

Current Bank Capital and Enforcement Action Considerations

by Joseph Lynyak

Because of the devastating effect that the COVID-19 pandemic has had on the entire U.S. economy, the federal Bank Regulators¹ have warned of the possibility that small, medium and large banks may soon be forced to recognize loan losses, which would include increasing allocations to a bank's allowance for loan and lease losses ("ALLL") and enforcing rights in collateral. These and similar GAAP and bank regulatory accounting requirements will adversely affect a bank's capital—and will likely result in a new cycle of regulatory enforcement actions and possible bank failures commencing in early 2021.²

Regulatory reaction by the Bank Regulators to bank capital deterioration is typically implemented through the issuance of enforcement orders against a bank that contain: (a) a capital directive that raises a bank's capital ratio requirement to a level that exceeds the minimum capital level necessary to be deemed a "well-capitalized" institution; (b) a prompt corrective action order that limits the range of a bank's discretionary functions; and (c) a multitude of regulatory improvements intended to improve the ability of bank management and a board of directors to perform their management and oversight functions.³

Responding at an early stage to a bank's capital deterioration presents the possibility of mitigating or avoiding personal liability to bank insiders, including a bank's senior management and its board of directors. Further, advance preparation may benefit a bank's holding company and its exposure to insolvency and bankruptcy. Unfortunately, the ability to adequately protect insiders and a holding company from claims brought by the Banking Regulators can become more difficult as a bank begins to recognize reportable capital losses.

Accordingly, this Alert is intended to focus on practical steps that a bank's management and board of directors can begin to consider *prior* to having to recognize significant credit losses and accompanying capital deterioration. The discussion in this Alert is excerpted from a comprehensive article to be published in the *Banking Law Journal* in December of

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2020 that analyzes bank enforcement actions and bank failures in detail.

What follows is a summary of actions that might be considered when a bank is at the early stages of recognizing loan losses, including: (a) ensuring compliance with applicable bank regulatory governance requirements; (b) ensuring that prior regulatory criticisms have been properly addressed; and (c) governance and operational protections that might be implemented to protect bank management and directors against allegations of breach of fiduciary duty.

Bank Regulatory Governance Review

Over the past twenty years, the focus on managing a bank has resulted in vast amounts of guidance issued by the Bank Regulators under the umbrella of risk management. Policies and procedures are required to be in place (depending upon the sophistication of the bank) to identify, quantify, and monitor risk over the entire range of a bank's operations. From the level of the board of directors to that of operating divisions, a bank is required to constantly monitor and assess risk and modify its business plan as appropriate.⁴

Among other things, risk management requires that a bank have in place reporting functions that permit management to identify and quantify risk, as well as to report to the board of directors emerging concerns in a manner that allows the board to address the same.

Although no one can be criticized for not identifying the economic collapse that has occurred as a result of the COVID-19 pandemic, the Bank Regulators judge the adequacy of risk management processes in hindsight—which potentially exposes all bank stakeholders to criticism after the fact.

To address this concern, a bank's board and management might consider a third-party analysis of the effectiveness of board and management oversight and controls being employed to govern the operation of the bank and its affiliates. The focus of such an analysis would be to evaluate whether a board and management were complying with their respective standards of care, including the tools being employed to properly comply with risk management protocols and similar guidance issued by the Bank Regulators. (The analysis should be updated periodically to document steps taken and alert the board and management to new issues.)

In circumstances in which the standard of care exercised by the bank's board of directors and management is reasonable, placing a report of this type into the official records of a bank can prove to be an effective prophylactic measure against future accusations by the FDIC. Moreover, even in instances in which the effectiveness of a board or the bank's management is found to possibly fall below a reasonable standard of care, taking steps to adopt recommendations for improved oversight further may protect insiders from allegations of breaches of fiduciary duty.

Addressing Prior Regulatory Criticisms

In the last two cycles of bank failures, bank officers and directors were often accused of breaches of duty following the occurrence of sudden and unanticipated adverse economic conditions and concomitant loan losses. When viewed in hindsight, claims made by the FDIC to recover for breaches of duty were frequently difficult to defend against, due in no small measure to the lack of evidence supporting prudent management in the official records of the bank.

A common allegation claiming liability experienced by banks is the failure to correct prior regulatory criticisms identified by a Bank Regulator in either a formal or informal examination. In common parlance, “matters requiring attention” or “MRAs” represent non-enforceable directives to correct perceived deficiencies—but the repeated failure to implement corrective action may eventually lead to a formal cease and desist or other enforcement order.

In a scenario in which a bank experiences capital losses, the failure to address prior MRAs can form the basis for an escalation in the speed by which enforcement actions may occur. Further, should the banking industry experience the issuance of numerous enforcement orders, the existence of unresolved MRAs can result in the threatened or actual assessment of civil money penalties against individual members of management and board members.

Should wide-spread bank capital losses begin to occur, a bank should consider creating a special compliance committee comprised of either the board of directors or senior management to oversee compliance with prior remedial directives.

In addition to correcting previous regulatory criticism, the process by which corrective measures are reflected on the bank’s records becomes important. While it is usual and typical to engage in numerous oral and “off-the-record” conversations with representatives of the Bank Regulators, such as with on-site examination staff, the law provides that only the official records of the bank or holding company are relevant should enforcement action be taken. Accordingly, a bank and its holding company should at all times record their reasonable efforts to respond to all regulatory orders, as well as investigations into all alternative means of resolving a capital deficiency.

