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SINNERS AT THE PEARLY GATES

A Primer on the Standards of Admission to the Banking Fraternity

PART ONE: UNLOCKING THE GATE

A number of years ago, one of the authors was called upon as a junior lawyer to review the Japanese corporation law in preparation for a proposed transaction. At first blush, the text of the law was entirely familiar. In fact, thought the author, this could very well be the corporation law of any number of states. Looking further, the author found that Japan had been forced to adopt this corporation law under the administration of General MacArthur following World War II. Further investigation revealed that there was little relationship between the law's text and the manner in which Japanese corporations are governed in practice.

A newcomer to the world of banking in the United States may be forgiven if his reaction is very much like that of the young lawyer looking at Japanese corporation law. Chapter and verse are familiar; the gospel is not. An individual seeking to form a new bank is looking at a statute that looks very much like the statutes he would be looking at if he were forming an ordinary business corporation. Nothing in the text of that statute suggests that the process has all the earmarks of ordination into the clergy.

This article gives a brief history of early banking law in the United States to provide some perspective on why the text of our banking law seems to differ from its substance; provides an overview of the legal framework for gaining entry to the banking business either de novo or by acquisition; and explores via hypothetical case studies some of the not infrequently encountered obstacles that must be dealt with by individuals seeking to enter banking either through the establishment of a de novo bank or by acquiring control of an existing bank. In the course of the article, we compare and contrast the procedures and standards applied by federal or state banking regulators in determining whether an individual may enter the banking business with those applied in determining whether one already engaged in that business should be barred from it.[1] The particular focus is on those elements that implicitly require a determination by the regulators of what may loosely be called the applicant's morality, as opposed to matters that can presumably be objectively determined, such as business experience. We then look at some factors that make it difficult to predict whether particular individuals will be allowed to enter banking, and suggest some improvements directed toward greater predictability.

We consider primarily three statutes: (i) the National Bank Act[2], which is the basic corporation law governing the formation and governance of federally chartered commercial banks; (ii) the Change in Bank Control Act,[3] which governs acquisition of a controlling interest in a federally chartered commercial bank; and (iii) the Federal Deposit Insurance Act[4], which, to a large extent, governs what its title implies. Specifically, we examine the standards applicable to the banking authorities' (i) determination of the suitability of directors and other managers in deciding whether to authorize formation of a new bank, (ii) approval of a change in control of an existing bank, and (iii) removal of directors and senior managers of an existing bank and/or imposition of an industry bar on such directors and senior managers. While we focus on national banking associations, we believe that generally the same principles apply to other federally chartered financial institutions and to state chartered institutions.[5]

First a word about the title. What is it about banking that makes anyone want to enter its gates in the first place? Why is it necessary so zealously to guard those gates? A large part of the answer lies in four letters -- FDIC. Federal deposit insurance is a central feature of our banking system.

The implicit subsidy provided by FDIC insurance makes it possible to leverage invested funds, at relatively small risk, to a degree unparalleled in other businesses. While other businesses may profit by

borrowing funds and relending at a higher rate, only banks are permitted to accept deposits from the general public. Under optimal circumstances, banks may hold as little a five percent (or even less) as a reserve against these deposits, providing leverage of up to twenty-to-one. And because those deposits are insured, depositors are willing to make their money available based entirely on convenience and interest rate being offered. The depositor need not be concerned with whether he will ultimately get his money back (at least up to the applicable deposit insurance limit).

The central thesis of the FDIC system is that the FDIC intends to insure depositors against the business risk of the depositary banks. It is not designed primarily as a fidelity bond ensuring the honesty of bank management. Nevertheless, our regulators must recognize that the FDIC's universe may include both saints and sinners and zealously guard against letting sinners steal from the poor box.

I. A BIT OF HISTORY

Our present National Bank Act is a direct descendent of the National Bank Act of 1864. Any discussion of the National Bank Act must begin with some consideration of the country's experiment with "free banking." Free banking, in its pure form, is a system in which virtually anyone can enter the banking business by making the required filings with governmental authorities. In a free banking system, the protection of depositors is based primarily on formal and objectively determinable requirements such as a requirement that each bank maintain reserves in the form of specified assets on deposit with the banking regulators.

Prior to 1837, the country had a mixed system of federal and state banks, but each bank was chartered via a separate legislative act, with its charter spelling out the restrictions on the bank's activities.[6] The first free banking laws were adopted by Michigan in 1837 and by New York in 1838, immediately after federal legislation creating the Second United States Bank was allowed to expire in 1836. The state free banking laws made the formation of banks very much like the formation of any business corporation under our modern general corporation laws. Typically, these laws called for each of the newly chartered banks to keep on deposit with a state official securities, specie or some combination thereof in a specified amount and of specified types, to be used to reimburse depositors if the bank failed.

Even a cursory look at the National Bank Act of 1864 ("NBA")[7] shows that that Act was originally intended to be a free banking statute. Section 5 of that Act, which remains essentially unchanged as 12 USCA §21, reads in words that will be familiar to any corporate lawyer: "... associations for carrying on the business of banking may be formed by any number of persons, not less in any case than five, who shall enter into articles of association, which shall specify in general terms the object for which the association is formed, and may contain any other provisions, not inconsistent with the provisions of this Act, which the association may see fit to adopt for the regulation of the business of the Association and the conduct of its affairs, which said articles shall be signed by the person's uniting to form the association, and a copy of them forwarded to the Comptroller of the Currency, to be filed and preserved in his office." Section 7 of the NBA specified minimum capital levels for each Bank, based on the population of the city where it was to be organized. Section 9 spelled out the requirements for directors of a national banking association: "... the affairs of every association shall be managed by not less than five directors, one of whom shall be the president. Every director shall, during his whole term of office, be a citizen of the United States; and at least three fourths of the directors shall have resided in the state, territory, or district in which such association is located one year next preceding their election as directors, and be residents of the same during their continuance in office. Each director shall own, in his own right, at least 10 shares of the capital stock of the association of which it is a director..." The act went on to require that each bank deposit with the Treasurer of the United States bonds in an amount of not less than one third of its paid in capital stock. Section 31 of the NBA required each association to have on hand at all times in specie an amount equal to at least 25% or 15% (depending upon the city in which it was located) of the aggregate amount of its notes in circulation and its deposits.

Note that the directors of a national banking association were not, so far as the statute was concerned, required to meet any requirements as to moral fitness. Nor was there any authority for a

governmental agency to pass on the fitness of these individuals. That proposition remains true of the National Bank Act of today. As we will note later, the "moral" requirements for formation of a bank are solely a matter of regulation.

The now well-established discretion of the Office of the Comptroller of the Currency ("OCC") in approving national bank charters appears to have been created in the administration of the first Comptroller of the Currency, Hugh McCulloch. McCulloch was a former head of the Indiana banking system and initially came to Washington to oppose creation of national banks through the National Bank Act.[8]

Indiana had had a disastrous experience with free banking in the 1850s, primarily as the result of legislation adopted by Ohio that seriously impacted Indiana State banks near the border between the two states.[9]

Be that as it may, McCulloch apparently reached an understanding with Salmon P. Chase, the then Secretary of the Treasurer, becoming the first Comptroller of the Currency in 1863. McCulloch, it appears, had a rather unique solution to the risks he saw as embodied in the National Bank Act's free banking provisions. He simply ignored them, boldly asserting that the approval of new national banks was at the sufferance of the OCC.[10] As we will see, this habit of claiming unbridled discretion did not stop with McCulloch.

II. LEGAL LANDSCAPE AND REGULATORY PERSPECTIVE

In viewing the present regulatory landscape, it may be useful to consider the three regulatory actions, approval of a new charter, approval of a change in control and removal of an institution-affiliated party, as a continuum, with each of the three processes representing a greater or lesser degree of focus on the entire business or focus on a particular individual.

In passing upon an application for a new charter, the regulators must focus on the proposed banking business as a whole, evaluating particular individuals primarily from the standpoint of their contribution to that whole. The OCC's standard form of letter denying an application puts it this way: "The decision to grant a new national Bank charter is not based on any single factor, but on a combination of factors unique to each application."[11] An application for approval of a change in control generally focuses on a smaller number of factors. Assuming that the regulators have not determined that the application should be treated as if it were a de novo application, consideration will be focused on how the proposed new control group will affect the operations of the established institution. Finally, in a removal proceeding, the focus will be on whether the continued presence of the particular individual will be harmful to the institution or its depositors.

An initial offering of securities provides a useful analogy to an application for a new bank charter. The applicant is in effect asking the regulators to "invest" in its proposed business. In the case of the FDIC, of course, the agency will be a real financial stakeholder in the proposed enterprise, since the FDIC will have to pick up the pieces if the enterprise fails. But the OCC (and other federal and state bank regulators) similarly has a stake in the success of the institutions under its oversight. A successful institution makes its job of ensuring the safety and soundness of the nation's banking system easier. An unsuccessful one makes its job harder. Just as the offering document in a securities offering is designed to persuade the investor that all of the pieces are in place for a successful business enterprise, so too the application for a new charter must touch all the bases in persuading the regulators of the institution's future success. Is there a market? What do you intend to provide that market? How do you intend to provide it? Is your capital adequate to carry out your plan? Does management have the necessary experience and skills? How do you intend to ensure compliance with legal requirements? What moral hazards, if any, are attached to proposed management? How do you intend to deal with those potential hazards? These questions and many others must be answered satisfactorily to persuade the regulators to "invest" in the new institution.

An application for approval of a change in control bears greater resemblance to a proxy solicitation. Again, assuming that new management does not intend to so radically change the institution's business plan as to cause the application to be treated as a de novo institution, the questions to be answered in the case of a change in control relate to whether the governmental "stakeholders" can feel comfortable

turning over management of the institution to this new group. The focus quite properly is more closely upon whether the proposed new managers should be trusted with management of the established institution. (It may be worth pointing out here that efforts to persuade the regulators that a less stringent standard should be applied to a "mere" shareholder who casts his vote annually for directors and does not intend to be active otherwise in management of the business than that applied to active managers have generally been unsuccessful.) The maxim "who pays the piper calls the tune" is the prevailing wisdom. That is, both regulators and the courts assume, realistically in our view, that an institution's directors are unlikely to be totally uninfluenced by the controlling shareholder.[12]

Finally, a proceeding to remove an institution-affiliated party is like the corporate decision to remove an officer or director for cause. The focus of the inquiry is entirely on the risks to the institution, its depositors and other stakeholders of allowing the specific individual to continue exerting significant influence over the institution's business.

Despite the fact that financial institutions are highly regulated enterprises, there is no general requirement in the banking laws of the US or most states for a government agency to approve the appointment of either a director or an officer, including the chief executive officer, of a bank. Generally speaking, directors are elected by shareholders, and officers are appointed by a bank's Board of Directors as with any other corporation.

Similarly, as a general matter a bank's Board of Directors is free to issue shares of its capital stock without seeking agency approval of the stock's purchaser.

There are four exceptions to this general proposition that a bank may choose its officers and directors and issue its shares like any other corporation. The first exception is upon the initial authorization of a bank to commence business. The second is upon a change in the percentage ownership of the bank sufficient to constitute a change of control under the applicable statute and regulations. The third is where officers, directors or controlling shareholders have been guilty of conduct which under the applicable statutory standards permits the regulators to remove the offending individuals from participation in a bank's affairs. The fourth, closely related to the third, is where the regulators bar a particular individual from acting as an officer, director or controlling shareholder of any financial institution. [13]

As we will see, while the approval process for bank formation may require findings as to a number of specific facts, it does not generally follow a trial type model. This is not necessarily a bad thing. In fact the process has generally worked remarkably well. Professor Kenneth Culp Davis, writing some 40 years ago, said "... I have praised the banking agencies for their successful avoidance of trial procedure for chartering banks and for approving branches [citation omitted]. A trial is surely a clumsy means of determining how many banks and which banks ought to serve a community... The Comptroller properly, in my opinion, avoids proceedings in which each witness presents a mixture of evidence and argument in favor of his view about economic imponderables and each cross-examiner presents arguments on the other side in the guise of questions. Written presentations of economic data, coupled with conferences, seem to me preferable to trials, except on issues of specific fact."[14]

(a) FORMING A DE NOVO NATIONAL BANK

1. PLANNING

It would be hard to overemphasize the importance of planning in bringing an application to a successful conclusion. The applicant and his attorneys must determine as early as possible what areas are likely to be of concern to the regulators. The application process must embody those concerns from start to finish. This is particularly true in the context of a de novo application, where multiple factors must be considered by the regulators and a weakness in one area may be compensated for by strength in another.

