is set forth below.

THE LIABILITY OF OFFICERS AND DIRECTORS

Because of the heightened liability that arises when executing a C&D order or a MOU, individual members of senior management and the board of directors must recognize the significant degree of personal liability that may result. This is because, if the remedial action promised by the institution fails to take place, both a C&D order and a MOU are enforceable against an individual member of management or the board in their personal capacities - even though that person signed as a representative of the institution. This means, for example, that in seeking to impose civil money penalties against a director, a Banking Regulator need not prove the existence of the underlying alleged violation that was the basis of a C&D order or MOU. Rather, the Banking Regulator need only prove the failure of the institution to comply with the terms of the C&D order or MOU.

This very real concern is frequently presented in the context in which either a MOU or a C&D order is being negotiated to settle a proceeding brought by a Banking Regulator. In such situations, the Banking Regulator is generally very inflexible in its negotiation posture and insists upon requiring certain specific remedial actions be taken by the institution, the failure of which may result in liability to those individuals signing in their capacities as representatives of the institution. For example, should a bank or thrift stipulate to a C&D order to raise a stated amount of capital, individual members of management or the board signing the document could be held liable for any failure to raise the required amount of capital, and civil money penalties could be imposed on each individual signing the document, despite reasonable efforts to comply with the order.

Similarly, the reluctance of the Banking Regulators to negotiate the terms of a C&D order or a MOU is particularly frustrating when basic agreement has been reached on a remedial program, and what remains is clarifying language setting out the expectations of the parties. For example, even though a Banking Regulator will orally assure a board that a “good faith” effort is the standard upon which compliance with a C&D order will be judged, unless that assurance is reduced to writing, a board member should assume that strict compliance with the terms of an order is the actual standard.[FN19]

Accordingly, both management and the board of directors of an institution should carefully consider the scope of consent decrees being negotiated with their Banking Regulator, including the scope of conduct that indicates reasonable compliance. Independent counsel for individual board members or members of management may be necessary to advise individuals regarding their personal liability.[FN20]

THE ADMINISTRATIVE HEARING PROCESS

Although it is clear that the preferable course of action in respect of an enforcement proceeding is some form of negotiated settlement, there are situations in which the liability to the institution and/or its officers and directors is so severe as to consider litigating the matter through the administrative hearing process. Either based upon factual or legal error, the Banking Regulator may place the institution in the position in which an objective third-party determination is requested to determine the veracity of the Banking Regulator's claims.

When considering whether to litigate or attempt to settle an enforcement proceeding, an institution, of course, must consider the cost and expense of responding to the action by means of the administrative hearing process.[FN21] More importantly, however, the institution must consider whether the use of the administrative process as part of an overall strategy to resolve the Banking Regulator's concerns would be advantageous in the particular circumstances.

It should be noted that, in accordance with due process requirements set forth in the federal Administrative Procedures Act (the “APA”), many of the formal enforcement actions taken by the Banking Regulators require a notice of charges to be served and a hearing to take place before an administrative law judge prior to the imposition of a proposed remedy. As a result, procedural rules governing the conduct of administrative proceedings have been issued by the Banking Regulators (and must be followed by an institution in order not to waive its due process rights). This may require, for example, responding to a notice of charges and of hearing in a C&D proceeding while at the same time attempting to negotiate a settlement with the Banking Regulator.

There are three general types of administrative proceedings relating to enforcement actions, which are explained in greater detail below:

ENFORCEMENT PROCEEDINGS GENERALLY

The vast majority of formal enforcement proceedings are subject to the APA and require:

(a) the issuance of a notice of charges and of hearing by the Banking Regulator;
(b) the appointment of an administrative law judge; and
(c) a hearing at which the Banking Regulator must meet a burden of proof regarding its alleged regulatory concerns and proposed remedies.

A limited amount of discovery and motion practice is permitted by the parties. Following the administrative determination by the judge, the Banking Regulator issues its determination based upon proposed findings of fact, following which the parties may appeal the agency determination to a federal court, which has limited review authority to determine whether the action by the Banking Regulator was based upon the evidence presented in the hearing.