Prophylactic Corporate Protections for Insiders

Because a bank’s capital inadequacy can quickly deteriorate into a failing bank scenario (which commences with the issuance of a capital order and a “prompt corrective action” order), suddenly bank insiders realize that they may be individually liable for alleged breaches of their respective fiduciary duties should the bank fail. At that time it may become impractical to put into place corporate measures that may provide bank insiders protections against personal liability.

Accordingly, the following steps might be considered *prior* to the issuance of capital directives and other enforcement orders:

Review Corporate Law Formalities. As is frequently the case, the articles and bylaws of a bank or its holding company may not reflect current legal protections available to officers and directors, such as liberalized corporate law indemnification procedures to pay defense costs to officers and directors who are targeted for breaches of fiduciary duty. (For example, several states provide potentially valuable limitations on liability for independent directors by authorizing standards of care that may be more beneficial than those that apply for a bank's officers.) It is therefore important to conduct a corporate review to determine whether these and similar protections might be available. In many cases, it may be necessary to amend (or restate) a bank's articles of incorporation and bylaws to adopt these corporate protections. However, the Bank Regulators may object to the adoption of such measures as a bank becomes more likely to fail.⁵

Review the Bank's Records Retention Policy. One of the most significant errors often made by a bank or a holding company is the failure to adopt a records retention policy that permits officers and directors to retain copies of materials that reflect the reasonable performance of their duties and compliance with their respective fiduciary obligations. For example, in practically every jurisdiction, board members as a matter of right may retain their own copies of board materials used by them to oversee the bank and management—whether in the form of paper copies or materials provided in electronic form.⁶ It should be noted that this area is a particularly sensitive one in the view of the FDIC, and appropriate legal advice is strongly recommended to create a records retention policy that balances the several legal perspectives.

Review D&O Insurance Coverage. It is critical to the welfare of both a bank's and a holding company's officers and directors that coverage under officer and director liability policies is available and clearly understood.⁷ Further, at the earliest opportunity, efforts should be made to determine whether additional coverage is available. Importantly, federal law specifically permits insurers to omit coverage for regulatory enforcement actions—including claims made by the FDIC following a bank failure. Obtaining this coverage (which often can be obtained for an additional premium) is a significant protection for board members and senior management.⁸

Assemble a Team. As capital adequacy becomes a concern, the creation of a cohesive team is a critical factor in both achieving success and demonstrating that fiduciary and corporate obligations were complied with as part of the process. Team members should include lawyers experienced in the representation of banks that have received capital-related orders, including dealing with the Bank Regulators. In addition, regional or national investment banking firms and other bank consultants are likely to be required.

While beyond the scope of this Alert, we note that a bank's current legal counsel may be disqualified in a potential failure situation—or else separate legal counsel may be required for several categories of bank stakeholders.

For example, a holding company may require legal counsel separate from attorneys providing advice to the bank itself, including advice such as: (a) the possibility of bankruptcy; (b) the obligation of the bank and/or the holding company to indemnify the bank's officers and directors; (c) securities law claims, including claims filed by the

holding company's common and preferred shareholders and holders of the holding company's debt; and (d) direct claims by the FDIC against the holding company, such as claims arising from capital maintenance agreements and other regulatory obligations.

It is also important to recognize that many stakeholders of a bank or a holding company may have different economic and legal positions from those of the bank itself. For example, individual directors of a bank's board of directors may require their own counsel to provide legal advice regarding compliance with their fiduciary duties.

Finally, in the instance in which a bank fails, the FDIC assumes the role of the client for a bank's regular legal counsel, and any records held by the bank's regular counsel becomes the property of the FDIC—which means that bank insiders cannot rely upon a former regular bank counsel for assistance in defending against claims brought by the FDIC.

¹ The term "Bank Regulators" includes the Federal Deposit Insurance Corporation (the "FDIC"), the Office of the Comptroller of the Currency (the "OCC") and the Board of Governors of the Federal Reserve System (the "FRB"). While the emphasis in this Alert will be on the regulatory actions and responsibilities of the federal Bank Regulators, many of the same considerations (and enforcement authorities) will apply to the regulatory oversight and safety and soundness responsibilities of comparable state banking agencies.

² See: <https://occ.gov/topics/supervision-and-examination/bank-operations/accounting/all/index-all.html>.

³ See: The International Lending Supervision Act, Pub. L. 104-208 (1996); Sections 8 and 32 of the Federal Deposit Insurance Act.

⁴ See: <https://www.fdic.gov/regulations/safety/manual/>; <https://www.occ.gov/news-issuances/bulletins/2011/bulletin-2011-12.html>.

⁵ The Bank Regulators have the authority under prompt corrective action authority to prohibit a critically undercapitalized bank from amending its articles and bylaws, which may have the effect of preventing a bank from updating its primary corporate chartering documents to provide available protections to bank insiders.

⁶ A bank's record retention policy should be comprehensive, and describe in detail copies of bank records that may be retained by board members when performing their management oversight. (Further, care must be exercised to address electronic communications and the retention policies applicable to insiders.)

⁷ It is important to understand that the interpretation of coverage provided by directors and officers liability insurance is highly specialized and is not a matter of general contract law. In the minimum, it is very useful to engage legal counsel with experience in the complexities of managing the relationship between the insurer and the officers and directors covered under a liability policy. Among other things, the technical requirements of notice and coverage terms under a policy must be well understood and managed so as to avoid inadvertently losing the ability to make a claim should a claim arise, including a claim based upon either an enforcement action or a bank failure.

⁸ Section 11(k) of the Federal Deposit Insurance Act.

