

REGULATORS' RESPONSIBILITY FOR SMALL BANKS' INABILITY TO FINANCE CUSTOMERS IN THE WAKE OF THE FINANCIAL MELTDOWN

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The financial meltdown in September 2008 shocked the average citizen into recognizing what the financial sector had failed to publicly acknowledge since at least the collapse of The Bear Stearns Companies, Inc. the previous March—that sinkholes in the economic landscape were prevalent and deep.¹ From September through the remainder of the Fall of 2008, media reports on a weekly basis confirmed that the world had indeed changed, as Lehman Brothers went bankrupt,² Fannie Mae and Freddie Mac were discredited,³ AIG faced insolvency⁴ and the stability of the United

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¹ The Bear Stearns Companies, Inc. was a global investment banking firm that began business in 1923 and employed more than 15,000 employees. Fortune magazine recognized the firm as one of “America’s Most Admired Companies” in 2007. The company, whose stock had traded above \$133.00 on the New York Stock Exchange within the previous twelve months, was sold to JP Morgan Chase for \$10.00 a share on May 30, 2008, and the Federal Reserve took responsibility for \$29 billion of “toxic” assets in Bear Stearns’ portfolio. *See generally* Roddy Boyd, *The Last Days of Bear Stearns*, CNNMONEY (Mar. 31, 2008, 1:59 PM), http://money.cnn.com/2008/03/28/magazines/fortune/boyd_bear.fortune/.

² Founded in 1850, Lehman Brothers Holdings Inc. filed for Chapter 11 bankruptcy protection on September 15, 2008, the largest bankruptcy in United States history. *See generally* Sam Mamudi, *Lehman Folds with Record \$613 Billion Debt*, WALL ST. J., (Sept. 15, 2008, 10:11 AM), <http://www.marketwatch.com/story/lehman-folds-with-record-613-billion-debt?siteid=rss>. Twenty-two additional affiliates filed petitions in the Bankruptcy Court. *See, e.g., In re Lehman Brothers Holdings Inc.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010).

The firm’s North American investment-banking and trading divisions, as well as its New York headquarters building, were purchased by Barclays, and its Asia-Pacific business and European and Middle East investment banking and equities businesses by Nomura Holdings. By October 13, 2008, the fourth largest investment bank in the United States was defunct.

³ *See* Press Release, Bd. of Governors of the Fed. Res. Sys., Statement by Fed. Res. Bd. Chairman Ben S. Bernanke (Sept. 7, 2008), *available at* <http://www.federalreserve.gov/newsevents/press/other/20080907a.htm>. Government-sponsored entities Fannie Mae (Federal National Mortgage Association, founded in 1938) and Freddie Mac (Federal Home Loan Mortgage Corporation, founded in 1970) required federal bailouts to survive. Kate Pickert, *A*

States banking system was called into question. A global economic crisis ensued, and three years later more than a few of the coals are still glowing.

An anticipated recovery in the housing sector evaporated in 2011, mortgage foreclosures remain stalled and a double-dip recession is seen by some as still possible. Sustained economic growth depends on new jobs, and job growth remains stagnant. On August 5, 2011, for the first time in history, the United States lost its Triple-A credit rating, when Standard & Poor's announced it was downgrading the United States debt rating to AA+.⁵ This action pushed the Dow Jones Industrial Average the next

Brief History of Fannie Mae and Freddie Mac, TIME (July 14, 2008), <http://www.time.com/time/business/article/0,8599,1822766,00.html>. Beginning in July 2008, media reports that the U.S. government was considering a plan to take over these entities, which owned or guaranteed as much as half of all residential loans, the values of which had severely declined. See generally Charles Duhigg, *Loan-Agency Woes Swell from a Trickle to a Torrent*, N.Y. TIMES (July 11, 2008), <http://www.nytimes.com/2008/07/11/business/11ripple.html?ex=1373515200&en=8ad220403fcfd6e&ei=5124&partner=permalink&expod=permalink>. The combined debt owned or guaranteed by the two companies was reportedly more than \$5 trillion. Kyle Baxter, *A Study of the Financial Crisis*, TIGHT WIND (Dec. 6, 2010), <http://tightwind.net/2010/12/a-study-of-the-financial-crisis/>. On September 7, 2008, Fannie Mae and Freddie Mac were being placed into conservatorship of the Federal Housing Finance Agency (FHFA). U.S. DEP'T OF STATE, CRS REPORT FOR CONGRESS: FANNIE MAE AND FREDDIE MAC IN CONSERVATORSHIP (Sept. 15, 2008), available at <http://fpc.state.gov/documents/organization/110097.pdf>. The FHFA director dismissed the chief executive officer and directors of the companies and caused the issuance of new securities amounting to 79.9% of each corporation to the Treasury. U.S. DEP'T OF STATE, CRS REPORT FOR CONGRESS: THE COST OF GOVERNMENTAL FINANCIAL INTERVENTIONS, PAST AND PRESENT (Sept. 23, 2008), available at <http://fpc.state.gov/documents/organization/110285.pdf>. As of mid-2011, the cost of the bailout of Freddie Mac was \$51.9 billion and the cost of the Fannie Mae bailout was \$89 billion. Nick Timiraos, *Freddie Says Loss Narrows*, WALL ST. J., Aug. 9, 2011, at C2.

⁴ American International Group, Inc. (AIG), an insurance corporation with worldwide businesses listed on the New York Stock Exchange, was granted an \$85 billion credit facility to enable the company to meet increased collateral obligations when it suffered a liquidity crisis as a result of the downgrade of its credit ratings below "AA" levels in September 2008. In the transaction, the company granted the Federal Reserve a stock warrant for 79.9% of its equity. See Press Release, Bd. of Governors of the Fed. Res. Sys. (Sept. 16, 2008), available at <http://www.federalreserve.gov/newsevents/press/other/20080916a.htm>. The Federal Reserve and the U.S. Treasury increased the potential financial support to more than \$182.5 billion by May 2009. Through a \$60 billion credit line and \$52.5 billion to buy mortgage-based assets owned or guaranteed by AIG, increasing the total amount available to as much as \$182.5 billion. AIG subsequently sold a number of its subsidiaries and other assets to pay down loans received, and continues to seek buyers of its assets. Press Release, Bd. of Governors of the Fed. Res. Sys., U.S. Treasury and Fed. Res. Bd. Announce Participation in AIG Restructuring Plan (Mar. 2, 2009), available at <http://federalreserve.gov/newsevents/press/other/20090302a.htm>.

