LEGAL ASPECTS OF PREPARATION OF REPORTS FOR POSSIBLE SUBSECTION (i) PROCEEDINGS

BY

G. J. OPPEGARD
Counsel, Federal Deposit Insurance Corporation

Presented at the

Conference of Supervising Examiners

Washington, D. C.

April 24, 1950

April 24, 1950

LEGAL ASPECTS OF PREPARATION OF REPORTS
FOR POSSIBLE SUBSECTION (i) PROCEEDINGS

It appears to me that in order to properly consider what are the "Legal Aspects of the Preparation of Reports for Possible Subsection (i) Proceedings", we should first refresh our minds on what are the legal aspects of the proceedings themselves.

To correctly appraise the significance and the proper use of these proceedings, it is helpful to first take a fast look at the Federal Deposit Insurance law -- its purpose and objectives. This is particularly important now when we are being charged from many quarters with appropriating supervisory powers.

Preliminarily, let us be reminded that, although banking is a private business, it is affected with a public interest. A bank operates almost exclusively on the funds of the public and, accordingly, it has its roots in, and gains its strength from, public confidence. This public interest is the touchstone for providing official supervision of the business. The purpose of such official supervision is to assure and justify that confidence.

In other words, the primary purpose of all bank supervision is to protect deposits and, incidentally, to thereby permit checks to

circulate freely as money. That purpose is also the primary purpose of Federal deposit insurance. Of course, technically speaking, the FDIC should not be denominated a supervising agency but, regardless of the connotation given it, Congress placed in the FDIC the duties and responsibilities of a supervising agency. In subsection (i) Congress said to our Board, in effect, it is your duty and responsibility to keep the insured banks within the well-marked channels of safe and sound banking. It did not give our Board any discretion in that respect. See for yourselves. The law reads:

> "Whenever the board of directors shall find that an insured bank or its directors or trustees have continued unsafe or unsound practices in conducting the business of such bank, or have knowingly or negligently permitted any of its officers or agents to violate any provision of any law or regulation to which the insured bank is subject, the board of directors shall first give to the Comptroller of the Currency in the case of a national bank or a District bank, to the authority having supervision of the bank in the case of a State bank, or to the Board of Governors of the Federal Reserve System in the case of a State member bank, a statement with respect to such practices or violations for the purpose of securing the correction thereof."

And here I might suggest the anomaly of placing on our Board the duty and responsibility to make banks stay within the confines of safe and sound banking. But Congress did not give our Board visitorial powers over all insured banks. In fact our effective visitorial powers are applicable to banks having only 15% of the insured deposits. As to insured banks carrying 85% of the deposits, we must rely on other agencies advising us

of whether the banks are engaged in any unsafe or unsound practices or violations of law. Yet, the duty of maintaining a safe and sound banking system is ours by Congressional mandate.

Another thing I want to point out and emphasize is that the Statute is primarily a so-called preventive Statute, i.e. its main purpose is, not to terminate the insurance, but to obtain corrections and thus to prevent bank failures. Purpose is to cure the corporate sickness, not to destroy it. The Statute affords our Board the opportunity to provide guides for the conduct of safe and sound banking by prescribing corrective measures. It proceeds on the theory that an ounce of prevention is worth a pound of cure by making it unnecessary to wait for insolvency in order to proceed against the bank. It is not necessary that the misconduct be so culpable as to justify receivership. The purpose is to nip misconduct before it renders the bank insolvent. (Obispo case). The statute also smacks of benevolence (to sin comes natural - to forgive is devine) in that it recognizes repentance. As noted, it provides a period in which corrections may be made and it follows that if corrections are made, the proceedings must be terminated.

So much for a brief reminder of what are the legal aspects and primary purpose of such a proceeding. Now to move closer to our subject, let us discuss the terms used. To properly utilize these proceedings, it is, of course, necessary that we know what

constitutes "unsafe and unsound practices". Violations of law or regulations are, in this respect, quite self-explanatory. The FDI Act does not define the terms "unsafe or unsound practices", and I have found no other law - State or Federal - defining them. We must, therefore, resort to custom and cases. Although Congress has not defined the terms, our Board of Directors has done so and has advised Congress thereof a number of times through its Annual Reports. For instance, in its 1936 Annual Report, on page 18, it listed 58 unsafe and unsound banking practices and violations of law and regulations for which 24 insured banks were proceeded against under subsection (i) during the year 1936. We presume that there is legal precedence for assuming that since Congress has taken no action to repudiate these characterizations by our Board as being unsafe or unsound banking practices under the FDI law, that it acquiesces in our Board's interpretations of that provision of our law.

