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# The Current Regulatory Environment and its Impact on Bank Directors

**The regulatory response to negative bank cycles evolve into three distinct phases.**

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**First, pessimistic, negative and critical examinations with calls for increased capital and other remedial action. Second, a significant increase in the number of bank closures. Third, litigation against officers and directors of failed banks as the FDIC seeks to reduce losses from the failed banks.**

We are currently transitioning out of phase one and are well into phase two.  Officers and directors of failed banks can anticipate phase three to be well underway by 2011 and 2012.  Directors of all banks should familiarize themselves with the recurring criticisms made against directors and take immediate and effective action to avoid and remedy them in the immediate future.

Early in 2008, adverse economic conditions were causing bank examiners to be more demanding and harsh in their evaluations. Bank supervision took on decidedly negative tone with the supervising agencies demanding greater loan loss reserves, additional capital and significantly more scrutiny of bank operations and activities.  The result was that the composite ratings of many banks were downgraded, which, in turn led to supervisory action such as memoranda of understanding or cease and desist consent orders.  Since FDIC enforcement actions against, directors, officers and others often lag bank closures by anywhere between 9 and 18 months, it is not surprising that we are just at the beginning of the third phase.  Given the soaring

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numbers of bank closures starting in 2008 and continuing throughout 2009 and 2010, this third phase will intensify in the coming months.

Since January 1, 2008, approximately 250 banks have been closed by the regulatory authorities. With more than 700 banks on the FDIC's watch list, by the time we reach the end of 2011, the total closed banks may well approach 500 and by its own projection, the FDIC expects the total loss to the insurance fund to approximate $89 billion for the period from June 30, 2009 to the end of 2013.

If the experience from the savings and loan crisis of the late 1980's and early 1990's is instructive, in at least 25% of the closed bank situations, the FDIC is likely to initiate some type of enforcement action against individual officers and directors, as part of its statutory mandate to recover loses from all available sources, to deter sloppy practices that may have contributed to those losses and to encourage safe and sound banking practices in the future. The FDIC's arsenal contains significant tools with which to carry out this mission, including claims against D&O insurance carriers, suits against individuals for monetary damages or restitution, asset freezes, removal from service and prohibition orders and administrative proceedings imposing cease and desist orders and civil money penalties. Often these come in combinations, depending on circumstances.

Generally speaking, the regulatory agencies ascribe to the principle that a bank board of directors has oversight responsibility for the bank. This means that the board has responsibility to hire competent and experienced management and to monitor bank management through the review of reports, whose accuracy and timeliness meets acceptable standards, and through interaction with appropriate bank management personnel, not just the CEO. It is fair to state that the regulatory agencies, and the FDIC in particular, regard oversight by a bank's board as the most significant role in the management of a bank, particularly in adverse and challenging circumstances. With this great expectation in mind, any significant breakdown in the proper functioning of a board will attract attention from the regulators. Unless the board sets the tone for a safe and sound functioning of the bank at all levels, losses that occur put the director behavior under scrutiny.

In today's world, in addition to financial matters such as the adequacy of bank capital, profit and loss and loan loss reserves, the regulators expect the board to be involved in enterprise risk management, the adequacy of internal controls, liquidity risk management, auditing and the adequacy of financial reporting and strategic planning and resource management. With all of this expanded responsibility, it is demanded that board governance reflect truly independent action without undue influence by the CEO or other management.

Reports of examination, and any enforcement steps that follow, address those instances where director behavior has fallen below these standards of conduct and raise the specter of director liability. For example, "hobby" directors who serve for social reasons and do not show a devotion to the tasks; directors who failed to recognize problems as they were developing and failed to take action when those problems became acute; in rare instances, where directors placed their personal interests above the safety and soundness of the institution; and directors serving under a domineering Chair or CEO and who failed to question or challenge practices which ultimately led to losses at the bank or perhaps even to its failure, increase the risk of personal liability for directors. We can anticipate that many directors of failed banks with significant real estate loan losses will claim that even the most conscientious director could not have anticipated the speed and depth of the collapse in the real estate market and resulting loan collateral values. Since this defense has not deterred critical reports of examination or enforcement actions against banks, it is not likely that it will deter formal claims against directors of failed banks.

There are recurring themes to regulatory criticisms of board conduct, some of which are reflected in demand letters sent by the FDIC to insurance carriers of failed banks. Such themes include: repeated waivers of bank policy or exceptions to policy leading to poor loan underwriting and excessive risk; facilitating an environment that permitted bank management to withhold material loan underwriting information; failure to recognize that high concentrations of risky lending would cause major problems for the bank in the event of an economic downturn; permitting board deliberations to be dominated by a strong-minded CEO whose policies involved excessive risk taking; creating personal financial incentives for bank directors that ignored good risk management techniques; and engaging under-qualified directors to serve on the board.

While most banks and bank directors do not fall into these categories and their reputations will not be tarred by the poor and inadequate performance by marginal players, nevertheless, the financial services industry can expect that over the next three to five years, these issues will dominate regulatory examinations, lead to heightened scrutiny of board conduct and form the core of litigation against directors of failed banks.

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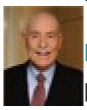
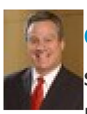


Harold P. Reichwald Mr. Reichwald is a highly experienced banking and finance attorney whose career encompasses domestic and international matters for banks and specialty finance institutions. His experience comprises a broad range of matters including: governance matters, sophisticated financial transactions such as asset securitization, LBOs, project finance, corporate lending and restructuring; representation of a variety of domestic and foreign financial institutions before the FDIC.



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Gene Elerding, a partner in Manatt, Phelps & Phillips' Los Angeles office, has created *The Check Guide*, describing the rules that apply to check disputes (e.g., forgeries, alterations, counterfeit items, stop payment orders, and many other subjects). The 2010 *Check Guide* contains helpful forms, sample contract terms, investigation checklists, and dispute resolution procedures that can be used by bank attorneys, operations officers, security staff and risk managers to resolve check disputes.

To read the 2010 Check Guide, please click here.