⁵ Standard & Poor's stated as part of the rationale that it was "pessimistic about the capacity of Congress and the administration to leverage their agreement this week into a broader [deficit cutting] plan that stabilizes the government's debt dynamics

trading day to its steepest one-day decline since December 2008 and its lowest close, at 634.76 (a 5.5% decline), since October 2010. Bank stocks experienced their largest one-day drop since April 2009, with Bank of America Corp. and Citigroup, Inc. suffering declines of 20% and 16%, respectively.

Notwithstanding concern that the economic recovery may be faltering, in many respects the U.S. economy has largely regained traction, at least from an economist's viewpoint. In the author's view, the essential structure of the capital markets and the financial institutions sector remain intact, and significant rebuilding has taken place.⁶ The reasons for and the response to the financial meltdown are as many and various as the books and blogs and broadcasts which followed. From the beginning, and with some justification, regulatory laxness was targeted as a substantial contributing factor to the excesses and abuses of the financial sector and its implosion. Not surprisingly, a pendulum swing towards tighter regulation resulted, which has had a disproportionate, negative impact on smaller businesses. The speed and scope of new legislation and increased regulation following September 2008 made careful and deliberate study difficult, with the inevitable result that implementation of targeted and measured remedies have been less important than swift and comprehensive action demonstrating government's willingness to "fix" the situation. Victory has been declared and, from a high altitude perspective, legitimately so. As a military M*A*S*H unit's work must be applauded for the lives it saves, the swift action of White House and Federal Reserve policymakers and efforts of lawmakers on Capitol Hill have indeed saved the patient. However, the costs have been substantial, and the fallout—particularly for small business—has been painful and is continuing. Regulatory hostility and new

any time soon." Nikola Swann, *Research Update: United States of America Long-Term Rating Lowered to 'AA+' on Political Risk and Rising Debt Burden; Outlook Negative*, STANDARD & POOR'S (Aug. 5, 2011), available at www.ft.com/cms/af2c4fac-bfc2-11e0-90d5-00144feabdc0.pdf.

⁶ While the recession officially ended in June 2009, and unemployment peaked in October 2009, one leading investment firm still characterized its "long held view that this will be a sluggish and distorted business cycle." RBC Global Mgmt.(U.S.), Inc., *Quarterly Review and Outlook* (Mar. 31, 2011), available at <http://us.rbcgam.com/resources/docs/pdf/quarterly-newsletters/QrtlyReview1Q11.pdf>. In the same report, RBC noted that equities had rebounded with most global stock markets fully recovered from the September 2008 market collapse. *Id.* Volatility and a gloomy economic outlook continued, however, with succeeding rounds of bad news. *Id.* In August 2011, the United States lost its Triple-A credit rating, and in September and October 2011, the European debt crisis dominated the media. *Id.* Federal Reserve Chairman Ben Bernanke on October 4, 2011, warned the Congressional Joint Economic Committee that the economic recovery "is close to faltering." Jon Hilsenrath & Luca Di Leo, *Bernanke Issues Warning, Urges Action on Economy*, WALL ST. J. (Oct. 5, 2011), <http://online.wsj.com/article/SB10001424052970204524604576610712269716064.html>.

policies emanating from Washington and state capitals are crimping the ability of small businesses to achieve financing and raise capital. Access to loans and local capital sources, advisors and intermediaries is being overly restricted by federally-directed policies.⁷

I. SETTING THE SCENE—BIGGER ISN'T ALWAYS BETTER

As with every human or natural disaster of great magnitude or effect, there are numerous culprits. In the aftermath of the financial meltdown it is easy to lay blame on the regulators, and much of it is justified. Congress used a meat cleaver in 2010 with the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act⁸ as it did in 2002 with the Sarbanes-Oxley Act,⁹ and is certainly culpable. In many cases, regulatory gaps rather than excessive regulation were revealed to be instrumental in the financial crisis. Greed and excess on Wall Street and among ordinary Americans grasping for their piece of the pie also contributed to an untenable and inevitably unsustainable period of prosperity—until the bubble burst. The inability and unwillingness of those who structured financial products and extended credit and those who invested and borrowed to acknowledge or evaluate risk is, with hindsight, astounding. Deals that looked too good to be true, as is always the case, were revealed to be held together only by theories and wishful thinking.

The United States financial sector and the capital and credit markets are complex and interconnected with those of the global economy. U.S. regulators do not implement or coordinate their policies or enforcement in uniform or even parallel fashion. In a democratic, capitalist system, that is difficult and may well be impossible to achieve. In a competitive world economy, lowest common denominator regulation would likely be ineffective, if not economically disastrous. The financial problems that overwhelmed the economy in late 2008 are not subject to easy analysis, and examination of only a few related segments of the economy cannot explain the resulting chaos. Nevertheless, a review of one significant aspect of our recent experience, with the goal of understanding at least a part of the reason why small businesses have been stifled in their historical role of leading economic development, is instructive. Specifically, this article explores why, in the aftermath of the financial meltdown, community banks have been unable to provide financing to help small companies grow and

⁷ Even prior to the financial meltdown in 2008, the primary non-bank regulator, the SEC, was criticized for not adequately assisting small business capital formation. Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J. L. & BUS. 1 (2007).

⁸ Pub. L. No. 111-203, 12 U.S.C. §§ 5301–5641 (2010).

⁹ Pub. L. No. 107-204, 15 U.S.C §§ 7201–7206, 116 Stat. 745 (2002).

create jobs as they historically have and why, perhaps, this recovery has been more protracted than prior recoveries.

Despite loose monetary policy, credit has only increased at a modest pace. In fact, since the financial crisis while bank profits have increased 136%, lending through June 30, 2011, had fallen in ten of the past twelve quarters and declined during the period by 9%.¹⁰ Lending to small businesses by U.S. banks declined during 2009–2010, according to the United States Small Business Administration (SBA).¹¹ In a release issued on February 10, 2011, the agency reported that small business lending dropped by 6.2%. While this was less than the 8.9% drop in large business lending, the study effectively confirmed the experience of smaller businesses, notwithstanding the assertions by bank regulators and larger banks that they were actively lending during this period.¹² Ironically, and notwithstanding the new small business loan programs touted by President Obama, the President's proposed SBA budget for 2012 of \$985 million represents a 45% decrease from the 2010 budgeted level.¹³

The analysis is not simple, and the picture is a fragmented mosaic of contradictory and conflicting regulatory policies and uneven playing fields. Development of a unified, rational, long-term approach to small business financing is politically unrealistic, and the idea of a simple, common-sense solution is naïve. Nevertheless, by isolating a number of high-level issues and discussing their effect on small business capital formation, an appreciation for what needs to be addressed becomes obvious.