Begin with the business plan. There is a temptation to regard the business plan as just another piece of paper that must be submitted with the application, and to simply mark up the plan of the bank closest to yours in concept and recently approved by the regulators. This is a serious mistake.[15]

In many ways the business plan should be treated like an Appellate brief, anticipating the areas in which questions may be raised about whether you meet

particular criteria set forth in the statutes and regulations. Does one of the proposed managers have a history of difficulty in complying with the Bank Secrecy Act? If so, devote some extra attention to the software systems and compliance personnel you plan to put in place to comply with that Act. Will you be starting the bank with a relatively small amount of capital? If so, consider and explain how you will meet demands for larger business loans without exceeding legal lending limits (e.g. by participating larger loans to institutions with which management has long-standing relationships), and pay extra attention to potential sources of additional capital.

In many, if not most, cases, the organizers will find it both expedient and cost-efficient to call on the services of one of a number of consultants specializing in the organization or acquisition of financial institutions. Often these consultants are themselves former bank regulators. In addition to their involvement in a variety of applications, these consultants may also bring to the table a familiarity with the agency personnel with whom they have regular dealings.

Preliminary informal meetings with the regulators can also be a tool both as a sales pitch and to sound out the areas likely to be a concern in your particular proposal. Take, for example, the proposed management team. If you think that one or more of your principal organizers will come across as somewhat lacking in experience, you will want to outline proposed additions to your management team to make up for their deficiency. You will not be able to get a yay or nay as to particular individuals, but by describing the qualifications and experience of those you are considering for the proposed open positions you may allay in advance an initial objection based on limited experience in one or more management areas. If the proposed CEO has never had complete charge of running a bank of comparable size, you will want the management team to include either a chairman or a COO with more experience than you might otherwise choose. If the management team member responsible for BSA compliance has had problems at a prior institution you will want to address both the systems and the support personnel you expect to put in place so that similar problems will not occur at the new institution.

2. APPLICATION PROCESS

The statutory requirements to form a federally chartered bank are a model of simplicity and will be familiar to all corporate attorneys. The organizers must:

- Draft and file articles of association with the OCC;
- Draft and file an organization certificate containing specified information with the OCC;
- Ensure that all capital stock is paid in; and
- Have at least five elected directors.[16]

But formal organization of the new bank has little significance in and of itself. In fact, the real-world approval process will have begun long before the bank's formal organization documents are filed.

Initially, a representative of the proposed organizers will have met informally with the OCC and presented a relatively complete business plan outlining the proposed market, financial strategy (e.g. sources of capital, sources of deposits and types of lending in which the bank will engage), and a management team. So far as concerns us here, this prefiling conference and the initial steps preceding the formal filing with the OCC are the most significant, for it is at this stage that the decision to accept or reject controlling stockholders and key members of management will be made.

If on the basis of one or more pre-filing conferences the OCC believes the bank has a reasonable prospect of success it will issue a letter granting preliminary approval to organize the bank.

Before the OCC will allow the bank to begin business the organizing directors must hire the remainder of bank management, establish the bank’s premises at the proposed site, raise capital, develop policies and procedures, and establish management information systems. They will have twelve months from the date of preliminary approval to complete these steps. The OCC will then complete a "preopening examination" and, if the results of that examination are satisfactory, it will issue a letter authorizing the new bank to begin business.

3. STANDARDS FOR APPROVAL OF APPLICATION TO FORM NEW BANK

There is, of course, no statutory guidance limiting the OCC's discretion in deciding to grant or withhold preliminary approval based on its evaluation of the proposed owners and managers. In fact, one would think based on the text of the National Bank Act that approval is at this stage a ministerial task.[17]

The Act itself doesn't begin to describe the process of regulatory approval. The applicant for a new charter must provide a detailed business plan analyzing in detail the proposed market area for the new bank, demonstrating a need for the services the organizers intend to provide and showing how they intend to meet that need.[18] Each organizer, proposed director and member of senior management must provide detailed financial and biographical information on an Interagency Biographical Information Form (IBFR) form.[19] Only then does the real consideration of the application begin.

In the absence of statutory guidance, the OCC's regulations claim what amounts to nearly unbridled discretion in evaluating the organizers and proposed management. According to the OCC's regulations, in evaluating an application to establish a national bank, the OCC considers whether the proposed bank:

- Has organizers who are familiar with national banking laws and regulations;
- Has competent management, including a board of directors, with ability and experience relevant to the types of services to be provided;
- Has capital that is sufficient to support the projected volume and type of business;
- Can reasonably be expected to achieve and maintain profitability; and
- Will be operated in a safe and sound manner.

The OCC may also consider additional factors listed in section 6 of the Federal Deposit Insurance Act, 12 U.S.C. 1816.[20]

Organizers “must have a history of responsibility, personal honesty, and integrity.” Proposed managers must be "competent" and must have " ability and experience relevant to the types of services to be provided."[21]

4. HEARING AND REVIEW

Under the applicable regulations an applicant for an OCC charter has no right to a hearing on the decision to grant or withhold that charter. The OCC may, however, grant a hearing upon written request. It is important to realize that any hearing granted by the OCC under its regulations is for the purpose of providing the OCC with information. It is not an adversarial proceeding. The OCC generally grants a hearing request only if it determines that written submissions would be insufficient or that a hearing would otherwise benefit the decision-making process. The hearing process consists of an opening statement by the applicant, a presentation by the applicant, an opportunity for hearing participants to ask questions of the applicant, a presentation by each other participant wishing to make a presentation, an opportunity for the applicant to question that participant, and closing statements by the applicant and by each participant. Both the applicant and other participants have an opportunity to submit post-hearing materials.[22] Under the OCC's regulations, the Administrative Procedure Act does not apply to any hearing granted in connection with approval or denial of a new bank charter. [23]

If the OCC denies application to form a new bank, it notifies the applicant in writing of the reasons for the denial. The applicant may appeal the denial to the Deputy Comptroller for Bank Organization and Structure or to the OCC's Ombudsman. [24] Neither the National Bank Act nor the OCC's regulations provide for judicial review of an OCC determination denying an application to form a new bank.

The regulations are quite clear in providing that a hearing before the OCC is optional on an application to establish a new bank. Nevertheless, the cases make it clear that under at least some circumstances an officer, director or organizer of a proposed new bank is entitled both to a hearing on the record and to judicial review of the OCC's decision. But just when do those rights apply, and what kind of hearing must be given when they do?[25]

Despite the provisions in the OCC's regulations indicating that the Administrative Procedure Act ("APA") does not apply, one's first inclination is to

seek an answer in that Act. Unfortunately, a clear answer is not to be found in the APA. The APA generally grants relatively broad rights to judicial review of the decisions of administrative agencies. But it contains two major exceptions. It precludes judicial review of an agency action to the extent that (1) the applicable statutes preclude judicial review, or (2) the agency action is committed to agency discretion by law.[26] Banking regulators have taken the position in the past that review of a decision to deny formation of a new institution is not available under the APA because that decision is a matter committed to the agency's discretion by law. They have had mixed results with this argument.

The first of these cases dealing with judicial review, *Apfel v. Mellon*[27] presents a marvelous example of bootstrap reasoning. The Court bootstrapped the result not from regulations of the Federal Reserve Board, the agency involved in the case, but from regulations of an entirely different banking agency, the OCC.

Apfel and others sought to establish an Edge Act Corporation to engage in foreign banking operations. Establishment of such a corporation required approval from the Federal Reserve Board. The applicants alleged that they had duly executed and filed a certificate for the organization of the proposed corporation, that the certificate fully conformed with the requirements of the act, but that the FRB had wrongfully refused to approve the certificate or to issue a permit to begin business as a body corporate under the Act.

The FRB admitted that the articles of association and organization certificate were in proper legal form, but stated it had refused to approve those documents on the grounds that the organizing group did not have the qualifications reasonably necessary to assure the financial soundness, reliable and competent operations of the proposed corporation to engage in the highly technical activities of international or foreign banking or other international or foreign financial operations and that it would be detrimental to the public interest to approve the articles or organization certificate and to issue a preliminary permit to commence business.

The court held that the decision to grant or withhold approval of the articles and organization certificate, and to issue or withhold the preliminary permit to commence business was within the FRB's discretion and could not be compelled by mandamus.

The Court began by noting that the applicable statute called for the FRB to "approve" the articles and organization certificate, and that the ability to approve implies the power to disapprove. So far so good. We now reach the bootstrap portion of the opinion. The Court indicated that the National Bank Act is analogous to the Edge Act[28], the statute in question in the case. It then noted that under the Comptroller's regulations relating to establishment of a national bank, the Comptroller may approve or disapprove an application for a charter based on, among other matters, the general character and experience of the organizers and the proposed officers, the adequacy of existing banking facilities and the need for growth and development in the town or city where the bank is to be located, the methods and banking practices of the existing bank or banks, the interest rate charged by existing banks, the character of the service they are rendering to their community, and the reasonable prospects for success of the new bank if efficiently managed. In other words, the court was saying that the statute governing an Edge Act corporation is like that governing a national bank; the Comptroller *says he is entitled* to approve or disapprove a new bank in his discretion. Therefore he *is entitled* to approve or disapprove a new bank in his discretion, and therefore the FRB similarly is entitled to approve or disapprove in its discretion. In other words, because the OCC claims by its regulations that it is entitled to disapprove a new bank in its discretion, the statute under which those regulations were issued authorize the OCC to disapprove the bank in its discretion. The applicable statute governing the FRB in this case is similar to the statute governing the OCC. Therefore the FRB is entitled under the statute to disapprove a bank in its discretion. But as we have seen above, from 1875 until 1908 the OCC had taken just the opposite position as to its discretion, believing that it was required to sanction the organization of any association complying with the simple statutory requirements of the National Bank Act.[29] Thus, it wasn't at all clear that in 1913, when the Edge Act was first enacted, Congress would have had any settled view as to the degree of discretion the National Bank Act conferred upon the OCC in passing upon a new national bank charter. Perhaps the OCC's then recent regulations, untested in litigation, were utterly

inconsistent with Congress's intent, and its earlier long-standing position was the correct one. To jump from an OCC power claimed only recently by regulation to the inference that that power was embodied in the National Bank Act, and then to the inference that that same power was embodied in the Edge Act represented something of a leap of faith.

Following on from *Apfel*, we have a far better reasoned opinion in *FHLB v. Rowe*, 284 F.2d 274 (D.C. Cir. 1960). In that case, two separate sets of applicants applied for permission to establish a federal savings and loan association in Largo, Florida. The Home Owners' Loan Act of 1933,[30] which authorized the organization of federal savings and loan associations, provided: "No charter shall be granted except to persons of good character and responsibility, nor unless in the judgment of the Board a necessity exists for such an institution in the community to be served, nor unless there is a reasonable probability of its usefulness and success, nor unless the same can be established without undue injury to properly conducted existing local thrift and home-financing institutions." The statute itself did not provide for a hearing, but the agency's regulations did provide for a hearing in the discretion of the agency. The FHLB granted a separate hearing to each group and after consideration of the two records granted the application of one of the two groups, the Hoadley group, and denied the application of the Rowe group. The Rowe group sought declaratory and injunctive relief, claiming that it should have been granted a comparative hearing before the Board (i.e. a hearing in which the issue would be which of two applications should be granted) rather than a separate hearing on its application (in which the issue would be whether its application should be granted). They argued that absent a record showing the reasons for choosing one group over the other the Court should overturn the Board's decision.

The Court held that the Rowe group was not entitled to review of the decision denying their application because that was a matter committed to agency discretion. It began by citing *Apfel* for the proposition that the word "approve" implies the exercise of discretion. It went on, however, with a careful look at the nature of the determination to be made by the banking regulators. It said: "The Attorney General's Committee on Administrative Procedure in reporting its recommendations to the Congress pointed out that in determining whether individuals are suited to engage in the banking business, or whether the community needs a bank, or whether a bank should be insured and similar questions, a congeries of imponderables is involved, calling for almost intuitive special judgment so that hearings are not ordinarily useful, and that the banking business is a delicate one so that the advantages and importance of ready and frank information may outweigh the dangers of accepting confidential information. Accordingly, and in the absence of any substantial evidence that there has been an abuse of power, the Committee is not prepared to recommend that either hearings be held prior to denial or that in all cases the identity of the author of the adverse evidence be disclosed to the applicant.'"[31] In other words, while some issues are appropriate to an adversarial process with a right of confrontation and cross-examination, where the issue is which of two applicants is more qualified to operate a bank the regulators must generally be afforded great latitude in exercising intuitive special judgment, rather than being second-guessed by a court.