It is important for an institution and its officers and directors to understand that the process of an administrative proceeding may be utilized to the strategic benefit of an institution, particularly in those cases in which the Banking Regulator is overreaching in its legal position, or else has requested an overly broad remedy for the perceived regulatory concerns. In such cases (assuming the institution's position can be proven), the administrative process can be employed to encourage the particular Banking Regulator to reconsider its position in light of proof that must be presented to an administrative law judge - which often may result in eliminating or narrowing either the perceived regulatory concerns or the remedy sought by the Banking Regulator. Further, as part of the administrative proceeding, the financial institution frequently is able to propose its own prospective cure for the regulatory concerns, as well as evidence that an overly broad remedy suggested by a Banking Regulator is inappropriate under the circumstances.

The time involved in completing the administrative hearing process - which can require a year or more - can be strategically valuable to a financial institution attempting to effect its own corrective action, particularly when the Banking Regulator's proposed remedy is overly broad and would unfairly restrict the institution when attempting to implement its own corrective action plan. In such cases, while simultaneously proceeding through the administrative process and remedying the regulatory concerns, the institution can use the hearing process to reduce or eliminate onerous remedial provisions initially requested by a Banking Regulator.

The procedural rules that govern an administrative hearing also may benefit an institution because during the initial stage in the process, the vast majority of work must be undertaken by the Banking Regulator. Following the filing of an answer to the notice of charges, the responding party (i.e., the institution or its officers and directors) is able to obtain documentary discovery from the Banking Regulator, and, in some cases, depositions are permitted. Among other things, the gathering of this information forces the Banking Regulator to disclose in advance the actual merits of its case, and often presents the opportunity for other staff members of the Banking Regulator to review the matter. (Of note is the fact that the confidential portions of a report of examination - which normally are never shared with the institution - are available through discovery.) Following completion of the discovery process, motion practice can be used to narrow or dismiss some or all of the Banking Regulator's action.

It should be noted that the procedural rules governing an enforcement proceeding require that discovery and motion practice be accomplished in accordance with the terms of a scheduling order issued by the administrative law judge, who frequently requires significant preparation for a hearing at an early stage in the process (which facilitates settlement by requiring the parties to disclose at an early stage in the proceeding the relative merits of their positions).

Finally, it is important to recognize that actively litigating a proposed enforcement order is not for the fainthearted. While reasonable people may in fact differ regarding the severity of a particular enforcement situation, the institution and its related parties risk the possibility of an escalating dispute with staff members of the Banking Regulator. The use of reputable, very skilled counsel in these instances is strongly recommended in order to provide useful advice to the institution and to act as a representative of the institution before the Banking Regulator to avoid unnecessary consequences or reactions.

ASSESSMENT OF CIVIL MONEY PENALTIES

While an administrative hearing is required prior to the collection of civil money penalties, the civil money penalty authority is particularly onerous because it is generally aimed directly at an individual member of management or an institution's board of directors, and the amount of the penalty is assessed by the Banking Regulators prior to a hearing.

The process is initiated by a simple letter notice to an officer or director informing him or her of the intention of the Banking Regulator to consider the assessment of civil money penalties, but offering that individual approximately 20 days in which to respond by setting forth those salient facts indicating why an assessment of civil money penalties would not be appropriate in the circumstances. The letters requesting mitigation information frequently contain nebulous and overly broad statements of fact, which place the targeted individual in the unenviable position of responding without a clear understanding of the specific factual allegations that form the basis for the proposed assessment of civil money penalties.

Following receipt of the information from the targeted individual intended to mitigate the decision of whether to assess civil money penalties, several of the Banking Regulators will perform an internal analysis using a matrix that assigns numerical values to various criteria to determine whether a civil money penalty should be assessed, and, if so, the amount of such penalty. If a civil money penalty is assessed, the individual (or the institution itself) may request a hearing prior to collection of the penalty.