¹⁰ Stephen Gandel, *After Three Years and Trillions of Dollars, Our Banks Still Don't Work*, TIME, Sept. 26, 2011, at 41. Non-farming, nonresidential small business loans of between \$100,000–\$200,000 declined to 2003 levels of less than \$60 billion. Robin Sidel, *Fed Up: A Texas Bank Is Calling It Quits*, WALL ST. J., Aug. 10, 2011, at C1 (citing FDIC data).

¹¹ *Small Firm Lending, 2009–2010: Harbingers of Growth*, U.S. SMALL BUS. ADMIN. (Feb. 10, 2011), <http://www.sba.gov/content/small-firm-lending-2009-2010-harbingers-growth>.

¹² In May 2010, U.S. Assistant Secretary for Economic Policy Alan B. Krueger testified that small business employee layoffs were due, at least in part, to the lack of access to credit. *Initiatives to Promote Small Business Lending, Jobs and Economic Growth: Before the H. Comm. on Financial Services*, 111th Cong. 2 (2010) (statement of James D. MacPhee, Chairman, Indep. Cmty. Bankers of Am.), available at http://financialservices.house.gov/media/file/hearings/111/5_17_10_macphee.pdf. He noted that small businesses are more dependent on bank credit than medium and large businesses that have access to credit through the corporate bond market. *Id.*

¹³ *FY 2012 Congressional Budget Justification and FY 2010 Annual Performance Report*, U.S. SMALL BUS. ADMIN. (2011), available at http://www.sba.gov/sites/default/files/FINAL%20FY%202012%20CBI%20FY%202010%20APR_0.pdf. See *infra* Part IV.A for a discussion of the Small Business Lending Fund and related programs.

By design, the examination of these issues is broad-brush, and its purpose is to suggest relationships between regulatory trends and effects that necessarily have resulted from a non-holistic approach to capital formation and smaller entities generally. The bottom line is that, despite the overwhelming influence of small businesses on innovation and job creation, the regulatory focus has been, and continues to be, on larger companies and larger financial institutions. Rather than encouraging a spectrum of market participants, the emphasis on “systemically significant” and “too big to fail” is squelching new business development and growth. By shining the light on some of the factors that have led to this unhealthy predicament, a more flexible and rational regulatory net may be woven to stimulate a more robust and diverse economy.¹⁴

Thomas Hoenig, the President and Chief Executive Officer of the Federal Reserve Bank of Kansas City for more than eighteen years until his retirement in October 2011, believes that by keeping interest rates near zero, the Federal Reserve is “asking savers to continue to subsidize borrowers.”¹⁵ In a *Time* magazine article in February 2011, Hoenig chastised his fellow regulators and complained that government policy continued to be favorable towards the Wall Street rather than the Main Street financial institutions. Hoenig’s view is that, instead of breaking up the mega-banks whose speculation led to the economic meltdown, the government has allowed them to grow larger.¹⁶ When questioned as to what the penalty for failure is, Mr. Hoenig replied, “We don’t have a market economy now.”¹⁷

Steve Stanek, a research fellow at the Heartland Institute in Chicago, asserted in a January 2011 article that the federal regulatory tilt towards large financial institutions was unfair and dangerous.¹⁸ He contrasted two recent *Wall Street Journal* articles, one noting that nearly one hundred small U.S. banks that received federal bailout funds showed signs they were in jeopardy of failing,¹⁹ the other reporting that, as demand for loans had

¹⁴ From a 30,000 feet perspective, in addition to federal bank regulatory hostility to smaller institutions, the author believes that state activism threatens a unified system of reasonable regulation, and obsolete securities regulations that are unnecessary for the protection of investors are sapping small businesses of their strength to innovate and create new jobs.

¹⁵ David Von Drehle, *The Fed’s Dissenter: Saying No to Easy Money*, TIME, Feb. 14, 2011, at 42.

¹⁶ See generally *id.*

¹⁷ Von Drehle, *supra* note 15, at 45.

¹⁸ Steve Stanek, *Woes of Protecting Businesses ‘Too Big to Fail’*, TBO.COM (Jan. 30, 2011), <http://www2.tbo.com/news/opinion/2011/jan/30/VWOPINO2-stanek-woes-of-protecting-businesses-too--ar-11476/>.

¹⁹ Michael Rapoport, *Bailed-Out Banks Slip Toward Failure*, WALL ST. J., Dec. 27, 2010, at C1.

begun to rise, some large, healthier banks were seeking to grab customers from weaker rivals.²⁰

Mr. Stanek recognized these larger banks as the same ones deemed “too big to fail”—and those most responsible for the poor underwriting, securitizations and unwise investments that resulted in disaster. Instead of being broken up and their assets sold to other banks, including smaller ones, the large banks received federal bailout funds:

How ironic that many of the struggling smaller banks would probably be stronger today if only they had been able to take over the assets of the big banks that would have failed without government interference. Instead, small banks continue to fail, at least in part, because the government interference that was meant to “save” the financial system has impaired their ability to compete with the firms that were most responsible for nearly wrecking the system in the first place. And how ironic that as the big banks become even bigger, and the financial system puts more of its eggs into one “too-big-to-fail” basket, the danger to the system becomes even greater.²¹

Mr. Stanek’s words were prescient. By September 2011, the stock price of the parent company for the nation’s largest bank, Bank of America, notwithstanding a \$5 billion investment by Warren Buffett, declined by 50%.²²

A joint letter sent to members of the U.S. Senate, the Associated Builders and Contractors, Inc. and the Independent Community Bankers of America in January 2011 asserted that “overly burdensome federal regulations negatively impact the economy,” and urged that a more balanced regulatory environment be encouraged to “allow community banks to continue to serve the needs of their local customers—small businesses.”²³ The letter emphasized the importance of community banks to

²⁰ Ruth Simon, *Banks Open Loan Spigot*, WALL ST. J., Dec. 30, 2010, at A1.