The Court reached the opposite result in *Klanke v. Camp*.[32] In that case the Court rejected the Comptroller's position that his determination on an application to establish a new bank was non-reviewable. It reached that result even without benefit of the history of the National Bank Act.

In *Klanke* the plaintiffs had applied to the Comptroller of Currency for permission to organize a new national bank. The Comptroller denied the application stating that there was no adequate need for a banking facility at the proposed location, that the ability and experience of the proposed organizers was insufficient, that the requested new bank would not be successful under its proposed leadership, that the objects contemplated by the National Bank Act would not be served, and that the granting of the charter application would be detrimental to the public interest. The plaintiff sought review of that determination under the APA.

The Comptroller argued that denial of an application is a matter committed to his discretion and therefore is not subject to judicial review. The *Klanke* court explicitly declined to extend the reasoning of *Rowe* and *Apfel* to decisions approving or disapproving national bank charters. After finding no statutory basis in Sections 26 and 27 of the National Bank Act,

it stated "... we are persuaded by the consideration that, to deny every possibility of judicial review in this situation is to vest the Comptroller with virtually unbridled authority. Such unlimited discretion is the cornerstone of authoritarian rule. But it is inconsistent with our form of government and it will not be inferred absent a clear and forthright manifestation of congressional intent."[33]

The plaintiffs' victory in *Klanke* proved to be Pyrrhic. While granting the plaintiffs the right to review of the denial based on an arbitrary and capricious standard, the court noted that they would have no right to depose the Comptroller nor require him to answer interrogatories, and would have to rely almost exclusively upon the letters denying their application, upon affidavits submitted by the Comptroller and upon information in the Comptroller's file in the case. They were ultimately unsuccessful in demonstrating that the Comptroller had abused his statutory authority.[34]

We have seen above that the legislative history does not in any fashion support the Comptroller's claim that denial of an application is a matter committed to his discretion. Whatever discretion the Comptroller may have in approving or denying a bank charter is the result not of a statutory grant of discretion but of a rather breathtaking power grab by the first Comptroller. The National Bank Act, with its roots in the free banking laws of the States, intended to grant the Comptroller of the Currency virtually no discretion. If the organizers had complied with all of the formal requirements of the Act, the Comptroller was to accept a filing and issue a certificate authorizing the bank to commence business. The single exception to that proposition is that the Comptroller was authorized to reject a filing if he determined that the organizers had formed the bank for reasons other than the legitimate objects contemplated by the Act.[35]

Where does this leave us? Under *Apfel* and *Rowe*, if a charter application is filed for an Edge Act bank or a savings bank there is no right to court review under the APA. Under *Klanke*, with virtually identical statutory language, denial of an application for a national bank is subject to review. As a practical matter this difference may not be significant, since any review will be only on the basis of the arbitrary and capricious standard, and will be based solely upon the contents of the agency's file.

(b) APPLYING FOR A CHANGE IN CONTROL

1. PROCESS

12 U.S.C. §1817, and Regulation Y of the Federal Reserve Board's regulations[36] require sixty days' prior notice to the appropriate regulatory agency by any person seeking to acquire control of an insured depository institution. For this purpose, "control" means ownership, control, or the power to vote 25 percent or more of any class of voting securities of the institution. In addition, notice may be required under some circumstances where a proposed acquisition that would result in the person owning or controlling the power to vote as little as 10 percent of a class of voting securities.[37] Within that sixty day time period (which may be subject to extension), the agency may disapprove the proposed change in control. The agency is then to conduct an investigation of the "competence, experience, integrity, and financial ability" of each person by or for whom the acquisition is to be made, and is to prepare a report containing, at a minimum, a summary of the results of its investigation.[38] It must also publish notice of the proposed change in control, identifying each person by or for whom the acquisition is to be made, and solicit public comment on the change in control. As in the case of a new charter application, the individual seeking to acquire control (or the controlling shareholders, officers and directors of the entity seeking to acquire control) must complete the IBFR form.[39]

2. STANDARDS FOR APPROVAL OF CHANGE IN CONTROL

The appropriate federal banking agency may disapprove any proposed acquisition if "the competence, experience, or integrity of any acquiring person or of any of the proposed management personnel indicates that it would not be in the interest of the depositors of the bank, or in the interest of the public to permit such person to control the bank...". [40]

Here, unlike the statutes governing initial organization of a de novo bank, we at least have statutory authority for the bank regulators to exercise discretion. But the breadth of that discretion remains

undefined and essentially unlimited. The phrases "interest of the depositors" and "interest of the public" are empty bottles that may be filled with a witch's brew of irrational prejudice, effectively admitting only those who are members of the club and know the secret handshake. By way of example, in one case state banking regulators were upheld in a determination that an individual seeking approval to acquire control of a New York bank could be rejected as lacking in character and fitness on the basis that he held a controlling interest in an out-of-state bank.[41]

3. HEARING AND REVIEW

If the agency disapproves a proposed change in control it must notify the acquiring party, providing a statement of the basis for the disapproval. An acquiring party who is turned down is entitled to an adjudicatory hearing on the record in accordance with Section 554 of the Administrative Procedures Act.[42] If, following the hearing, the proposed acquisition is again disapproved the proposed acquiring person may seek review of the decision at the Court of Appeals level. The decision will be set aside if found to be arbitrary or capricious or to violate the procedures established by the applicable statute.[43]

(c) REMOVAL OR INDUSTRY BAR

1. PROCEDURE FOR REMOVAL OR INDUSTRY BAR

Broadly, Section 8(e)(1) of the Federal Deposit Insurance Act[44], authorizes a bank's primary federal regulator to remove, or impose a complete industry bar against, any director, officer, employee, or controlling stockholder of, or agent for, an insured depository institution, as well as certain others who participate in the affairs of an insured institution. Removal is commenced by service of a written notice of the applicable agency's intention to remove, or impose an industry bar against, the individual. The agency may simultaneously suspend the individual from participation in the bank's affairs pending resolution of its removal proceeding. The notice of intention to remove must state the facts constituting grounds for removal and fix a time for a hearing not later than 60 days after service of the notice. If the hearing results in a determination that there are grounds for removal or prohibition, the agency issues an appropriate order or, in the case of a national bank, forwards the ALJ's findings and conclusions to the Board of Governors of the Federal Reserve System for determination of whether an order should issue.

2. STANDARDS FOR REMOVAL OR INDUSTRY BAR

To effect removal, or an industry bar, the regulatory agency must determine that the subject of its action:

- violated a law or regulation, cease-and-desist order or condition imposed in writing by the agency in connection with the grant of an application or request;
- violated a written agreement between the institution and the agency;
- engaged or participated in any unsafe or unsound practice in connection with an insured institution or business institution; or
- committed a breach of the subject's fiduciary duty;

It must further find that by reason of the violation, practice, or breach:

- the institution or business institution has suffered or will probably suffer financial loss or other damage;
- the interests of the insured depository institution's depositors have been or could be prejudiced; or
- the subject has received financial gain or other benefit by reason of the violation, practice, or breach;

Finally, the agency must additionally determine that the violation, practice, or breach:

- involves personal dishonesty on the part of the subject, or
- demonstrates willful or continuing disregard for the safety or soundness of the financial institution or business institution.

As one court succinctly put it, “in order to impose this sanction, the FDIC must establish each of the three statutory criteria — ‘misconduct’ ... ‘effect,’ ... and ‘culpability.’”[45]

Note first of all that the misconduct providing a basis for removal need not be misconduct involving the

particular financial institution, or indeed any financial institution at all. It may also involve a "business institution." A bank president skimming cash receipts from the candy store he operates on weekends might find himself the subject of a removal proceeding.

The *misconduct* and *effect* criteria either represent objective facts or are of a nature almost inherently calling for the exercise of agency discretion. As a result, the cases generally revolve around elements of culpability -- whether the violation involves personal dishonesty and whether it demonstrates willful or continuing disregard for the safety and soundness of the institution. In either case, when it comes to those criteria we are dealing with determinations of the kind typically made by courts rather than by boards of directors in the course of managing their businesses. This is undoubtedly clearest where a case involves personal dishonesty. In that regard, an agency is not limited to examining the statutory elements of a crime in determining whether it involves personal dishonesty. The agency is entitled to look at the underlying facts. For example in *Hendrickson v. FDIC*,[46] the FDIC had removed the president of a bank based on his conviction on a willful failure to file a Form 8300 (the form required to report cash receipts over $10,000) with the IRS while employed in his brother's coin dealership and precious metals business. The president argued that removal was improper because failure to file a form with the IRS does not necessarily involve personal dishonesty. However, the court upheld the agency's decision because while the president had pleaded guilty only to willful failure to file the form, the record indicated that he had back-dated a copy of the form he was required to file and placed a copy of the document in the business's files to mislead the IRS auditors.

The more nebulous area is in the phrase "willful or continuing disregard for the safety or soundness of the institution." Most of the litigation in this area focuses on that phrase, and particularly on what constitutes "willful or continuing" disregard.

In *Brickner v. FDIC*, [47] the plaintiffs argued unsuccessfully that "willful or continuing disregard" constitutes a single standard and that the language of that phrase is too vague to allow its application absent some clarification by the FDIC. The Court accepted the agency's interpretation that "willful disregard" and "continuing disregard" present two distinct, alternative standards for removal, and that although "continuing disregard" may require some showing of knowledge of wrongdoing, it does not require proof of the same degree of intent as "willful disregard." Use of the word "disregard," suggested voluntary inattention. Thus the "continuing disregard" standard refers to a mental state short of "willfulness" and akin to "recklessness." [48]

It seems fair to say that to be guilty of continuing disregard one must be something more than negligent, but need not be "really really negligent." Continuing disregard falls between these two bookends. As one annotator put it, "The cases under §1818(e) also suggest that a finding of 'continuing disregard of the safety or soundness of an insured depository institution' requires, at a minimum, a pattern of negligent conduct involving several (that is, more than two) instances of misconduct."[49] By way of illustration, in *Kim v. Office of Thrift Supervision*[50] the Court held that where a bank officer was one of several officers and directors who approved a few questionable loans out of hundreds of loans, and that a few relatively minor and technical violations of banking regulations occurred while the director was the president of the bank, the OTS's allegations did not rise to the level of continuing disregard. See also [Anonymous] v. FDIC,[51] where an individual only tangentially involved in two or three loans was not guilty of continuing disregard under the statute. On the other hand, in *Brickner v. FDIC*[52] the Court held that accepting assurances of a cashier that he would correct excessive grants of credit which had been criticized on three separate occasions by the examiners constituted continuing disregard under the statute.

In the 11th Circuit, even a series of negligent banking practices is apparently insufficient to establish continuing disregard. In *Doolittle v. National Credit Union Admin.*[53] the Court, construing a somewhat similar statute, and citing *Brickner*, suggested that in order to constitute continuing disregard the conduct in question "must have the same magnitude as personal dishonesty." This seems inconsistent with the legislative history of §1818(e). As originally enacted in 1966, personal dishonesty was required for removal. The statute was amended to add the willful and continuing disregard language. The reason for the amendment was explicitly to increase the authority of banking regulators to remove officers and directors

where conduct did not necessarily demonstrate personal dishonesty but was nevertheless sufficiently adverse to the interests of the institution to require their removal. In the words of the Federal Reserve Board, recommending amendment of §1818(e), "Under present law (Section 8(e) of the Federal Deposit Insurance Act), a bank director or officer who has engaged in a violation of a law, rule, or regulation... may be removed only where he shown that he has engaged in an act amounting to personal dishonesty. Such a showing is often difficult to make, and the present law thus effectively bars removal of individuals who have repeatedly demonstrated gross negligence in the operation or management of a bank, or a willful disregard for the safety and soundness of the bank, but who cannot be shown to have exhibited personal dishonesty."[54]

3. HEARING AND REVIEW.

The person served with a notice of intention to remove is entitled to a hearing on the record in accordance with the APA.[55] A party to the proceeding may obtain review by the Court of Appeals where the home office of the institution is located or in the Court of Appeals for the District of Colombia Circuit.[56] The decision will be set aside if found to be arbitrary or capricious or to violate the procedures established by the applicable statute.[57]

III. THE FOUR SONS: CASE STUDIES APPLYING LEGAL FRAMEWORK TO SPECIFIC FACTS.

"It follows that there are four sons: One wise; and one wicked; One simple; and one who knows not how to ask."