As noted above, because of the necessity of establishing facts supporting the institution or its officers or directors, it is critical that substantial effort be exerted to respond to the request for mitigation information within the 20-day period.[FN22] This process often requires assembling and analyzing documents or transactions that occurred over an extended period of time, and arranging in a comprehensive manner those facts, including personal financial information, which support a conclusion that the assessment of a civil money penalty is not appropriate.[FN23]

TEMPORARY C&D AND REMOVAL AUTHORITY

In rare situations, based upon perceived immediate harm to the institution, the Banking Regulators possess the authority to issue temporary C&D orders and temporary suspension and removal orders, all of which are immediately binding upon the institution, its officers, directors and other institution-affiliated parties, without the requirement of a hearing. Such orders are similar in nature to temporary restraining orders, or “TROs,” obtained as part of civil litigation, and are immediately applicable on all parties having notice of such orders.

In the case of a temporary C&D or removal order, the FDIA requires that an application be made in court for the removal or modification of the order, and a hearing is required within a stated period to determine whether the order should remain in effect until a hearing is conducted by an administrative law judge.

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FOOTNOTES:

[FN1] The discussion set forth in this article is applicable to commercial banks, savings associations, thrift and loans, holding companies, subsidiaries and affiliates, as well as officers, directors and employees. While the focus of this article is on the liability of insured depository institutions and their officers and directors, similar concerns are presented for all “institution affiliated parties,” such as law firms, accounting firms and other consultants.

[FN2] For purposes of discussion, the federal financial institution regulators will be referred to in this article as the “Banking Regulators.” It should be noted that each Banking Regulator generally utilizes the same source for its enforcement authority, which is set forth as part of the Federal Deposit Insurance Act (the “FDIA”).

[FN3] While beyond the scope of this article, it should be noted that the FDIA provides a multitude of remedial alternatives to the Banking Regulators to cure a perceived regulatory problem, including, among others: (a) requiring reimbursement, restitution, indemnification or loss guarantees; (b) the imposing of growth restrictions; (c) requiring asset sales or other dispositions of problem assets; (d) requiring the rescission of contracts; and (e) requiring the employment of qualified management. Further, the general enforcement authority found in the FDIA overlaps with specific remedial authority the Banking Regulators may individually possess under their separate enabling statutes (such as the National Banking Act or the Federal Reserve Act) or special purpose laws (such as the Sections 23A and 23B of the Federal Reserve Act or the Truth-in-Lending Act).

[FN4] In addition to terminating an institution's deposit insurance, the FDIC is authorized to seize a “critically undercapitalized” institution, whose capital has fallen to less than 2 percent of total assets, pursuant to the “prompt corrective action” authority of Section 38 of the FDIA.

[FN5] The practical difficulty of restoring an institution's capital in the midst of an 8(a) proceeding is the reluctance of the capital markets to invest new capital following a review of the extensive securities disclosures that an institution must make regarding its regulatory condition.

[FN6] One strategy that is frequently considered by an institution to increase its capital ratios is the sale of assets at a favorable price. This practice is frowned upon by the Banking Regulators, particularly the FDIC, because typically an institution can only sell its valuable assets, with the result that the institution is left with nonperforming or poorly performing assets, and ultimately a greater loss to the FDIC as a receiver. If asset sales in this situation are not carefully considered, such sales could form the basis for claims against management and a board of directors should the institution fail.

[FN7] The International Lending Supervision Act granted the Banking Regulators the authority to set virtually any capital level for an individual institution. Recent court decisions suggest that the level of capital set by a Banking Regulator is a matter of agency discretion, and hence subject to very limited judicial review.

[FN8] In addition to the use of the general removal and prohibition authority, a Banking Regulator may temporarily suspend an officer or director from contact with the institution, which is effective immediately upon service of the order.

[FN9] It should be noted that the Federal Civil Penalties Inflation Adjustment Act authorized the Banking Regulators to adjust the amount of the maximum penalties to account for inflation.

[FN10] It should be noted that from time to time, several of the Banking Regulators have been willing to deem a MOU not to constitute a “written agreement” for purposes of the FDIA, and hence neither subject to public disclosure nor enforceable by civil money penalties. The decision not to treat a MOU as a written agreement is purely a matter of discretion by the Banking Regulators, and in part depends upon the seriousness of the regulatory concerns. The decision not to treat a MOU as a written agreement generally does not relieve an institution from disclosure obligations arising pursuant to the federal securities laws.

[FN11] The result of this grant of agency discretion has resulted in the Banking Regulators using capital directives with increased frequency.