²¹ Stanek, *supra* note 18.

²² While it is almost universally acknowledged that job growth is necessary for a sustained economic recovery, Bank of America laid off approximately 6000 employees in 2011 and announced on September 12, 2011, that it intends to eliminate another 30,000 jobs, or approximately 10% of its staff, by 2014. Hugh Son, Dawn Kopecki & Max Abelson, *Bank of America to Slash 30,000 Jobs in Cost-Cutting Plan*, BLOOMBERG (Sept. 12, 2011, 3:07 PM), <http://www.bloomberg.com/news/2011-09-12/bofa-to-slash-30-000-jobs-in-first-phase-of-cost-cutting-program.html>.

²³ Letter from M. Kirk Pickerel, President and CEO, Associated Builders and Contractors and Camden R. Fine, President and CEO, Indep. Cmty. Bankers of Am., to Senate (Jan. 20, 2011) (on file with author).

small business, stating that these institutions support 31% of all small business loans that are less than \$1 million.

Losses by banks and bank failures have been hallmarks of the 2008–2010 recession. In 2010, 157 banks failed, 50 of them in just two states, Florida (29) and Georgia (21).²⁴ Nationally, there have been 386 bank failures since the beginning of 2008, 326 of which had total assets of less than \$1 billion.²⁵ While the current pace of failures has slowed, there had already been 64 bank failures in 2011 (through August 16, 2011).²⁶ The number of banks on the “problem list” of the Federal Deposit Insurance Corporation (FDIC) rose to 888 as of March 31, 2011, representing approximately 12% of all FDIC-insured institutions—the highest number in nearly twenty years.²⁷ In Florida, as of December 31, 2010, there were only 246 insured institutions, down nearly 20% from the 307 banks and thrifts in the state at the end of 2008. These financial institutions collectively had at the end of 2010 approximately 27,000 employees, nearly 13% less than they did at the end of 2008.

II. SMALL BUSINESS AS THE AMERICAN ECONOMIC ENGINE

Small businesses make up the backbone of the U.S. economy. Each year, the SEC, by law, hosts the SEC Government-Business Forum on Small Business Capital Formation. At the 28th Annual Forum, held in Washington, D.C. on November 19, 2009, SEC Chairman Mary L. Schapiro explained the SEC’s three-pronged mission: to protect investors, to maintain fair and orderly markets and efficient markets, and to facilitate capital formation. She began her remarks as follows:

Today we are focusing primarily on the third, facilitating capital formation. But, I think it's important that we don't think of these three prongs as distinct or separate goals. They are in fact intertwined and interdependent. We cannot have fair and efficient markets without the ability of companies to effectively raise capital, and companies cannot raise capital unless investors believe that the markets are fair and orderly. Without access to capital,

²⁴ *Bank Failures in Brief*, FDIC, <http://www.fdic.gov/bank/historical/bank/2010/> (last updated June 22, 2011). Information regarding the number of insured financial institutions, bank failures and related information is taken from the website of the Federal Deposit Insurance Corporation, www.fdic.gov.

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Potential Mixed Messages: Is Guidance from Washington Being Implemented by Federal Bank Examiners?: Hearing Before the H. Subcomm. of Fin. Inst. and Consumer Credit*, 112th Cong. 54 (2011) (statement of Christopher J. Spoth, Senior Deputy Dir. Div. of Risk Mgmt. Supervision, Fed. Deposit Ins. Corp.), available at <http://financialservices.house.gov/UploadedFiles/081611fdic.pdf> (hereinafter *Potential Mixed Messages*).

business slows. Without investor confidence, capital disappears. That is something the business community knows all too well, and it is something that I, as the daughter of a small business operator who recently retired at the age of 88, understand as well. Today's forum specifically addresses small business capital formation. This is particularly appropriate, because as President Obama recently said, small businesses fuel our prosperity and have to be at the forefront of any recovery.²⁸

SEC Commissioner Troy A. Paredes added his voice of support for small businesses:

Although attention often seems to focus on larger enterprises, we need to appreciate that small and emerging businesses offer unique opportunities for investors, entrepreneurs, employees, and consumers. Smaller companies, however, also face distinct challenges and hurdles A small firm should not necessarily be subject to the same regulatory demands that a Fortune 500 company is required to shoulder. Among other things, one needs to consider the disproportionate burden that a given regulatory requirement can impose on a small business and the costs we all bear if, as a result, businesses struggle to get off the ground or expand. When a small business can't secure funding at a reasonable cost, for example, the economy is deprived of the firm's full participation in the marketplace.²⁹

At the following year's Forum, on November 18, 2010, Chairman Schapiro reiterated these points, noting that reliable data suggested small businesses had created 60% to 80% of net new American jobs over the last ten years:

And it's not just the number of jobs created that are important; it's the kind of jobs. At a time when improving our global trade position is a top priority, small businesses produced almost a third of America's exports. And, at a time when expanding those exports—while increasing domestic market share—often means producing the

²⁸ Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n., Remarks at the 28th Annual SEC Gov't-Bus. Forum on Small Bus. Capital Formation (Nov. 19, 2009), available at <http://www.sec.gov/info/smallbus/gbfor28.pdf>.

²⁹ Troy A. Paredes, Commissioner, U.S. Sec. & Exch. Comm'n., Remarks at the 28th Annual SEC Gov't-Bus. Forum on Small Bus. Capital Formation (Nov. 19, 2009), available at <http://www.sec.gov/news/speech/2009/spch111909tap.htm>.

technology's cutting edge, small business employees earn patents at 13 times the rate of those in larger firms.³⁰

The critical role of small business as a driver of the U.S. economy and a vital part of the recovery is undisputed. Nevertheless, while acknowledging the distinct challenges and hurdles that small businesses face, the disproportionate impact of regulatory compliance often creates barriers to entry or expansion. How this works in practice sets the stage for a better understanding of how regulation that may be necessary and desirable on a policy basis can, nonetheless, stifle small business growth due to the difficulties of smaller entities to meet the regulatory burden.