Mekhilta of R. Ishmael (c. 300)

For purposes of the discussion that follows, let's assume that each of four separate clients come to you expressing an interest in entering the banking business. Each of these clients has been successful financially in other fields, but each also carries at least some baggage from his prior business life. We'll call the clients Mr. Banks, Mr. Lord, Mr. Tippets, and Mr. Stock.

(a) THE WISE SON

Mr. Banks has a long history in the banking industry. His family going back many generations have been bankers and his grandfather was the founder of what was formerly the leading bank in his suburban community. Mr. Banks served as Chairman and Chief Executive Officer of that bank until it was acquired several years ago by a larger institution. At the time of the acquisition an investigation was pending relating to the bank's possible violations of the Bank Secrecy Act.[58] Mr. Banks explains that he had no personal involvement in any of these possible violations. However, many if not most of the violations could be attributed to the fact that his relatively small institution had never been profitable enough to justify installing state-of-the-art software for monitoring compliance and preparing suspicious activity reports. The individual in charge of BSA compliance had developed the bank's compliance program using spreadsheets and other general-purpose software coupled with a great deal of manual entry and review of transactions. The acquiring institution had insisted that the investigation be terminated prior to closing of the purchase, so Mr. Banks, as well as the bank he was managing, entered into a cease and desist order with respect to future violations of the Bank Secrecy Act. Mr. Banks' entire business life has been spent in banking, and he has recently been offered the opportunity to purchase a substantial block of stock in a private offering by a proposed de novo bank, and to become its chairman. This bank will also be a community bank, but the offering memorandum suggests it will be significantly larger than the institution Mr. Banks previously led, and the other organizers envision a rapid expansion of the institution's operations by establishing new branches in nearby communities.

While you are at lunch, Mr. Banks happens to mention an article in the newspaper indicating that one of his favorite Italian restaurants was recently shut down as the result of an IRS seizure for unpaid taxes. He tells you that he had heard that the restaurant had been under FBI surveillance because it had developed a reputation as a meeting place for members of organized crime. He had always liked the restaurant, and in fact had for years been getting a birthday card from it just before his birthday.

Let's take a look at the possible areas of concern the regulators might have about Mr. Banks, and see what we can do to smooth the approval process for him. Recalling the factors to be considered, there should be no issue about his being familiar with banking laws and regulations, and his experience is relevant to the types of services to be provided. There may be some concern that he has never had primary responsibility for a bank of the size called for by the business plan, so we may want to urge him to add at least one senior officer with experience at a larger bank to his management team. No doubt the most serious problem we will need to deal with is the cease and desist order Mr. Banks entered into in order to facilitate closing the sale of the bank he previously managed. Failure to ensure that all transactions requiring reporting were duly recorded and reported may be cited by the regulators as indications that Mr. Banks is not sufficiently "competent." Our application will need to explain in considerable detail the circumstances surrounding both the violation and the execution of the cease and desist order. We will need to be careful here because casting all of the blame on subordinates might be regarded as an absence of "a history of responsibility."[59]

In an ideal world we would like to be able to demonstrate that Mr. Banks had recommended to his board that they devote more resources to installing BSA compliant systems, and that his board had overruled him on that point. Failing that, we will want to ensure that the business plan calls for acquiring the most up-to-date and the best regarded software and systems for BSA compliance, and for hiring a highly experienced BSA compliance officer with an unblemished record at another bank. We may also want to recommend that the Bank outsource its internal audit function to a firm of sufficient stature to inspire confidence on the part of the regulators.

With the wide discretion conferred on regulators in the bank approval process, nothing is entirely certain, but on balance, with proper planning and presentation, we should be able to push Mr. Banks' application through to fruition without a great deal of difficulty.

Suppose, however, that shortly before expiration of the period for public comment on the application you get a disturbing call from the agency official managing your application. He tells you that he has just received the results of a routine inquiry made to the FBI about Mr. Banks, and the FBI indicates that Mr. Banks maybe an associate of organized crime. He suggests that this raises serious questions about Mr. Banks' personal honesty and integrity. He further points out that it is the applicant's burden to demonstrate honesty and integrity and invites submission of evidence on the point. You ask him to provide a copy of the adverse information to which you have to respond, and he refuses, saying that such information is exempt from disclosure as information compiled for the purpose of a criminal investigation under the Privacy Act.[60] What do we do now?

As noted above, as a general matter there is no right to a hearing in connection with an application to the OCC to approve issuance of a new bank charter or to authorize a bank to commence business. The OCC's regulations provide only for a discretionary hearing. Do we then ask for a discretionary hearing to address the concerns raised by the FBI's information? Almost certainly not. We are not looking for the kind of hearing that would call for notice to the general public, a presentation on behalf of the applicant and questions from anyone who might happen to show up. The type of hearing called for by the OCC's regulations simply would not provide a suitable forum for us to address either the legal issue of Mr. Banks's right to access to the adverse information in order to rebut it, or the fact issue of whether Mr. Banks lacks the requisite honesty and integrity to run a bank. As the Comptroller's Licensing Manual says, "A hearing is neither an adversarial proceeding nor a forum for the presentation or settlement of legal arguments."[61]

The time has come to put on our litigator's hat. Our argument is that if the OCC intends to rely on secret sources to deny an application based on a finding that organizers or management do not have a "history of responsibility, personal honesty, and integrity," or that proposed management is not "competent" or lacks the "ability and experience relevant to the types of services to be provided," the organizers are entitled to confront and rebut the source of that information. We will present this argument first to the OCC and then, if we are unsuccessful at that level, to a court. Essentially we will prepare a brief. That brief will be presented first to the OCC in the form of a letter, and if we are unsuccessful in persuading the OCC that our position is correct, it will be modified as a court filing.

Our presentation will run something like this:

A quick look at the factors the OCC's regulations call for it to consider in connection with a new charter application demonstrates convincingly that several of those factors call for decisions that are by their nature businessmen's judgments, and are thus appropriate to leave to the discretion of agencies with unique industry expertise. For example, whether the proposed bank has sufficient capital to support its projected volume and type of business, or whether proposed management is "competent" to manage a bank are questions courts are ill-equipped to determine. Whether the bank can be expected to achieve and maintain profitability is likewise a business determination ill-suited for second-guessing by a judge. In evaluating these business type questions the OCC effectively functions as a super Board of Directors, presumably applying the same analytic tools and reaching a conclusion in the same manner as we would expect the Board of Directors itself to use.

In contrast, other items to be considered require moral or values-oriented judgments about particular individuals. Whether the experience of the proposed directors is relevant to the types of services to be provided, and whether organizers have a history of responsibility, personal honesty and integrity are matters on which the OCC has no more expertise than a court, and matters like those on which courts have traditionally passed. And indeed the cases suggest that where a denial is based upon judgments similar to those traditionally made by courts the affected individual have recourse to the courts and are entitled to an opportunity to rebut the specific evidence on which the OCC proposes to base its action.

In *Greene v. McElroy*,[62] the petitioner, an aeronautical engineer, was the general manager of a private corporation engaged in developing and producing for the Armed Forces goods involving military secrets. The military contracts required the corporation to exclude anyone not holding a security clearance from its premises. The Department of Defense, without explicit authorization by either the President or Congress, had promulgated regulations governing administrative hearings to be held on the grant or denial of a security clearance. These regulations permitted the agency to deny access to adverse information "tending to compromise investigative sources or methods or the identity of confidential informants." In accordance with these regulations, petitioner Greene was not given the opportunity to confront or cross-examine witnesses against him. Following such a hearing, Greene was stripped of his security clearance on the grounds of alleged Communistic associations and sympathies. As a result, the corporation discharged him and he was unable to obtain other employment as an aeronautical engineer. He sued for a judgment declaring that the revocation of his security clearance was unlawful and void and an order restraining the Secretaries of the Armed Forces from acting on it. The court held that in the absence of explicit authorization from either the President or Congress, the Secretaries of the Armed Forces were not authorized to deprive Greene of his job in a proceeding in which he was not afforded the safeguards of confrontation and cross-examination.

The issue, as the Court framed it, was whether the Department of Defense has been authorized to create an industrial security clearance program under which affected persons may lose their jobs and may be restrained in following their chosen professions on the basis of fact determinations concerning their fitness for clearance made in proceedings in which they are denied the traditional procedural safeguards of confrontation and cross-examination. It stated "the question which must be decided in this case is not whether the President has inherent power to act or whether Congress has granted him such a power; rather, it is whether either the President or Congress exercised such a power and delegated to the Department of Defense the authority to fashion such a program.

The case is worth quoting at some length.

> Certain principles have remained relatively immutable in our jurisprudence. One of these is that where governmental action seriously injures an individual, and the reasonableness of the action depends on fact findings, the evidence used to prove the Government's case must be disclosed to the individual so that he has an opportunity to show that it is untrue.[63]
> ...
>
> We must determine against this background, whether the President or Congress has

delegated to the Department of Defense the authority to by-pass these traditional and well-recognized safeguards in an industrial security clearance program which can operate to injure individuals substantially by denying to them the opportunity to follow chosen private professions.[64]

The court pointed out that nowhere in the applicable statute, or its amendments, was there any specific authority to create a clearance program similar to that in question

We deal here with substantial restraints on employment opportunities of numerous persons imposed in a manner which is in conflict with our long-accepted notions of fair procedures.[65]
...

Before we are asked to judge whether, in the context of security clearance cases, a person may be deprived of the right to follow his chosen profession without full hearings where accusers may be confronted, it must be made clear that the President or Congress, within their respective constitutional powers, specifically has decided that the imposed procedures are necessary and warranted and has authorized their use. Such decisions cannot be assumed by acquiescence or non-action. [Citations omitted]. They must be made explicitly not only to assure that individuals are not deprived of cherished rights under procedures not actually authorized, [citation omitted] but also because explicit action, especially in areas of doubtful constitutionality, requires careful and purposeful consideration by those responsible for enacting and implementing our laws. Without explicit action by lawmakers, decisions of great constitutional import and effect would be relegated by default to administrators who, under our system of government, are not endowed with authority to decide them.

Where administrative action has raised serious constitutional problems, the Court has assumed that Congress or the President intended to afford those affected by the action the traditional safeguards of due process.[66]

....

We decide only that in the absence of explicit authorization from either the President or Congress the respondents were not empowered to deprive petitioner of his job in a proceeding in which he was not afforded the safeguards of confrontation and cross-examination.[67]

Just as with the regulations under scrutiny in *Greene*, the OCC's regulations relating to the grant or withholding of approval to form a new bank have been neither required nor explicitly authorized by the applicable statute -- here the National Bank Act. The teaching of *Greene* is that under those circumstances an agency determination having the effect of preventing an individual from following his chosen profession, he must be afforded a hearing in which he has the opportunity to confront witnesses providing the information on which the agency's decision is based, and is entitled to review of that decision by the courts.

One might argue that *Greene* is highly fact-specific in that it deals with an aeronautical engineer, for whom denial of a security clearance was equivalent to an industry bar because virtually all potential employers were likely to have at least some military contracts. However, the cases indicate that the principle of *Greene* is not so limited.

In *Connelly v. Comptroller of Currency*,[68] the plaintiff had been employed in the Texas banking community for approximately 20 years. In 1983 he accepted an offer to become president of a new national bank which was in the process of organization. After receiving the plaintiff's biographical information, the examiner reviewing the application contacted one of his colleagues who was reviewing the holding company of two banks of which the plaintiff had been president. The examiner asked the colleague to gather what information she could as to the plaintiff's past performance as president of the two banks. She gathered documents from the loan review department of one of the banks showing that a number of loans were characterized as classified. She also obtained a monthly watchlist report indicating that the plaintiff

had originated a number of loans at that same bank that were in the classified category at the time of the report. The colleague left a message for the president of the holding company, who, on calling her boss back, indicated general dissatisfaction with the plaintiff's administrative ability and said he could not recommend the plaintiff for a chief executive officer position. The examiner met with the plaintiff after receiving his colleague's report and asked about his own performance at the bank. The plaintiff acknowledged that there had been problems but indicated that many of the problems had originated in actions of officers and employees before his tenure as chief executive officer.

Based on the above information and interview the examiner informed the organizers of the bank that their application would not be approved with the plaintiff as president. The sole reason given was that "we are of the opinion that Mr. Connelly does not possess the qualifications required for the position of President of Westwood National Bank..."[69]

The examiner did not contact any of the references the plaintiff had provided and did not again contact the plaintiff after he received the written information from his colleague. The plaintiff was apparently never told that his nomination was in jeopardy because of his own performance or because of an unfavorable oral evaluation by the president of the holding company. The organizers of the proposed bank then terminated the plaintiff's services.

The plaintiff sought damages for among other things violation of his due process rights under the Fifth Amendment.