However, there is some case law on this subject. It was held in Dickenson vs. Cass Co. Bank, (Iowa, 1895) 64 N.W. 395, that a showing that the bank was continuing business at a loss and allowing assets to become of such a character and so scattered as not to be readily realized on was unsound banking practices.

In the case of Robinson vs. Parker (Wisc. 1927) 213 N.W. 653 at p. 655, the Court said:

> "But by far the most dangerous and serious condition in a bank is met where the capital is either substantially impaired or entirely wiped out. Such a condition manifests imminent danger to depositors, and requires prompt and efficient action on the part of the banking department. But even under such a situation the commissioner, in the exercise of a wise judgment, in many instances, by his advice and suggestion, has averted many a disastrous failure."

Harley vs. Peoples (Mo.) 94 S.W. 953. The Court upheld the right of the Commissioner to request the change in the directorate of a corporation for unsafe and unsound practices.

In In re S. Lunghino & Sons, 163 N.Y.S. 10, the appellate court agreed with the lower court that the following were unsafe and unsound practices: dealing in purely speculative securities, running of business as a speculation, placing of inflated valuations on properties owned, the hypothecation of good securities as collateral for loans, failure of officers to devote sufficient time to banks' business, and allowing the capital to become heavily impaired. The appellate court said that: "Such were some of the utterly reckless and irresponsible methods of (bank) at the time of the refusal of the superintendent to grant (it) permission to continue its business." In Leary vs. Capital Trust Co., 265 N.Y.S. 856, the appellate court said that the lower courts refusal to permit a trust company to invest one-third of its assets in a lease and furniture and fixtures was not an arbitrary exercise of

power on the part of the Superintendent. See also Harlan Valley Title and Mortgage Co. vs. White, 296 N.Y.S. 424. * See extra sheet.

However, I am not going to spend much time with you on the question of what constitutes unsafe or unsound practices. After all, the Legal Division must largely rely on you examiners as to what constitutes unsafe and unsound practices. You are experts, the technicians, in that respect. At this point, I want to refer you to the instructions governing the examination procedure for the preparation of subsection (i) cases as set out in the black instruction book. These instructions have been very carefully prepared and no examiner should endeavor to prepare a record for such a proceeding without being thoroughly familiar with them.

You will observe that we have there defined "unsafe and unsound practices" as those practices "which are contrary to accepted banking standards and the continuance of which are hazardous and may result in ultimate loss to depositors, this Corporation, and its stockholders." You will further observe that such practices may consist of either affirmative or negative action, or both. Needless to say, great caution must be observed in invoking these proceedings and greater caution must be observed in so denominating a practice. We must be sure that the practice complained of is in fact an unsafe and unsound practice. For instance, I have a report on my desk now in which the examiner has charged the bank

with an unsafe and unsound practice in investing 38.6% of its assets in loans. He points out, in support of this charge that the national average of loans to total assets of all insured commercial banks is 27.6%. I do not believe that the fact that the bank has 38.6% of its assets in loans is per se an unsafe or an unsound practice, nor do I believe that the fact that the national average of loans to total assets in all insured banks of 27.6% proves the charge

In determining whether a particular practice is an unsafe or unsound practice, consideration must be given to the statutes under which the bank is operating. These governing statutes express the public policy in respect to the operation of the banks within their purview. The people of a State, for instance, have prescribed the powers of its State banks, and have marked the boundaries of their activities. This does not mean, however, that unless a bank violates the governing law, it cannot be proceeded against in these proceedings. Congress recognized that a bank may not violate any law yet it may be engaging in unsafe and unsound practices - because the law reads - unsafe or unsound practices or violations of law. Furthermore, a bank may comply with the State law, yet be engaged in an unsafe and unsound practice. The bank may erroneously do that which it is authorized to do when done properly. (Improvident loans - unwise investments). It may have the minimum

capital required under the State law, yet our Board may find that its capital is inadequate in view of its asset condition, and that the operation with such inadequate capital is an unsafe and unsound practice. Nor does it mean that State statutes control over the FDI law. Where the two clash, the FDI law, being a Federal law, prevails.