In a submission to the 29th Annual SEC Government-Business Forum on Small Business Capital Formation in November 2010, the American Bankers Association commented that increasing the shareholder thresholds for registration and de-registration under Section 12(g) of the Securities Exchange Act of 1934, as amended (Exchange Act), smaller publicly-held community banks and savings associations would save approximately \$250,000 per bank. The letter continued with the following statement:

In the banking industry, it is understood that every one dollar saved can support \$7–\$10 of new lending. As a consequence, we believe that raising the shareholder threshold can have an immediate and positive impact on the amount of capital that could be deployed by community banks to increase lending to small businesses in their communities.³¹

The effect of strict regulation on the unavailability of credit has resulted in a lack of optimism for many small business owners. The *Wall Street Journal* reported that an index of small business confidence declined in July 2011 to its lowest level since September 2010 and that small firms consistently expressed more pessimism than larger ones, purportedly because they have less access to credit.³²

³⁰ Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Remarks at the 29th Annual SEC Gov't-Bus. Forum on Small Bus. Capital Formation (Nov. 18, 2010), available at <http://www.sec.gov/infor/smallbus/gbfor29.pdf>.

³¹ Memorandum from Carolyn Walsh, Vice President & Senior Counsel, Ctr. for Sec., Trust & Invs., Am. Bankers Ass'n to the 29th Annual SEC Gov.-Bus. Forum on Small Bus. Capital Formation (Nov. 9, 2010), available at <http://sec.gov/info/smallbus/2010gbforum/2010gbforum-aba.pdf>.

³² Kathleen Madigan, *Small Business Confidence Dips to Lowest Level Since July 2010*, WALL ST. J. REAL TIME ECON. BLOG (Sept. 13, 2011, 8:16 AM), <http://blogs.wsj.com/economics/2011/09/13/small-business-confidence-dips-to-lowest-level-since-july-2010/> (citing *Small Business Optimism Index*, NAT'L. FED. OF INDEP. BUS. (Aug. 9, 2011), <http://www.nfib.com/press-media/press-media-item?cmsid=57841>).

These and other participants in the SEC Forum from the banking, investor and legal communities pointed out other regulations that unduly burden smaller companies and inhibit capital formation and offered suggestions for addressing their concerns.³³ Many of these recommendations have been repeatedly made and yet have not been given serious attention by the regulators. While some of the recommendations could not withstand the scrutiny of the federal rulemaking process, many promising proposals do not even have the possibility of public exposure. In many cases, it is because the SEC and the bank regulatory agencies are preoccupied—and obsessed—with the larger institutions. Therefore, many potentially beneficial proposals will remain unexplored or on the back burner.

III. COMMUNITY BANKS UNDER SIEGE

A. *The Background*

The United States has the most robust and diverse banking sector in the world. In contrast to many countries, where banking institutions are closely affiliated with governments or royal families, or other developed nations in which only a few megabanks exist, the United States has an unrivaled depth and breadth of financial depository institutions. The American Bankers Association, representing banks of all sizes and types of charters, is the dominant voice for the nation's \$13 trillion banking industry and its two million employees. Within this large and diverse banking sector are a great number of "community banks." The Independent Community Bankers of America has nearly 5000 members of all sizes and charter types. The association represents more than 20,000 locations, employing nearly

³³ At the same Forum, a submission from the Angel Capital Association, representing more than 6500 accredited angel investors in its 150 member angel organizations in 44 states, offered recommendations relating to angel investing, including changes to the accredited investor standards and the general solicitation prohibition. Written Statement of Marianne Hudson, Angel Capital Ass'n, for the 29th Annual SEC Gov.-Bus. Forum on Small Bus. Capital Formation (Nov. 18, 2010), *available at* www.sec.gov/info/smallbus/gbfor29.pdf. The submission noted that an analysis by the U.S. Census Bureau and the Ewing Marion Kauffman Foundation in 2009 and 2010 found that "businesses that were less than five years old created all of the net new jobs in our country over the last 25 years." *Id.* The organization estimates that angel investors may be responsible for up to 90% of the outside equity raised by 30,000 to 50,000 start-up companies after the capital resources of their founders are exhausted. *Id.* The letter stated that approximately 250,000 angels invest \$20 to \$30 billion per year in promising early-stage companies, with investments from \$10,000 to \$200,000 per company. *Id.* Based upon a membership survey, the organization noted a trend for individual angels to join together in formal angel groups to pool their expertise and capital to make total investments of \$100,000 to as much as \$2 million in a range of companies, a large portion of which are in technology, clean tech and life science fields. *Id.*

300,000 employees and holding \$1 trillion in assets, \$800 billion in deposits and \$700 billion in loans to consumers, small business and the agricultural community.

These “Main Street” community banks have a different business model from large and internationally active institutions. Organized by local businesspersons, community banks serve local businesses, often in a single county and, generally, within a single state or in contiguous states. The boards of directors of these institutions are comprised of local community leaders and businesspersons, and the investors are primarily from this same community. Because these institutions historically were primarily chartered by the states and organized with small amounts of capital, quite often less than \$15 million, their lending limits were low and, therefore, loan facilities were generally small. Real estate loans form the backbone of loan portfolios of these institutions, particularly in high-growth and Sunbelt states. Relationships between community banks and their regulators historically were in a very real sense *friendly*. The regulators were focused on the safety and soundness of deposits, and bank inspections were intended to ensure banks conformed to their regulatory responsibilities. The attitude of the regulators, importantly, was that they were there to assist the banks for which they were responsible. Except where there were indications of fraud, gross mismanagement or utter lack of attention by the board of directors, regulators were flexible and patient and, in a true sense, *helpful* in assisting community banks to operate in a safe and sound fashion. Examinations, while focused on compliance, were also intended to instruct and improve bank practices and procedures.

B. *The 2008 Financial Meltdown*

“Main Street” community banks generally have a different business plan than large financial institutions. Accordingly, they should, and in many cases they do, have a different banking regime. The Dodd-Frank Act, enacted into law on July 21, 2010, in many important respects differentiates between community banks and large banks, for example with respect to the FDIC assessment base, stricter oversight of too-big-to-fail institutions and protection for trust preferred securities. Nevertheless, many aspects of regulation do not so differentiate, and most of the time the smaller institutions bear the brunt of increased regulation or lack of flexibility. Particularly following the financial meltdown, community banks have found themselves in a no-win situation, with too many problem assets, insufficient capital and regulators that are no longer patient, flexible or helpful.