The court initially determined that the plaintiff's contract providing for his employment by the bank was at least arguably a constitutionally protected property interest because there is a constitutional right to hold specific private employment free from unreasonable governmental interference. Alternatively, his reputation and future employment opportunities were liberty interests entitled to protection.

The Comptroller argued that the discretionary hearing provided for under the OCC's regulations satisfied the plaintiff's due process rights. He argued that the charter applicant could have refused to comply with his request that they find another nominee for the position, forcing the Comptroller to reject the application so that they could then appeal the rejection.

The court rejected this position. It pointed out that it is unreasonable to think that investors would so jeopardize and delay their application for the plaintiff's benefit, since his nomination may have been of minor concern to those involved in setting up the bank. More important, the regulations are intended to provide charter applicants and members of the public with an opportunity to be heard, and are not designed to provide due process protection to nominees rejected during the application process. The court held that the minimum due process to which a plaintiff is entitled includes the right to timely and adequate notice, the opportunity to confront adverse witnesses, and to present oral evidence when there are issues of material fact to be resolved. Since the plaintiff was never told that his suitability was in question until he was told by the charter applicants that his services were terminated because his nomination had been rejected, he was not confronted with the evidence against him or granted an opportunity to rebut that evidence. Accordingly, he was denied due process. He was entitled to examine documents, letters and intraoffice memoranda in the administrative file in order to determine whether the OCC complied with the requirements of Section 27 that it make "a careful examination of the facts" before exercising its discretion.

On the basis of *Greene*[70] and *Connelly,*[71] it seems pretty clear that Mr. Banks is entitled to at least learn the basis of the OCC's conclusion that he is an associate of organized crime. After making our arguments, we manage to persuade the regulators that Mr. Banks is entitled to an opportunity to rebut whatever evidence forms the basis for their conclusion. They disclose that among the records discovered after seizure of all the records of Mr. Banks' favorite Italian restaurants there was a list of regular patrons of the restaurant together with their home addresses and dates of birth. The FBI's listing of Mr. Banks as an associate of organized crime was the unhappy result of his name's appearing on this list of regular patrons of the restaurant alongside the names of a number of figures convicted or suspected of organized criminal activity. The regulators,

recognizing that a challenge to their proposed decision would be sustained by the courts withdraw their objection and approve issuance of the charter.

(b) THE WICKED SON

Mr. Lord was formerly the owner of a number of residential apartment buildings located primarily in low income neighborhoods in Brooklyn, the Bronx and Newark, New Jersey. More recently, he disposed of those holdings and became a real estate developer. He believes he has developed considerable expertise in real estate lending, having been on the borrower's side of the transaction so many times. He would like to form or acquire a bank in the Brooklyn neighborhood where he has recently been renovating apartments and building condominiums, and to develop the bank into a regional or national franchise. He asks for your assistance in starting or acquiring the proposed new bank.

During the time Mr. Lord owned and managed apartment buildings those buildings were subject to a number of housing code violations, and in some cases the violations were not immediately remedied. He explains to you that despite his best efforts, it simply was not possible to maintain the buildings to code standards. For example, in several of the buildings his workmen found that vandals had repeatedly ripped out new copper plumbing he had installed and sold the metal for scrap. Mr. Lord tells you that when he was a landlord he was often assailed in the press by tenant groups and others calling him a "slum lord." He is quite concerned about the requirements for public notice of the organization of a new bank or of a change in control upon purchase of an existing bank. He believes that his previous nemeses still bear considerable resentment toward him and are likely to oppose his being permitted to organize a new bank or take control of an existing bank. A quick Internet search shows you that there are a number of tabloid newspaper articles from the time reporting the criticisms leveled at him by various groups of community activists.

Mr. Lord's concerns illustrate another aspect of the bank chartering process that we haven't yet touched on. The process can become a highly political one. Planning for a transaction expected to have a high political content may be particularly challenging. To illustrate, Citibank's proposed acquisition in 2000 of Associates National Bank and Hurley State Bank generated some 150 responses, virtually all of them opposing the acquisition. It also drew considerable interest from several congressmen and senators as evidenced by the cc recipients of some of the correspondence relating to the acquisition.[72] Following the close of the comment period for the proposed acquisition (which was extended for 10 days beyond the statutory expiration date), Citibank held a number of meetings with the activist organizations and was forced to negotiate a number of changes in the way it's CityFinancial subsidiary carried on business as well as changes in the proposed operation of Associates.

In Mr. Lord's case we would like if possible to plan his transaction in such a way as to avoid the circus-like environment that sometimes surrounds these proceedings. There is no way to avoid the public notice requirements on either a de novo application or acquisition of control of an existing institution. However, we can take steps to see that the proceedings triggered by the public notice will occur in a forum far less likely to draw opposition.

For Mr. Lord, we will suggest that instead of trying to start or acquire an institution in a hostile political environment he should consider acquiring a federal thrift charter in a location well removed from his desired market area. In general, a thrift charter offers several advantages over a national bank or a state chartered bank. Most important for our purposes, in the case of federally chartered thrift institutions state laws that might otherwise limit branch banking into a state other than the thrift's home state are preempted. We will suggest that Mr. Lord seek to acquire a thrift located in Florida or another relatively remote jurisdiction where he would nevertheless want to develop a branch network in due time. Beginning his operations elsewhere will serve two purposes. First, he will minimize the likelihood of encountering opposition from the activist groups that have historically dogged his every move, as those groups tend to be somewhat locally focused. Second, it will give him an opportunity to develop a track record of lending to low and moderate income borrowers. After a year or so of operations elsewhere he will be in a position to move into the Bronx and Brooklyn markets he desires either through establishing new branches or acquiring branches from existing institutions. A favorable track record developed

elsewhere will give him ammunition you will need to counteract any adverse comment that may be forthcoming from community activists.

We should highlight one additional issue we are likely to encounter in pressing Mr. Lord's application. Historically, thrift regulators have treated applications by real estate developers to charter or acquire thrifts with some skepticism. That skepticism is not wholly unjustified. On reading the many cases dealing with fallout of the thrift crisis of the 1980s one repeatedly sees instances in which loans have been made to related parties (at FDIC subsidized rates) despite statutes limiting transactions with bank insiders. We will need to be sure that Mr. Lord understands that he will not be able to treat a controlled thrift institution as his personal piggy bank for funding his real estate development transactions. Ideally, we would like to be able to tell the regulators that his real estate development enterprises will not in any case be borrowers from the thrift.

Can we succeed in getting Mr. Lord through the pearly gates? For the reasons outlined in Part II, it is difficult to give anything even approaching a definitive answer. Mr. Lord is to some extent between Scylla and Charybdis. On the one hand, there is a risk that the regulators will find that his company's failure to comply with building regulations indicates a general propensity on Mr. Lord's to disregard legal requirements. On that basis they might conclude that he lacks the required integrity to be permitted control of a financial institution. To avoid that inference, Mr. Lord may argue that in an organization of the size he was managing matters such as housing code violations were dealt with at a relatively low level in the organization and the violations would not normally come to his attention. Unfortunately that argument creates the risk that the regulators will decide that Mr. Lord is not competent to manage an organization of the size of the proposed bank, particularly in light of the degree of attention his company's violations received in the press.[73] With proper planning of the type described above, he may be able to enter the gates. But success is far from assured.

(c) THE SIMPLE SON

Mr. Tippets is the former chairman of the board of a public company he founded a number of years ago. Over the years the company had become highly successful and profitable, and eventually it was acquired by another public company in a merger transaction and became a division of the acquiring company. The acquiring company agreed to register the shares Mr. Tippets received in the acquiring company for resale into the market from time to time, and that registration statement had become effective. However, Mr. Tippets had not sold any of the shares covered by that registration statement or any other shares. During the time he was managing the public company Mr. Tippets had established several charities to fund what he regarded as worthy causes. He held investment power with respect to the investments of these charities, and had contributed significant amounts of stock in his company to them. That stock became stock of the acquiring company in the merger, which was also registered for resale.

While chairman of the Company he founded, Mr. Tippets had also served as a director of a local community bank. Not long after his company was acquired, the Chairman of the Board of that bank died unexpectedly, and Mr. Tippets was elected Chairman.

In connection with the acquisition of his company, the acquiring company had retained Mr. Tippets as a consultant for a period of two years to assist with, among other things, financial reporting relating to the operations of his former company (now a major division of the acquiring company).

Since the acquisition, the division that was formerly Mr. Tippets' company has been experiencing declining revenue. The acquiring company's public reports and press releases have accurately described the division's declining revenue and suggested that the decline was likely to continue for some period of time. About six months ago Mr. Tippets received a copy of the preliminary draft of the division's financial statements for the quarter. The acquiring company's policy was to impose a blackout on sales by employees and consultants covering the period from preparation of the initial drafts until public release of the acquired company's quarterly financial statements, and Mr. Tippets knew of that policy.

About the time Mr. Tippets received the draft financial statements he had been thinking he was somewhat remiss in not directing the sale of at least a part of the shares he had contributed to his charities in order to diversify their investments. The revenue figures shown in the draft financial statements were entirely consistent with the company's press releases dating back to shortly after the acquisition. Those press releases had been predicting a continuation of the declining earnings, and accordingly it did not occur to Mr. Tippets that sales at those times might constitute insider trading. He directed the sale of significant portions of the stock his charities held in the acquired company. These sales allowed the charities to avoid further loss in the value of the shares they held. Neither Mr. Tippets nor any member of his family sold any of the acquired company's shares or otherwise benefited personally from the sale of the company's shares by the charities, and in fact Mr. Tippets and members of his family personally continued to hold a large position in the company, made no sales from that position during the entire time in question, and as a result suffered significant losses on that stock.

The SEC subsequently investigated sales of the Company's securities by the charities and commenced a proceeding against Mr. Tippets alleging insider trading. Mr. Tippets settled the SEC proceeding by entering into a consent judgment in which he neither admitted nor denied violating the securities laws but agreed not to violate those laws in the future.

The OCC now seeks to remove Mr. Tippets as a director of the bank under Section 8(e)1 of the FDIC Act. Mr. Tippets and the bank ask you to assist in resisting that removal.

The OCC's argument is as follows. To justify removal the agency must establish misconduct, effect and culpability. The *misconduct* requirement is satisfied because the information contained in the draft financial statements Mr. Tippets received belonged to the acquired company and Mr. Tippets had a fiduciary duty not to use that information for the benefit of anyone other than the acquired company. It cites *U.S. v. O'Hagan*[74] for that proposition. The *effect* requirement is satisfied because even though Mr. Tippets did not receive any gain from the charity's sale of the stock, he received an "other benefit" in the form of recognition and gratitude for his generosity resulting from the funding of charitable causes from the charities' assets. The *culpability* requirement is satisfied because Mr. Tippets was guilty of personal dishonesty. He knew that sales were not permitted during the blackout period and directed the charities' sale despite that knowledge.

Can we successfully resist removal? We believe the answer is yes. While the OCC's claim that Tippett's conduct violated fiduciary obligations is somewhat novel in that the obligations related to information rather than to money, we would not expect to get very far challenging that part of the claim. Bank personnel deal regularly with information entrusted to them by the bank's customers, and the regulators are unlikely to accept the proposition that misuse of that information is not a violation of fiduciary duties.

The effect element of the alleged violation provides a more promising avenue of attack. Are recognition and approval from one's fellows sufficient to constitute an "other benefit" under the statute. So far as we have been able to determine, such ephemera have never been found to be "other benefits" for that purpose. On the other hand, we are also not aware of any cases rejecting such an argument. Under the circumstances here it seems a difficult argument for the regulators to sustain. Since Mr. Tippetts continued to hold his personal stock while his charities were disposing of theirs, he not only didn't make any money from the transactions. He probably lost money.

Our strongest line of defense here is one based on Mr. Tippetts' mental state. The cases make it clear that in order to remove an officer or director under Section 8(e)(1) of the FDIC Act, the regulators must show scienter. The learning of *Hendrickson* [75] is that the agency should look beyond the offense or violation forming the basis for the removal action to determine whether the underlying facts demonstrate personal dishonesty. Here the only testimony bearing on our client's mental state will presumably be his testimony that he did not regard the financial statements that had been delivered to him as material information, since they did nothing more than to confirm that problems which have been disclosed on ongoing basis continued to be

problems. At most, our client was guilty of faulty judgment in making that call, or at worst of simple negligence. Since one or two instances of simple negligence are insufficient to establish the necessary level of scienter, our client's actions here do not satisfy that requirement.[76]

Mr. Tippetts' case illustrates an interesting anomaly in the banking law. The moral threshold for entry into the banking system is significantly higher than the standard of conduct for staying in that business. The applicant for a new charter must be above suspicion like Caesar's wife. But to remove an officer or director the regulators must demonstrate, if not blood on the subject's hands, at least significantly more than the fact that they have been recently washed. There can be little doubt that the OCC would be upheld in determining that an applicant who had been enjoined from trading on inside information in the immediate past did not have the history of responsibility, personal honesty and integrity required for entry into the banking priesthood. Yet once admitted, the same conduct that would otherwise preclude him from entry is insufficient to have him defrocked.