[FN12] While beyond the scope of this article, it should be noted that numerous policy statements and notices are issued by the Banking Regulators that identify acts or practices that are either unsafe or unsound, or else require an institution to adopt policies and procedures regarding the subject matter of the statement or notice. Although such pronouncements are generally issued without the benefit of public comment, the failure by an institution to comply by adopting policies and procedures can be remedied by a Banking Regulator by the issuance of a safety and soundness order.

[FN13] As discussed below, following the commencement of an enforcement action, significant efforts must be made to present the institution's version of disputed facts in order to create an administrative record. Following the entry of an order (whether it be a consent C&D order, a MOU or a C&D order following a hearing), numerous reporting requirements are typically imposed on the institution, the preparation of which requires a large time allocation by senior management.

[FN14] It should be noted that the analysis in respect of compliance examinations appears to be somewhat different, and focuses instead on strict compliance with laws and regulations that are deemed to have important public policy implications, such as the Community Reinvestment Act, the Equal Credit Opportunity Act, the Fair Housing Act and similar laws and regulations.

[FN15] While the authority of the Banking Regulators to issue regulatory directives formerly was very suspect, the FDICIA significantly enhanced the Banking Regulators' authority to issue directives through the prompt corrective action provision of the FDIA. In addition, as a result of the issuance by the Banking Regulators of their “safety and soundness” guidelines pursuant to Section 39 of the FDIA, the Banking Regulators' authority to issue directives has been enhanced. (Because of the limited ability of an institution to appeal the issuance of a directive issued pursuant to the FDIA, the use of directives has become a favored remedial approach by the Banking Regulators.)

[FN16] It is essential that the institution adopt a comprehensive approach to proposed enforcement actions by attempting to resolve all outstanding issues at one time. Candid discussions with an institution's Banking Regulator are often necessary to determine whether an unspoken “hidden agenda” of the Banking Regulator includes the resignation or removal of a member of the board or management. While distasteful, such conversations must occur in order to avoid what can appear to be a never-ending series of follow-up actions by the Banking Regulator.

[FN17] Among other things, the Banking Regulators evaluate compliance by members of a board and management with their respective fiduciary duties by the degree to which the institution responds, or fails to respond, to regulatory criticisms set forth in a report of examination. The repeated failure over the course of several examinations to objectively inquire into the accuracy of a Banking Regulator's concerns, and to take appropriate action, is almost certain to result in liability for the board or management should the institution incur a loss. Moreover, because in significant loss situations the nature of a proposed penalty is impacted by a showing of recklessness or intentional behavior, the timely presentation of the reasonable action by an institution and its officers and directors may preclude the imposition of severe penalties.

[FN18] A collateral result of publicly announcing the entry of a C&D order or MOU is the institution of securities lawsuits, particularly in those instances in which the Banking Regulators believe an institution's loan loss reserve is inadequate and has been understated over a period of time. Enforcement orders issued by the Banking Regulators and related examination material (obtainable through discovery) are frequently the evidentiary basis for a securities disclosure claim.

[FN19] It cannot be overstated that a board and management should attempt to distinguish their obligations as agents of an institution under a C&D order or a MOU from their capacities as individual investors, particularly when an institution requires capital. In such situations, members of a board and management must retain the ability to make personal investment decisions, rather than be deemed to guarantee a capital contribution set forth in an enforcement order.

[FN20] For example, in situations in which an enforcement action is being initiated solely against the institution, a settlement document should only be executed by an agent of the institution authorized by the board of directors to act in that capacity.

[FN21] The cost of legal representation can be significant to individual officers and directors, particularly in cases in which the government's case is based upon a large volume of documents. Because, depending upon state law, many liability insurance policies have provisions that, except from coverage regulatory enforcement actions, officers and directors must be mindful of the availability of indemnification for defense costs pursuant to the institution's articles and bylaws, and state or federal law.

[FN22] It is our experience that the Banking Regulators will usually grant extensions of time to respond to a request for mitigation information, and may also agree to clarify the basis for the proposed assessment of civil money penalties.

[FN23] While beyond the scope of this article, providing personal financial information to a Banking Regulator requires compliance with federal criminal statutes. Prior to disclosing such information, consultation with counsel is strongly recommended.

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