Some specific federal policies led to disastrous results for smaller banks. For example, smaller banks were encouraged by their regulators, through the favorable capital treatment they received, to invest in preferred

securities issued by two federally-chartered entities, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).³⁴ When these government-sponsored organizations faltered, the federal government took them over and their perpetual preferred securities became worthless, resulting in a tremendous financial blow to the small banks that held them. Almost overnight, millions of dollars of capital that had been presumed to be safe and secure became worthless and the banks that had relied on these investments, often at the recommendation of their bank examiners, were undercapitalized.³⁵

As the financial crisis deepened, regulatory authority shifted from the regional offices of the FDIC, the Office of Thrift Supervision (OTS) and the Federal Reserve System (Federal Reserve) to their Washington headquarters. The influence of the regional regulators diminished, and decision-making shifted to remote, policy-focused agency officials in Washington, D.C. Instead of bankers dealing with regional officers they knew—and who knew the institution—and who could make decisions, bankers were told that matters were being “coordinated” with headquarter’s officials. Decisions were made on the basis of broadly-focused remedial policy, often by new personnel or those who had recently assumed new responsibilities as a result of agency reorganizations. As criticism of the major banking institutions mounted in Congress, decisions were postponed, the incentive for an individual agency official to take responsibility in a shifting environment diminished, and walls of distrust between banks and regulators were created. Ultimately, it became clear that the disconnect between public policy statements emanating from agency heads in Washington and the bank examiners had widened to the point where it could not be resolved.³⁶ In theory, the regulators were supporting small

³⁴ In the risk-weighted capital analysis imposed by bank regulators, *see* Cohn & Yadley, *supra* note 7, Fannie Mae securities, as well as those of other lower risk government sponsored securities, were risk-weighted at 20%. *Id.* Mortgage loans (current, properly underwritten and fully secured by first liens on one-to-four family residential properties) are risk-weighted at 50%. *Id.* Commercial loans, considered much riskier assets, have a 100% risk weighting. *Id.*

³⁵ “This was an unprecedented breach of faith.” *Initiatives to Promote Small Business Lending, Jobs and Economic Growth, H. Comm. on Fin. Servs.*, 111th Cong. 4 (2010) [hereinafter *Incentives*] (statement of James D. MacPhee, on behalf of the Indep. Cmty. Bankers of Am.).

³⁶ U.S. GOV'T ACCOUNTABILITY OFF., GAO-11-489, BANKING REGULATION: ENHANCED GUIDANCE ON COMMERCIAL REAL ESTATE RISKS NEEDED 30 (2011), available at <http://www.gao.gov/products/GAO-11-489>. Many bankers felt that the management component of the CAMELS rating was being more critically assessed, blaming management for the deterioration in their bank's portfolios, instead of recognizing the effects of the broader economic downturn, which was out of management's control. Fed. Deposit Ins. Corp., Off. of the Comptroller of the Currency & Bd. of Governors of the Fed. Res. Sys., *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Dec. 12, 2006), available at <http://www.fdic.gov/news/news/financial/2006/fil06104.html>.

business. In a Financial Institution Letter issued in February 2010 and captioned "Meeting the Credit Needs of Creditworthy Small Business Borrowers," the agency stated, "Financial institutions that engage in prudent small business lending after performing a comprehensive review of a borrower's financial decision will not be subject to criticism."³⁷ While under this policy examiners were not supposed to adversely classify loans solely due to a decline in the collateral value below the loan balance, provided the borrower had the willingness and ability to repay the loan according to reasonable terms, this was not the case in practice. Although senior bank regulators proclaimed that their agencies supported new lending activity, their examiners were tightening the regulatory screws and making it increasingly difficult for community banks to do business and earn profits.³⁸ As the financial condition of banks worsened, the opportunities to grow out of their problems or raise capital diminished, and a downward spiral began that often ended in bank failure.

Between January 1, 2008, and August 16, 2011, 386 banks had been closed by regulatory authorities, with 157 bank failures in 2010 alone and sixty-four through the first seven and one-half months of 2011. There were 888 institutions on the FDIC's "watch list" of troubled banks as of August 16, 2011. The condition of the Deposit Insurance Fund has improved over the past several quarters and, at June 30, 2011, achieved its first positive quarter-end balance (\$4.9 billion) since June 30, 2009.³⁹

C. Bank Regulatory Oversight Fans the Flames

The Dodd-Frank Act and regulatory activism undoubtedly has led to improvements and corrected some of the laxness that evolved during the expanding economy leading up to late 2008. But some of the sharpest focus, while helpful in an overall sense, has acted primarily to assuage government consciences and mask areas where more profound and difficult

³⁷ FDIC, *Meeting the Credit Needs of Creditworthy Small Business Borrowers* (Feb. 12, 2010), available at <http://www.fdic.gov/news/news/financial/2010/fil10005.html>.

³⁸ Support for the assertion by many community bankers that bank examiners are acting too rigidly was found in a recent U.S. Government Accountability Office (GAO) report to the Committee on Financial Services. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 36 (Concluding that in many cases examiners did not properly calculate or support commercial real estate (CRE) concentrations and CRE concentration thresholds were being interpreted as limits, without reviewing the bank's risk management practices and examining how the federal banking regulators responded to CRE trends prior to, and after, the economic meltdown, how the CRE Guidance has been interpreted by agency officials, and whether the CRE Guidance is being consistently applied to banks).

³⁹ As the larger banks recovered from the crisis and new assessments were levied by the FDIC, by mid-2011, the Federal Deposit Insurance Fund had been replenished to its pre-September 2008 level. *Quarterly Banking Profile: First Quarter 2011*, 5 FDIC Q. 1, at 14 (2011).

issues remain. One example is executive compensation, undeniably an important target, but the aim is off-center. On February 7, 2011, the Board of Directors of the FDIC approved a joint proposed rulemaking to implement Section 956 of the Dodd-Frank Act, prohibiting incentive-based compensation arrangements that encourage inappropriate risk taking by covered financial institutions and are deemed to be excessive, or that may lead to material losses.⁴⁰ FDIC Chairman Sheila Bair said, "This proposed rule will help address a key safety and soundness issue which contributed to the recent financial crisis—that poorly designed compensation structures can misalign incentives and induce excessive risk-taking within financial organizations."⁴¹

While the goal is laudatory, it does not follow that the regulatory response will have a major positive impact. Substituting the judgment of the FDIC and the other regulators as to what is *excessive risk*, especially with respect to smaller commercial banking institutions, for that of business people is of questionable value and counterproductive. The experience of many community banks undergoing regulatory scrutiny during the past three years suggests that the regulators today do not accept *any risk*.⁴² The same regulators that examined banking institutions prior to 2007 and did not express disagreement with those banks' assessment of risk, now criticize them for taking *excessive risk*.⁴³ The determination of what compensation is excessive is similarly quixotic. Regulations under the Troubled Asset Relief Program, first presented to Congress on September 19, 2008, by then U.S. Secretary of the Treasury Henry Paulson, set the bar for non-incentive based annual compensation at \$500,000,

⁴⁰ Incentive Based Compensation Arrangements, 76 Fed. Reg. 72 (proposed Apr. 14, 2011) (to be codified at 12 C.F.R. pt. 372).