(d) THE SON WHO KNOWS NOT HOW TO ASK

Mr. Stock made his fortune trading stock more than 10 years ago. He never was licensed as a broker or dealer under the Exchange Act. Unfortunately, he also made a few mistakes in choosing his advisers and was reluctant to spend a great deal of money on legal advice. As a result, his knowledge of the requirements of the securities laws was superficial to say the least, generally consisting of various bits of wisdom and urban legends picked up from participants in the brokerage industry. Over the course of his stock trading career he had had two separate run-ins with the SEC. The first involved unregistered sales of securities by a company in which he was a half owner. There was no allegation of his personal involvement in these sales -- the SEC complaint identified him as a co-owner of the defendant company but the transactions in question apparently were effected by his partner in the business. In the second SEC action, the SEC alleged that at approximately the same time as the first transaction Mr. Stock and his partner agreed to buy restricted securities of a different issuer from a former director of the issuer with the intention of immediately reselling those securities without registration. This transaction had been structured as a loan secured by the stock and the former director had defaulted on the first interest payment which had been due one month after closing. Mr. Stock tells you that he did not consult a lawyer about the particular transaction, but that the lawyer he had used in earlier transactions advised him that that stock which an affiliate had held for more than two years and then pledged to secure a loan could be sold by the lender to satisfy a default without registration in reliance on Rule 144.[77] The SEC further alleged that Mr. Stock had violated the Williams Act because the shares he and his partner acquired represented more than 5% of the outstanding stock of a company registered under the Exchange Act, and they had not filed an ownership statement under Section 13(d) of that Act.[78] Mr. Stock tells you that he didn't know that the Williams Act required reporting of the acquisition of 5% or more of a registered issuer's stock.

Mr. Stock and his long-time business partner from the securities business have been offered an opportunity to buy a minority interest in a bank holding company. The offer comes from a business acquaintance who owns 85% of the holding company's voting stock and is offering to sell Mr. Stock and his partner shares representing 30% of that voting stock, leaving the business associate with a 55 % controlling interest.

Mr. Stock tells you that his earlier experience with the SEC taught him that he should be cautious of plunging into the financial services area without consulting an attorney at every step of the way, and asks your assistance in completing the transaction.

You explain that even though the business acquaintance will maintain voting control of the holding company, the interest that Mr. Stock and his partner propose to buy will exceed the 25% threshold and will be deemed "control" under the Change in Bank Control Act.[79] They will have to file a notification of change in control with the Federal Reserve Board under that Act.

Will Stock's earlier run-ins with the SEC lead to disapproval of the proposed share purchase?

Before we even prepare the retainer agreement, we need to come to grips with the possible conflict we

may have in representing both Stock and his partner in the transaction. It may be in Stock's interest to cast the blame for the earlier securities law violations on his partner, and if so, we clearly can't represent both of them in the transaction. In fact one of the first question they ask after receiving the bad news that government approval will be required is whether they can't just split the proposed investment into investments of 15% by each of them.[80] After further questioning, you learn that neither Stock nor his partner intends to make the investment if the other one doesn't, and they really do intend to operate as a team rather than independently with respect to the investment. We conclude that even if the two potential clients split up their ownership, they will fall within the "acting in concert" provisions of the regulations, requiring a filing.[81] And since our two clients will be acting in concert there is nothing to be gained by trying to advance Stock's interest at the expense of his partner.

As noted above, the agency may disapprove the proposed acquisition if it finds that the competence, experience, or integrity of any acquiring person or of any of the proposed management personnel indicates that it would not be in the interest of the depositors of the bank, or in the interest of the public to permit the change in control. We have far fewer variables to work with in planning the submission of our notice of a change in control, compared to the a number of variables in a de novo application. The focus of the inquiry must be on the acquiring person and the proposed management personnel.

We will need to persuade the regulators of two things. First, that our clients' offenses under the securities laws do not indicate a lack of either competence or integrity. Second, that insofar as those violations might suggest a cavalier attitude toward compliance with legal requirements, that inference is not appropriate here. The problem is not that our clients didn't care. It is that in their youth and inexperience they didn't know enough to ask their lawyers. Our clients have learned from the earlier experience, and steps will be taken to eliminate any likelihood that they will be inclined to overlook technical legal requirements in the future.

The authors are not aware of any case law holding that either sale of unregistered securities or failure to file a required Williams Act report demonstrates an absence of integrity. This seems an appropriate place to bring into play the well-recognized distinction between acts that are *malum prohibitum* and acts that are *malum in se*. There is nothing inherently wrong with selling stock without registration under the Securities Act. Neither is there anything inherently wrong in not filing a Williams Act report. Both of these violations are violations solely because they violate statutory mandates -- mandates with which those not initiated into the securities brotherhood are not likely to be familiar. These violations occurred ten years ago at a time when our clients were novices to securities trading. Neither of our clients held an NASD license of any type and nothing in our clients' educational background provides a basis for thinking they should have known of the applicable legal requirements. The most that can be said is that our clients were foolish in relying on second-hand information and legal advice given in other contexts instead of paying for proper legal advice on the particular transactions. In other words, the violations demonstrate at most that our clients ten years ago lacked the experience they should have had before engaging in the kinds of securities transactions they were carrying out.

Turning now to the second point we wish to make with the regulators -- steps to avoid future problems -- we may have another opportunity for planning in advance of filing with the regulators. We can insist that the seller our clients are purchasing their shares from includes in the purchase contract a provision requiring the seller to cause the holding company to hire or retain (or to continue to hire or retain) a general counsel or an outside firm familiar with all aspects of the laws applicable to financial institutions, and make that general counsel or outside firm available for consultation with our clients from time to time as they may request, at the holding company's expense, on matters relating to our clients' obligations arising out of their ownership of shares of the holding company. Alternatively, our clients might insist that as part of the consideration for the purchase the holding company would reimburse our clients a reasonable amount for the costs of consulting their own counsel following the closing as to those obligations. In either case, we can then use the fact that they insisted on such a provision to demonstrate that our clients both recognize their earlier error and are making provision to avoid repeating that error in the future.

Will we succeed in persuading the regulators that they should not disapprove our clients' application? The authors believe there is a better than even chance that we should, but there is no assurance. In any event, we will have positioned our clients as best we could to challenge a disapproval under the arbitrary and capricious standard that would apply to such an appeal.

PART TWO: A BETTER SET OF KEYS?

Part One of this article describes the processes for obtaining a new bank charter, for acquiring control of an existing bank and for removal of an officer, director or controlling shareholder of an existing bank. In this part of the article, we explore why determining whether a particular applicant seeking to establish a new bank or acquire an existing bank will be able to pass regulatory muster remains something of a black art, suggest improvements in the process designed to create greater transparency in the process, and suggest changes that may be needed in the processes as a result of the vast increase in both public and non-public information available to regulators in passing upon proposed bank startups and acquisitions.

A SECRET RITUAL

Some 40 years ago, Professor Kenneth Culp Davis described the federal agencies' procedures for chartering banks and authorizing branches as follows:

> Even though these two functions often involve business interests of great magnitude, the banking agencies have been deciding cases (1) on the basis of secret evidence -- evidence which is quite unnecessarily concealed from affected parties, (2) with no systematic statement of findings on issues of fact, (3) without furnishing parties reasoned opinions on issues of law or policy, (4) without building a body of case law that is open to public inspection and that can be used for confining and guiding discretion, and (5) without clarifying or even attempting to clarify the details of policies through rulemaking, policy statements, or of opinions.[82]

In the years since the Davis article, items 2, 3 and 5 have undergone significant improvement. Today, decisions to deny the establishment of a new bank are provided to interested parties with a detailed statement of the reasons for the decision. And statements of policy have largely been articulated, though not with the degree of specificity one might wish. Items 1 and 4 even today leave a great deal to be desired. In fact it may be fair to say that the risk that a decision today will be based on secret evidence may be even greater than at the time Davis wrote. As to the development of a body of case law open to public inspection, the proliferation of easily searchable data makes it far easier to disseminate the necessary information than at any time in the past, but the agencies' treatment of written decisions constituting that case law have rendered much of the available information far less useful than it might be.

Part I of this article no doubt left the reader less than fully satisfied. Regulations and criteria are perfectly fine in the abstract, but we don't earn our keep by spinning abstractions. We earn our keep by helping clients. To be helpful to our clients, we need to know specifics: will my particular client's history keep him out of the banking business. The approval process as presently structured doesn't provide us with the necessary guidance. We believe there are several reasons for this.

LIMITED NUMBER OF REJECTIONS

The number of administrative decisions denying approval for chartering new banks, as well as the number of decisions disapproving proposed changes in control of existing banks is limited. According to the OCC's annual report for the 2006 fiscal year, the OCC's application activity with respect to new charters and changes in bank control were as follows:

	Applications received		FY 2006 Decisions			
	FY 2005	FY 2006	Approved	Conditionally approved	Denied	Total
Change in Bank Control	17	9	4	0	0	8*
Charters	26	47	4	30	0	34

*Four applications for change in control were withdrawn.

During the period from January 1, 2002 through September 30, 2006, activity relating to notices of change in control were as follows:

OCC Change in Bank Control Act Activity CY 2002-FY2006

Year	Received	Acted On	Not Disapproved	Disapproved	Withdrawn
FY 2006	9	8	4	0	4
FY 2005	17	17	17	0	0
FY 2004	16	14[1]	13	0	0
FY 2003*	16	10	9	1	0
CY 2002	0	10	9	1	0

* Reporting changed from calendar year to fiscal year, starting October 1, 2002 (FY 2003).

[1] Includes one notice with no activity. The OCC considered it abandoned.

The small number of disapprovals is not particularly surprising. As we indicated in Part I, the application process typically begins with an informal discussion with the regulators. Our experience is that where it is clear at the outset that approval will not be forthcoming the applicant simply never files his application. In addition, proper planning, together with informal interaction with the regulators can minimize the chances that an application will be disapproved. In most cases the organizers are likely to bend to the regulators' demands as to the proposed bank's management personnel by replacing an individual to whom objections have been raised, rather than challenging the regulators' exercise of their extremely broad discretion under the statutes. And when it is clear that that avenue is foreclosed because of the importance to the proposed organization of the particular individual to whom objection has been taken there is little point in suffering a denial of the application rather than simply withdrawing it. The result of all of these factors is that we simply do not have many charter rejections from which we can draw conclusions.

EXCESSIVE REDACTION IN PUBLISHED DECISIONS

Even where applicants have pressed forward and ultimately received rejection letters, those rejection letters are of little help in evaluating what the OCC regards as black marks in evaluating an individual's competence, experience or integrity. While the rejection letters are readily available on the OCC's web site, the OCC almost invariably redacts the entire description of information reflecting adversely on individual managers.[83]

The cumulative effect of eliminating potential applicants before an application is filed, adjusting the management team to avoid objections expressed informally to the applicant and excision of significant parts of those few decisions in which an application is actually disapproved creates a black hole in the universe of available information. We are left not knowing what is or is not sufficient to establish the experience and integrity demanded of those organizing or seeking to acquire a bank.

OPENING UP THE PROCESS

This informational black hole need not exist. While both the regulators and the regulated may legitimately want to avoid airing particular applicants' dirty laundry in published decisions, it does not follow that the bases on which applicants have historically been rejected as a result of lack of experience or integrity on the part of proposed management or controlling shareholders must remain forever a deep dark secret. We suggest that it would be most helpful for the OCC and other regulatory agencies to publish on a periodic basis compendia of the fact patterns leading to such rejections. Those fact patterns could be edited to remove dates, names and names of institutions, together with other information that might specifically identify the individual involved. They might include not only edited excerpts from decisions denying formation of a bank or disapproving a change in control, but also excerpts from letters and other correspondence with applicants (with appropriate editing) which otherwise might never see the light of day, including requests for additional information and supporting documentation to satisfy concerns emerging as a result of the agency's investigation. The availability of this early-stage correspondence could be of great assistance to practitioners. For example, if

the organizers decide to replace one or more members of proposed management in response to regulators' comments at informal meetings, that decision provides a useful guidepost to other applicants as to whether their proposed management personnel will be satisfactory. Similarly, this early-stage correspondence may highlight potential weaknesses in the initial business plan -- weaknesses other applicants will wish to avoid or address at the outset.