For instance, the State statutes prescribe the minimum capital requirements for a State bank. Query - is this Corporation bound by such statutes either in admitting a bank to deposit insurance or in continuing its insured status. The Attorney General of Iowa, in an opinion of April 28, 1949, to the State Superintendent of Banking, Mr. Newton P. Black, advised him that this Corporation could not require Iowa banks to provide capital funds in excess of the amount required by the State statutes. His position, as I read his opinion, is that if a bank has the minimum capital required under the State statute, this Corporation would have to find favorably upon the factor of "adequacy of its capital structure" in admitting the bank to deposit insurance; and that an insured bank meeting the requirements of the State statutes in that respect could not be proceeded against under subsection (i) for inadequacy of capital. We do not agree with either of his positions. As stated, in admitting a State bank to deposit insurance one of the factors to be considered by our Board is the "adequacy of its capital structure". In addition to that, the Board must

first determine, upon the basis of a thorough examination of the bank, that its assets in excess of its capital requirements, are adequate to meet all of its liabilities. If Congress had intended that the Board should be restricted to a consideration of meeting the State requirements in respect to capital funds, it could have said so. This it did not do. On the other hand, Congress expressly said our Board should determine the adequacy of the capital. Provided, in doing so, it shall not discriminate against a State bank because its capital is less than the amount required for admission into the Federal Reserve System. This proviso means that our Board shall not deny a bank deposit insurance simply because its capital is less than that required for admission to the Federal Reserve System. As we know, the minimum capital requirements vary in the several states. To say that our Board's discretion is controlled by the State statutes is to say that our Board must apply a variable standard which will necessarily result in discrimination. And it follows, that our Board is not bound by the State authority in determining the adequacy of the capital of an operating insured bank.

OFFICIAL STATEMENT

I shall now briefly discuss the statement of unsafe or unsound practices which is sent to the Supervising Authority.

The law says that when our Board of Directors finds that an insured bank is engaged in unsafe or unsound practices or

violations of law, it must send a "statement with respect to such practices or violations of law, for the purpose of securing the correction thereof." This statement is the equivalent of a complaint in a civil action or an indictment or information in a criminal action. The statement must show a prima facie case and we must remember that - on him who avers - is the burden of proof. The Corporation is the plaintiff and the bank is the defendant. The burden of proving its case is on the plaintiff, the Corporation. The defendant - the bank - need not disapprove anything until the Corporation has proven the unsafe or unsound practice against the bank or the violation of law. The examination reports are admissible in evidence and their contents constitute evidence and, in so far as our Board of Directors is concerned in making its original findings of unsafe or unsound practices or violations, constitute the only evidence upon which it preliminarily acts. The examination reports must, therefore, support each and every charge of unsafe or unsound practice or violation or, to put it another way, only unsafe or unsound practices or violations which are thus established, i. e. proven by the evidence contained in the examination reports, can be included in the official "statement". At the hearing, the examiner may enlarge upon the contents of his examination report from his memory or notes. However, such testimony is not available for the Board in the first instance in making

its findings. I point this out merely to emphasize that the reports themselves must be sufficiently complete with factual information so that they will afford the basis for and support the Board's findings.

The most important thing from your standpoint as examiners, in the preparation of a case for proceedings under subsection (i), is to have the necessary facts to support each charge and that such necessary facts are recorded upon the report. This cannot be over-emphasized. It is the crucial test by which your case will either stand or fall. In this respect, I want to caution you that conclusions are not facts. I am speaking of facts supporting the charges, not the conclusions or opinions of the Field Examiners. Please be sure that your examiners know the difference between the two. Unless they know the difference between the two, they cannot properly prepare an examination report to support such a proceeding. And, of course, their success in supporting the charges will depend upon the extent of their knowledge of the facts and their ability and care in recording them.