⁴¹ Press Release, FDIC, FDIC Board Approves for Public Comment Interagency Rule to Implement the Incentive-Based Compensation Requirement Under Dodd-Frank Reform Act (Feb. 7, 2011).

⁴² Examiners are focusing on the value of collateral irrespective of the income or cash flow of the borrowers; placing loans on non-accrual even though the borrower is current on payments; discounting entirely the value of guarantors; criticizing long-standing practices and processes that have never been questioned before; and substituting their judgment for that of the appraiser.

Incentives, *supra* note 35, at 5.

⁴³ OTS failed to take steps that could have prevented the failure in November 2009 of Century Bank FSB of Sarasota, Florida, according to the U.S. Treasury's Office of Inspector General. The Inspector General found that the OTS did not act quickly enough to intervene when the thrift's conditions were declining. The failure of Century Bank reportedly cost the FDIC \$266.5 million as of March 11, 2011. Margie Manning, *Treasury Review: OTS Fell Short in Preventing Century Bank Failure*, TAMPA BAY BUS. J. (July 18, 2011, 12:23 PM), <http://www.bizjournals.com/tampabay/news/2011/07/18/treasury-review-ots-fell-short-in.html>.

admittedly a living wage and generous for most Americans, but hardly “excessive” in comparison to professional athletes, Hollywood actors and aging rock stars.

The bedrock issues that adversely affect access to capital for small businesses are layers below executive compensation. A brief review of the bank regulatory oversight system is helpful to an understanding of the current situation.

D. *A Primer on Bank Regulation and Supervision*

While the regulations and the oversight differ somewhat depending upon whether an institution is primarily regulated by the U.S. Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), or the Office of Thrift Supervision (OTS)⁴⁴ at the federal level, and for state-chartered banks, by various state administrators, the regulatory scheme is by and large, while not uniform, substantially the same. Particularly in times of economic distress as has been experienced over the past four years, the importance of federal deposit insurance has militated in favor of a greater role for the FDIC and more uniformity of oversight.

Bank supervision begins with routine bank examinations performed by the federal bank regulatory agencies (OCC, Federal Reserve, FDIC and OTS) and state banking commissions. If an examination reflects problems, the regulators monitor the institution more closely, limit its incentives to take excessive risk, require more capital and more frequent reporting—and ultimately, if the situation becomes dire, close the bank. Each bank has a primary federal regulator: the OCC for national banks, savings banks and federal branches of foreign banks; the Federal Reserve for members of the Federal Reserve System; and the FDIC for state insured banks and state branches of foreign banks.

Examinations of deposit institutions are conducted periodically, usually on twelve to eighteen month cycles, and comprehensively cover all aspects of activity, from consumer protection areas such as truth-in-lending and community reinvestment regulations, to trust operations and the adequacy of data process systems. The most significant review is the “safety and

⁴⁴ OTS, as with many institutions it formerly supervised, has gone away. Under the Dodd-Frank Act, the Office of the Comptroller of the Currency (OCC) assumed responsibility for the ongoing examination, supervision, and regulation of federal savings associations on July 21, 2011. The OCC on July 20, 2011, issued a final rule implementing several provisions of the Dodd-Frank Act, including changes to facilitate the transfer of functions from the OTS. Section 312 of the Dodd-Frank Act also transferred supervisory and rule-writing authority for SLHCs and their non-depository subsidiaries from the OTS to the Federal Reserve Board on July 21, 2011. Further, the Dodd-Frank Act included provisions applicable to the FDIC with respect to state savings associations. *See* 12 U.S.C. §§ 5381–5641 (2010).

soundness” examination, usually conducted collaboratively or jointly among the applicable regulators (e.g., for a state-chartered bank in Florida, the FDIC and the Florida Office of Financial Regulation). The key areas of review are capital adequacy, asset quality, management, earnings and liquidity. An exit interview is conducted by the examiners and generally several months later, a Report of Examination is delivered to the bank. Ratings (CAMELS ratings) on each of the five key areas of review, and overall, are assigned within a range of 1 to 5, with 1 being the best score. A composite CAMELS rating of 1 means that the bank is performing well above average, and a composite 2 means the bank is performing adequately. A 3 rating brings the institution into the realm of more-than-normal supervision because it indicates below average performance. It is at this point that the special scrutiny begins. If a bank is assigned a CAMELS 4 rating, this means that there are serious problems, and a CAMELS 5 rating generally means that the bank likely will not recover and will be closed.

When examinations reveal weaknesses in one or more areas, the regulators will require the bank’s board of directors to adopt “resolutions” to acknowledge the problems, assume responsibility and take corrective action. This special oversight is generally accomplished in a non-public manner and allows the bank time to correct its deficiencies or improve its practices. Another common informal action when a bank receives a CAMELS 3 rating is a “memorandum of understanding” (MOU) that contains specific remedial measures and timeframes within which improvements are required. MOUs are not published, which is beneficial to the bank from a customer and competitor perspective. Historically, these written agreements accounted for somewhat more than one-half of all supervisory corrective actions. If a capital deficiency was the bank’s primary or sole problem, a capital directive in the form of written agreement sometimes was used to remedy the situation. An “individual minimum capital ratio notice” (IMCR), which does not require the consent of the bank, is another form of capital directive.