While not a perfect analogy, we note that the SEC in May of 2005 began to make available to the public the text of comment letters issued by its staff on registration statements and periodic reports under the Securities Act of 1933 and the Securities Exchange Act of 1934, together with issuers' responses to those comment letters. The SEC's review and comment process had been in effect for many years, but until the Commission determined to make these letters publicly available the positions the staff was taking on a number of issues could be gleaned only through direct correspondence with the staff on a particular filing, word-of-mouth, and/or appearances by staff members at CLE seminars.

Public release of the comment letters has opened to practitioners and entire body of "lore" and has, in the judgment of many practicing in that field, substantially eased the burdens associated with preparing disclosure documents, as well as reducing the burden on the SEC's staff. We suggest that our proposal could have a similar favorable effect in the banking field, eliminating in advance many of those candidates for management positions who might otherwise be rejected only after considerable time has been devoted to investigating and evaluating them, and also reducing the time spent by regulators on potential applications that will never be filed.

SECRET EVIDENCE AND INFORMATION OVERLOAD -- HOW DO YOU CROSS-EXAMINE A DATABASE?

Professor Davis described the pre-approval investigation being performed in connection with new bank applications at the time of his article as follows:

> [W]hen the Comptroller receives an application, an examiner is directed to make an investigation. He is instructed to interview proponents and opponents, as well as local businessmen....
>
> Some of the information the investigating examiner brings in may be of a highly personal character. The examiner is instructed to investigate 'qualifications and integrity of the organizers, directors, officers, and other principles of the proposed bank'... the examiner must 'evaluate' each such individual as to such factors as 'sincerity of purpose' and 'character and standing in the community.' Although such mixtures of information and subjective opinion or emotion may properly be protected from public knowledge, I think the irreducible minimum of procedural fairness requires that no derogatory information or opinion should be used against any individual whose rights are at stake without privately confronting him with it and its source and listening to what he has to say.

That description seems almost quaint today. While interviewing proponents, opponents and local businessmen may still provide regulators with a great deal of useful information, those sources of information pale in comparison to the quantity of data collected today and available through simple searchers and through data mining techniques.

When Professor Davis wrote, there was at least a reasonable chance that the subject of an investigation would have a good idea of the sources the investigator consulted. If an investigator came around asking questions of the subject's acquaintances, former employers and local community leaders, chances are that that information would filter out to the subject in one fashion or another. Similarly, the subject of an investigation would likely have a fairly accurate picture of what could be gleaned about him from the media and public records. But consider for a moment how each of us carries out our own factual investigations today.

Certainly a starting point is likely to be a search of the information available on the Internet. That initial search will turn up perhaps hundreds and perhaps thousands of possible sources some of greater reliability and some of lesser reliability. In a few short hours an investigator may click through perhaps 100 of those URLs, rejecting some immediately, skimming some and reviewing some in detail. News stories such as those about our Mr. Lord's activity as a

"slum lord" will undoubtedly figure prominently among the sources coming to the investigator's attention, coloring his point of view.

This preliminary search will almost invariably implant in the investigator's mind facts that will enter into his overall evaluation of the subject of the search. Many of the avenues pursued will probably not even be recorded. Others may be printed out and placed in the record of the investigation. How can the subject of the investigation assure himself that the "facts" the investigator has uncovered present a fair and accurate impression of the subject's character?

Next consider specific pre-identified databases. Guidelines adopted as far back as 1988 by the FRB, OCC, FDIC, FHLBB and NCUA called for the following standard background checks on all individuals subject to background investigations:

- FBI General Index Namecheck;
- United States Custom Service Namecheck
- Drug Enforcement Administration Namecheck
- Search of internal agency records and of databases to which the agencies have access;
- Check records on an interagency basis when an individual has been involved with institutions under another agency's regulatory jurisdiction; and
- Check with state depository institution regulatory agencies when an individual has been involved with institutions under a state's regulatory jurisdiction.[84]

Add to those records the additional data created and maintained by the regulatory agencies themselves specifically to facilitate investigations of individual applicants. For example, OTS officials have testified that the OTS maintains its own secret database known as the Confidential Individual Information System containing information concerning “individuals who have filed notices of intent to acquire control of savings associations, individuals who have applied to become senior officers or directors of savings associations, individuals who have a history of professional ethics, licensing or similar disciplinary problems, or have been subject to an agency enforcement action, and individuals involved in a significant business transaction with an institution.” [85] Information in that database is shared with, among others, the SEC, the CFTC, NASDR, the National Association of Insurance Commissioners and the banking regulators of forty-one states. It seems a reasonable guess that the OCC, FDIC and other banking regulators each maintains a similar database and makes it available to other agencies. In addition, since reports of examination of financial institutions are stored in digital format, even relatively simple data mining techniques can locate every mention of any individual referred to in any way in one of those reports from the time he first entered the industry.

Beyond the government-maintained databases we have, of course, the massive quantities of data collected and maintained by private data brokers. According to one report the FBI has for at least several years been purchasing access to databases maintained by Choicepoint, a private data broker whose databases contain “billions of personal records about nearly every person ...in the United States." [86] The extent to which the data is shared with federal bank regulatory agencies is unclear. But so far as the authors are aware there is no legal restriction on the use of such information to complete an investigation of those seeking to establish or acquire banking institutions. Moreover, unlike many of the databases maintained by governmental agencies, databases maintained by private data brokers are generally not subject to the requirements of the Privacy Act.[87]

Effectively, then, we have an entirely new body of secret evidence to which the regulators may refer in passing on applications to start or acquire a bank.

Add to the information contained in deliberately maintained databases the vast quantity of information available today through a simple Google, AltaVista or Yahoo search, and the volume of secret, or at least unidentified, evidence that may affect a regulator's decision on an application represents not just a difference in amount, but a difference in kind of evidence from that available in Davis's day. How are we to apply Davis's procedural safeguards -- the right to counter adverse evidence presented to the regulators and to require written opinions setting forth their basis of decision -- in this environment? The very real risk is that regardless of what an agency's written opinion says, the examiner's decision may have been heavily colored in advance by information that will never see the light of day.[88]

The vast quantity of additional information available to regulator suggests that it may be time to reconsider the degree of discretion granted to the banking regulators in determining whether or not a hearing is appropriate, and to more closely tailor the form of hearing to the matter to be considered. It may be appropriate to expand the right of an applicant that has been rejected to allow the applicant to examine the agency official conducting the investigation as to the information he reviewed in reaching his decision. Such a procedure has been adopted by at least one state's banking law. The Wyoming banking law provides that "[t]he state banking commissioner shall submit his findings verbally and in writing at the public hearing on the application and shall be subject to cross-examination by any interested party." [89] If examination of the agency official indicates that the decision to deny the application was affected by information not otherwise made available to the applicant the applicant would be afforded the right to cross-examine witnesses and present testimony challenging that information. So far as consideration of the application was affected by information which the agency believes should not be available to the applicant, those portions of the record containing that information would be submitted to the court on a sealed basis in connection with any challenge of the denial.[90]

SUMMING IT UP

Despite the questionable historic basis of our present system of admitting new entrants to the banking field, that system has for the most part worked well. Through a combination of formal and informal procedures, sorting out those who will be admitted to the inner sanctum from those who will not is a relatively efficient process. Improvements are possible and desirable both in increasing the transparency of determinations made in the regulatory process and in coping with systemic information overload that is likely only to increase in the future. We have tried in this article to suggest the direction these improvements might take.

NOTES

[1] Those who practice in the banking area will immediately note that we have treated in a relatively indiscriminate fashion the decisions and standards of the alphabet soup of regulatory agencies responsible for regulating banking institutions, as well as the actions of various state banking regulators under our country's dual banking system of federal and state banks. We have done so because in our view the principles we suggest should be equally applicable regardless of which federal or state regulator is responsible for a particular decision.
[2] 12 U.S.C. §21 et. seq.
[3] 12 U.S.C. §1817(j).
[4] 12 U.S.C. §1811 *et. seq.*
[5] Most state banking laws closely resemble the federal model, though there may be significant variations from state to state. For example, New York, in addition to providing for background investigation by the Banking Department, requires submission directly to the Banking Department of a report prepared by a private investigator. In New Jersey, notice of each application for a new banking charter must be given to New Jersey Bankers Association, and the New Jersey League of Community Bankers. NJAC § 3:1-2.5. A hearing is mandatory in all cases, and interested parties are afforded the opportunity to oppose the application at the hearing. Information to be presented at the hearing is presented by sworn testimony and is generally limited to matters raised in the application or in objections filed prior to the hearing. Questions may be addressed to the applicant, objectors and witnesses after each of their presentations by the hearing officer or Department hearing panel. Cross-examination is permitted in contested cases NJAC § 3:1-2.14.
[6] During the period from 1811 to 1816, there were no federally chartered banks, as the legislation chartering the First United States Bank was allowed to expire in 1811 and the Second Bank of the United States was not chartered until 1816
[7] History Central, National Bank Act - June 3, 1864, http://www.historycentral.com/documents/Nationalbank2.html
[8] Profile: Hugh McCulloch at http://www.occ.treas.gov/OCC140th/McCulloch.htm
[9] Indiana adopted its free banking law in 1852. Ohio passed a law in May 1854 that made it illegal as of October 1, 1854, for anyone in Ohio to use small banknotes issued by banks in other states. This decrease in the demand for Indiana banknotes resulted in the return of the notes for redemption and decreases in the prices of Indiana bonds, which were about two-thirds of the banks' security deposits. G. Dwyer, Wildcat Banking, Banking Panics, and Free Banking in the United States, Economic Review of the Federal Reserve Band of Atlanta, December 1996.
[10] From 1875 until 1908, Comptroller's office took precisely the reverse position -- that the Comptroller had no discretionary power in the matter, but must necessarily sanction the organization of any association complying with the statutory requirements. Scott, In Quest of Reason: The Licensing Decisions of the Federal Banking Agencies, 42 Chicago Law Review 235 (1975).
[11] Disapproval Letter, http://www.occ.treas.gov/corpbook/occforms/DisapprovalLetter.doc.
[12] *Sletteland v. Federal Deposit Insurance Corporation*, 924 F.2d 350, 288 U.S. App. D.C. 106 (1991). "We defer to the FDIC's reasonable interpretation that subsection (7)(D) authorizes the agency to apply the same standard of 'competence, experience, or integrity' to controlling shareholders and management." It is worth noting that the regulatory agencies have been willing to entertain creative solutions other than exercise of their statutory remedies of disapproval or removal. The authors are aware of at least two recent instances in which regulators accepted an effective "neutering" of controlling shareholders' control through a voting trust arrangement rather than requiring those shareholders to divest their interests in the institutions.
[13] In addition to the provisions discussed in the article, the FDIC's determination to grant or withhold insurance involves an evaluation of a bank's management, and may lead organizers to replace one or more individuals, and 12 U.S.C. §1831i requires regulatory approval for the appointment of officers and directors of undercapitalized institutions. Those provisions are beyond the scope of this article.
[14] Kenneth Culp Davis, Administrative Procedure in the Regulation of Banking, *Law and Contemporary Problems*, Vol. 31, No. 4, Banking: Part 1: Banking Regulation (Autumn, 1966), pp. 713-722 at 715.
[15] For a classic example of how not to prepare a business plan, consider this excerpt from the OCC's letter disapproving the application for a proposed First Value National Bank, National Association, Corporate Decision #97-64, August 1997: "Our field investigation also revealed that the organizers copied almost the entire narrative section of the operating plan from another charter application that was previously approved by this office. Because the operating plan is a near duplicate of another bank's charter application, it is difficult to assess the nature and extent of the organizers' involvement in its

preparation, to gauge the organizers' true vision of the proposed bank, and to accurately assess its prospects for success. This fact reflects negatively upon the group's ability to establish and operate a successful bank. In the charter evaluation process, the OCC considers it to be critical that all organizers, particularly the proposed chief executive officers, be involved in the development of the operating plan."

[16] 12 U.S.C. §21; 12 CFR §5.20.

[17] 12 U.S.C. §§26, 27.

[18] See Comptroller's Licensing Manual -- Charters, http://www.occ.treas.gov/corpbook/group4/public/pdf/charters.pdf.