We all realize the difficulties confronting the examiner in acquiring the facts. He cannot take the time to go out and inspect the security supporting loans or appraise the assets or solvency of the borrowers but that is a difficulty inherent in the proceedings and which he must do his best to

overcome. An apology is inadequate to prove a charge. Please bear in mind that the legal presumptions are all in favor of the bank. For instance, the solvency of the borrower is presumed until the contrary is shown. The integrity of the notes and securities is presumed until the contrary is shown. A note is presumed to be worth its face value until the contrary is shown. Therefore, when an examiner places a note in a substandard, doubtful or loss classification, the evidence he has in his possession must overcome the presumptions mentioned and must affirmatively show that the classification is proper. It isn't sufficient for the examiner to merely state his opinion in that respect. His classification expresses his opinion. What he must put in the record is the facts on which his opinion is based and the probative value of his opinion is measured by his factual statement in support thereof.

REQUESTED CORRECTIONS

As pointed out, the "statement" is sent to the Supervising Authority for the purpose of securing the correction of the unsafe or unsound practices or violations complained of. The law then says that, unless the corrections shall be made within the time specified, our Board "if it shall determine to proceed further" shall give the banks not less than 30 days written notice of intention to terminate the status of bank as

an insured bank and shall fix the time for hearing, etc." This, no doubt, means that if corrections have not been substantially made, the Board should proceed with the termination.

To determine whether the required corrections have been made, it is necessary to make a reexamination of the bank. This reexamination may be confined to ascertaining whether the necessary corrections have been made. I observe, however, that it is the practice to also make a regular examination of the bank. The instructions to examiners contained in the black book are very comprehensive in this respect and must, of course, be carefully followed. The examiner, in the confidential section of the report, must take up each charge of unsafe and unsound practice and violation and show in detail just what the bank has done by way of correction.

There is one point I want to make and it is this. I frequently find that the bank in making all or a major portion of the corrections requested in respect of substandard, doubtful or loss classifications, winds up on such reexamination with totals of such classifications larger than those on the previous examinations on which the proceedings were based. If the examiners were lawyers, I would say that it looks like they were building a case. In other words, on such reexamination, the examiner reclassifies the assets and gives them a much more

severe classification than he did on previous examinations. It is difficult to prove that the assets have deteriorated so rapidly between the examinations. Furthermore, such reclassification cannot be used in determining either (1) whether the corrections have been made or (2) the asset condition of the bank, for the purpose of the pending subsection (i) proceedings. Any required correction so broad as to include such a prospective classification would be of doubtful legitimacy. To make myself clear, let me cite an illustration. Say John Jones has a $10,000 note in the bank during the examinations on which the subsection (i) proceedings are based, which note was not classified. Such note if classified in the reexamination should not be considered in determining whether the necessary corrections have been made. Clearly, if the Corporation may reclassify assets more severely upon such reexamination, and such reclassification is to be taken into consideration in determining whether the necessary corrections have been made, then the bank should in justice be entitled to a further period for corrections and the proceedings could run on ad infinitum. Furthermore - suppose bank says - we have corrected all these since Examiner was there. How can we refute it?

The Corporation may, of course, since the examiner is in the bank make a general regular examination at the time. However, proper segregations should be made in the white section

of the report to show the portions thereof which pertain to the subsection (i) proceedings and the portions which have no bearning thereon. In fact, the reports should be so drawn that a separation may readily be made of the pertinent portions of the report from the impertinent portions thereof. I am always fearful that some good lawyer will object to the introduction of our reexamination report on the ground that it contains considerable material which is immaterial to the proceedings and prejudicial to the case. I am going to go into a huddle with your Chief, Col. Sailor, about changing our instructions in this respect. I want you gentlemen also to give it some thought. The job is to do it in a way least difficult for the examiners.

In summary. These proceedings were designed by Congress to provide means by which insured banks may be compelled to conduct their affairs in a safe, sound and legitimate manner. The power carries with it an opportunity and, of course, a corresponding responsibility. The opportunity to confine bank operations within proper banking channels and thus to provide the country with a strong and sound banking system - and the concomitant responsibility of so doing. The power must, of course, be used judicially and impartially. Let us remember that the letter killeth - but the spirit giveth life. In instituting the proceedings, be sure of three things - (1) that the practice complained of is an unsafe or unsound practice

or a violation of law; (2) that the facts support the charge; and (3) that the facts are recorded in the examination report.

In conclusion, let me compliment you examiners on the splendid job you have done in the preparation of reports for subsection (i) proceedings. You have exercised skill and care, and have meticulously followed instructions in that respect.