[19] See Comptroller's Licensing Manual -- Background Investigations, http://www.occ.treas.gov/corpbook/group1/public/pdf/backgrnd.pdf. In New York, at least, the applicant for a state bank charter must also provide the agency with a thorough investigatory report from a private investigator.

[20] 12 CFR §5.20(f)(ii). The factors to be considered in determining whether FDIC insurance is to be provided are:

- The financial history and condition of the depository institution.
- The adequacy of the depository institution's capital structure.
- The future earnings prospects of the depository institution.
- The *general character and fitness* of the management of the depository institution. (Emphasis supplied)
- The risk presented by such depository institution to the Bank Insurance Fund or the Savings Association Insurance Fund.
- The convenience and needs of the community to be served by such depository institution.
- Whether the depository institution's corporate powers are consistent with the purposes of this chapter.

[21] 12 C.F.R. §5.20 (f)(ii); (g)(3)(i).

[22] Comptroller's Licensing Manual—Public Notice and Comments http://www.occ.treas.gov/corpbook/group1/public/pdf/PI.pdf.

[23] 12 C.F.R. §5.11(g)(3).

[24] 12 CFR §5.13.

[25] At this point is worth noting that even where a discretionary hearing has been granted in accordance with OCC regulations, the type of hearing is likely to be ill-suited to passing upon the moral fitness or honesty of the proposed organizers or managers of the new bank. The immediate tipoff here is the regulations' public notice requirements. The purpose of the hearing is to give those who would be affected by the grant of a new bank charter an opportunity to present reasons for their support or opposition to the charter grant-- is a new bank needed at that location, how adequate are the services provided by existing banks, what is the competitive situation, etc. In fact, if one or more of the organizers or managers of the proposed bank is well known and likely to inspire controversy, the public hearing format bids fair to turn the hearing into a three ring circus rather than a dispassionate evaluation of the fitness of these individuals.

[26] 5 U.S.C. §701.

[27] App. D.C. 94, 33 F.2d 805 (1929).

[28] 12 U.S.C. §611 *et seq.*

[29] *Supra*, n. 10.

[30] 12 U.S.C. §1461 *et. seq.*

[31] 284 F.2d at 278.

[32] 320 F. Supp. 1185 (S.D. Tex. 1979).

[33] 320 F. Supp. at 1187 (S.D. Tex. 1979).

[34] *Klanke v. Camp*, 327 F. Supp. 592 (S.D. Tex. 1971).

[35] 12 U.S.C. §27

[36] 12 C.F.R. Part 225.

[37] 12 C.F.R. 225.41(c)(2).

[38] 12 U.S.C. §1817(j)(2).

[39] Comptroller's Licensing Manual—Background Investigations, http://www.occ.treas.gov/corpbook/group1/public/pdf/backgrnd.pdf.

[40] 12 U.S.C. §1817 (j) (7)

[41] *Alvarez-Stelling v. Siebert*, 98 Misc. 2d 1055, 415 N.Y.S.2d 378 (Sup. Ct. 1979).

[42] 5 U.S.C. §554.

[43] See generally 12 U.S.C. §1817(j).

[44] 12 U.S.C. §1818(e)(1)

[45] *Oberstar v. Federal Deposit Insurance Corporation*, 987 F.2d 494 (8th Cir. 1993)

[46] 113 F.3d 98 (7th Cir. 1997).

[47] 747 F.2d 1198 (8th Cir. 1984).

[48] *Brickner, supra* n. 47 at fn 6.
[49] Annot.: When has bank official demonstrated "willful or continuing disregard" for safety or soundness of bank justifying removal and bar by appropriate federal banking agency pursuant to 12 U.S.C.A. § 1818(e), 130 A.L.R. Fed. 561
[50] 40 F.3d 1050 (9th Cir. 1994).
[51] 619 F. Supp. 866 (D.D.C. 1985).
[52] 747 F.2d 1198 (8th Cir. 1984).
[53] 992 F.2d 1531, 7 FLW Fed C. 449 (11th Cir. 1993).
[54] Letter dated September 5, 1975 from Board of Governors of the Federal Reserve System, CCH Federal Banking Law Reporter 1973-78 Transfer Binder ¶ 96,641.
[55] 12 USC §1818(e)(4).
[56] 12 USC §1818(h).
[57] See generally 12 USC §1817(j).
[58] 31 U.S.C. §5311 *et. seq.* For those unfamiliar with it, this rather Orwellian named statute makes it unlawful for banks to keep certain of their clients' transactions secret from the government.
[59] There is some support for the view that in the bank licensing context the acts of a subordinate may be attributed to the subordinate's manager in evaluating the manager's fitness to manage a financial institution. See *Cornelius v. Connecticut Department of Banking*, No. CV044000627, 2005 WL 1757631 (Conn.Super. Jun. 14, 2005) (Unpublished Opinion). (Employees of a mortgage broker operating as a sole proprietorship submitted forged appraisal reports. No evidence of any knowledge or involvement by the proprietor. "Under the doctrine of respondeat superior, a master is liable for the wilful torts of his servant committed within the scope of the servant's employment and in furtherance of his master's business... The master is not held on any theory that he personally interferes to cause the injury. It is simply on the ground of public policy, which requires that he shall be held responsible for the acts of those whom he employs, done in and about his business, even though such acts are directly in conflict with the orders which he has given them on the subject.... It is not unreasonable, arbitrary, capricious or erroneous for the commissioner to make the determination that the submission by a licensee of false documents to support mortgage loan applications supports a finding that the "character, reputation, integrity and general fitness" of the licensee is not such as to warrant a belief that such licensee's business would be operated soundly and efficiently in the public interest.") This does not appear to be a widely held view.
[60] See 5 U.S.C. 552a(j)(2).
[61] Comptroller's Licensing Manual—Public Notice and Comments http://www.occ.treas.gov/corpbook/group1/public/pdf/PI.pdf at 13. See also discussion of *Connelly v. Comptroller of the Currency* at page 16.
[62] 360 U.S. 474 (1959).
[63] 360 U.S. 474, 496.
[64] 360 U.S. 474, 499.
[65] 360 U.S. 474, 506.
[66] 360 U.S. 474, 507.
[67] 360 U.S. 474, 508.
[68] 673 F. Supp. 1419 (S.D. Tex. 1987) rev'd in part on other grounds, 876 F.2d 1209 (5th Cir. 1989).
[69] 673 F. Supp. 1419, 1423.
[70] Supra, p. 62.
[71] Supra, n. 68.
[72] See letter dated November 7, 2000 from Citigroup to Julia L. Williams, Esq. at http://www.occ.treas.gov/foia/11_7response.pdf.
[73] See fn. 59.
[74] *United States* v. *O'Hagan,* 521 U. S. 642 (1997).
[75] Supra, n.46.
[76] The cases indicating that simple negligence does not provide a sufficient basis for removal arose under the "willful and continuing disregard" language of the Act, and not under the personal dishonesty language. Since the "willful and continuing disregard" language was added to cover cases in which the regulators were unable to show personal dishonesty (see discussion at page 11), the absence of sufficient scienter to show continuing disregard should *a fortiori* negate personal dishonesty.
[77] While the advice Mr. Stock received is true as a general matter, it applies only to a bona fide pledge. The SEC has historically been highly skeptical that a bona fide pledge occurred where a default on the underlying obligation occurs soon after the pledge was made.
[78] 15 U.S.C. §78m(d).

[79] 12 U.S.C. 1817(j).
[80] Under the applicable regulations, the acquisition of 10% or more, but less than 25%, of a holding company's stock is deemed to be a change in control unless another person holds a larger block than the block of stock to be acquired. Since the proposed seller would continue to hold 55% of the holding company's stock, acquisition of 15% by each of Stock and his partner individually would not be deemed a change in control.
[81] See 12 C.F.R. 303.82.
[82] Kenneth Culp Davis, Administrative Procedure in the Regulation of Banking, *Law and Contemporary Problems*, Vol. 31, No. 4, Banking: Part 1: Banking Regulation (Autumn, 1966), p.713.
[83] See e.g. Banco de Prestamos National Bank (proposed), Corporate Decision #97-59, July 1997; First Value Corporation, Corporate Decision #97-64, August 1997; Security National Bank (Proposed) Corporate Decision #2001-09 May 2001;Rock Asia Capital Bank, National Association (Proposed) Corporate Decision #2003-8, July 2003.
[84] Joint statement of guidelines on conducting background checks and changing control investigations dated January 22, 1988, 1999-2000 CCH FBLR Transfer Binder ¶ 83-913.
[85] Testimony of Scott Albinson, Managing Director, Supervision, Office of Thrift Supervision before the House Committee on Financial Services, Subcommittee on Oversight and Investigations and Subcommittee on Financial Institutions and Consumer Credit, March 6, 2001, http://www.ots.treas.gov/docs/8/87082.html.
[86] Harris, D., FBI, Pentagon pay for access to trove of public records, GovExec.com November 11, 2005, www.govexec.com/story_page.cfm?articleid=32802&sid=28
[87] 5 U.S.C. § 552a(m)(1) provides that when an agency provides by a contract for the operation by or on behalf of the agency of a system of records to accomplish an agency function, the agency shall, consistent with its authority, cause the requirements of the Privacy Act to be applied to such system. The extent to which a contract to purchase data constitutes operation of the private system "by or on behalf of the agency" is beyond the scope of this article.
[88] See e.g. *Leuhrs v. Spaulding*, 80 Idaho 326, 328 P.2d 582 (Idaho 1958). The commissioner of finance had determined that bank incorporators had complied with all provisions of law required to cntitle bank to engage in banking, but refused to approve the charter because the proposed President had “never run a bank.” Rejecting a claim that the appropriate remedy would be an order directing the regulator to act by either approving or disapproving the proposed charter, rather than an order directing him to grant the charter, the Court said: “The evidence justifies the conclusion that before the suit was commenced the defendant had determined to deny the application but perhaps had not decided upon the reason to be assigned. Formal demand that he act or a suit to require him to act undoubtedly would have produced a denial based upon grounds clearly involving discretion. A suit of that character would have marked the end of plaintiffs' hope to obtain charter.”
[89] Wyoming Statutes §13-2-211 (b).
[90] See e.g. Citizens National Bank of Southern Maryland v. Camp, 317 F. Supp. 1389 (D. Md. 1970) “If the Comptroller's final decision on the application is adverse to Citizens, and further court proceedings are had, the material not made available to counsel should be submitted sealed to the Court, so that it may review the propriety of the ruling.”

Practice Areas

- Banking and Finance
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- Litigation

Education

- J.D., Benjamin N. Cardozo School of Law, Yeshiva University, 1984
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- New Jersey (1985)
- U.S. Court of Appeals for the Second Circuit (2000)
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Pinchus Raice represents financial institutions and individuals in negotiating and completing mergers and acquisitions in the community banking industry, and represents banks and bank officers and directors before all federal and state bank regulatory agencies, including contested administrative proceedings. Pinchus has served as outside counsel to numerous New York and New Jersey-based commercial and savings banks in a broad range of matters; as in-house counsel to a New York savings bank; and as a federal bank regulator with the FDIC's New York office.

Pinchus' practice includes the representation of commercial banks, corporations and individuals in complex commercial litigation involving banking and intellectual property matters. Pinchus has extensive experience representing commercial and savings banks, publicly and closely held corporations, commercial real estate investors and other individuals in a broad range of bank-related litigation, including bank fraud litigation, directors' and officers' liability suits, accountants' liability suits, letters of credit litigation, Uniform Commercial Code claims and real estate-related litigation.

Pinchus recently represented one of the nation's largest real estate holders in the acquisition of a controlling interest in a bank that is among the fastest growing commercial banks in the country, and the selling shareholders of a bank in the sale of that institution to a publicly traded bank holding company while concurrently representing the selling institution in a threatened Financial Crimes Enforcement Network action seeking civil money penalties for alleged violations of the Bank Secrecy Act, obtaining a very favorable outcome.

Publications

- Co-author (with David C. Thomas), *Sinners at the Pearly Gates - A Primer on the Standards of Admission to the Banking Fraternity* (February 2007)

Professional Affiliations

- New York County Lawyers Association, Member, Committee on Banking (1988-96)
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Most recently, Mr. Thomas has concentrated his practice in the area of bank acquisitions. He represented the former President of a quasi-governmental mortgage agency in negotiating a $100 million contract to acquire a municipal securities dealer and corporate securities dealer.

Previous Positions

- Raice, Paykin, Greenblatt, Lesser & Krieg LLP, Partner (2000-05)
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- Leibowitz & Peterson, Partner (1985-90)
- The Singer Company, Corporate Counsel – Finance (1984-85)
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