Section 8 of the Federal Deposit Insurance Act provides the FDIC with a broad range of formal administrative enforcement powers.⁴⁵ When a bank is rated a CAMELS 4 or 5, this is generally considered severe enough to warrant formal action under Section 8, usually in the form of a “cease and desist” order—directing the bank to cease and desist from engaging further in specified unsafe and unsound practices at the risk of serious sanctions for failure to do so.⁴⁶ Cease and desist orders become publicly available upon

⁴⁵ 12 U.S.C. § 1818(b) (2006).

⁴⁶ The regulators sometimes move swiftly through the various stages of special oversight and may skip a level of supervision. The author represents a national bank with an overall CAMELS rating of 3 which recently was placed under a formal agreement (the OCC’s version of a consent order), even though the bank was not, prior to that event, under any special oversight. Efforts to impose a

entry and are published by posting on the agency's website or news release. These orders are generally viewed as an extremely negative sign in the marketplace by customers and investors. The trading price of a publicly-traded bank is adversely affected and larger customers with deposits in excess of federal insurance limits often are concerned. While representatives of regulatory agencies dispute these market and competitive effects on banks, the agencies have tacitly admitted that this is indeed the case through a change in nomenclature. The words "cease and desist" have been eliminated, and the administrative documents imposing these sanctions are now captioned "Consent Orders" and generally referred to simply as "Orders."

The negative marketplace reaction to the Consent Order directly affects one of the primary "unsafe and unsound" practices that the bank is directed to correct—operating with an inadequate level of capital protection for its assets. In other words, the bank is directed to improve its capital position by raising more money while the adverse publicity caused by the Order chills the market and makes it increasingly difficult for the bank to do so. Finding new investors is nearly impossible because the Order requires the bank—should new capital not be available—to provide the regulators within a matter of weeks with a contingency plan, which would include a plan to sell or merge the bank or voluntarily dissolve it. With the possibility of closure hovering so near, even existing shareholders are reluctant to invest further for fear of "throwing good money after bad."

In addition to raising more money, there is an alternative to improving the bank's level of capital protection for its assets—reducing the level of the assets. However, this alternative points out another primary "unsafe and unsound" banking practice—inadequate earnings. The typical Order directs the bank to increase earnings to augment capital and support reserves. Obviously, with a reduced level of income-earning assets, it is more difficult to increase earnings. If the bank is having difficulty raising capital or improving earnings, and it is restricted in growing its new loan portfolio, then it will similarly have difficulty correcting a third primary "unsafe and unsound" banking practice—placing an excessive concentration of loans in commercial real estate and construction. With the depressed economy of the past four years, particularly in Sunbelt states, there has been essentially no new residential or commercial real estate construction. But pre-2007, these types of loans represented a substantial part of new loans, and therefore constitute a substantial part of existing portfolios.

For good measure, this situation results in yet a fourth primary "unsafe and unsound" banking practice—operating with an excessive level of

adversely classified loans and assets.⁴⁷ The array of corrective actions required in the Order comes full circle because the bank is directed to remain “well capitalized.” This, unfortunately, proves to be an elusive concept. As discussed below, a bank today must have and maintain a 10% total risk-based capital ratio to be well-capitalized under bank regulatory capital guidelines, but the current level of total risk-based capital required by many Orders is 13% or 14%. The most common measure of community bank capital adequacy is the Leverage Ratio, which under bank regulatory capital guidelines must be at least 5% in order for an institution to be considered “well capitalized.” Under most Orders that ratio is raised to 8% or 9%.

E. Regulatory Impediments to Lending

1. Bank Capital Requirements

It is axiomatic that a bank must have funds in order to make loans. These funds come from customer deposits and capital, which may be borrowed funds or equity. How much capital a bank must have, and how capital is measured, are not simple issues. The first formal bank capital adequacy standards were pronounced in 1981 in a joint policy statement issued by the OCC and the Federal Reserve.⁴⁸ Beyond the published guidelines, the specific level of required capital was intended to be handled on a case-by-case basis. As a direct result of an adverse appellate court ruling that set aside a portion of an OCC cease and desist order on the basis that the agency had no specific statutory or regulatory authority to impose a 7% capital requirement, legislation confirmed the federal policy that the bank regulators indeed have the authority to cause banking institutions to achieve and maintain adequate capital.⁴⁹ Capital, thus, has become the Holy Grail for bank regulators.

The purpose behind capital requirements is to assure that a bank has adequate capital to reflect the risks incurred by the bank in making loans. How risk is measured is a subjective, complex matter, of course, and how the value of the assets constituting capital is measured is similarly complex.⁵⁰ Capital is further segmented into categories (e.g. Tier 1 capital,

⁴⁷ A typical Consent Order addresses the issue of too many classified loans by requiring the bank to eliminate some of those assets immediately. For example, in a March 2011 Order entered into by a bank holding company and its state-chartered subsidiary bank with the Federal Reserve, the bank was required to eliminate from its books “by charge-off or collection” all assets or portions of assets classified “loss” in the bank’s last examination.

⁴⁸ Statement of Policy on Capital Adequacy, 46 Fed. Reg. 248 (Dec. 28, 1981).

⁴⁹ First Nat’l. Bank v. Comptroller, 697 F.2d 674 (5th Cir. 1983).

⁵⁰ Capital is not the same as equity on a balance sheet, and not all dollars are equal from a regulatory perspective. “Tier 1 capital” is the primary determinant of a

Tier 2 capital, Total Risk-Based Capital) and the capital actually required by the regulatory agencies has routinely become greater than the level established by the guidelines. For example, Tier 1 capital of 5% no longer means that a bank is “well-capitalized” by the regulators if a bank has a CAMELS rating below a 2. This is true even though some analysts believe that inadequate capital is not a verifiable major cause of bank failure.⁵¹ Tier 1 capital of 8% or higher is required for banks under MOUs. Given the subjectivity that pervades the capital area, perhaps the only statement that can be made with certainty is that 2% is a hard floor—below which a bank will be closed.⁵²

Different amounts of capital are required with respect to different kinds of loans. For example, concentrations of subprime loans will require banks to hold capital that is one and one-half to three times the normal requirement. Capital requirements for income-producing real estate loans are much higher than for owner-occupied real estate loans. While there is a sound basis for this policy, in practice its application can become difficult. Contrast, for example, an office complex owned and operated by a commercial developer and managed by a leasing firm with a small office building owned by a lawyer, whose firm occupies a portion of the building, with the remainder leased to three other small firms. Even though the risk profiles of these two credits may be significantly different, the capital requirements are the same—or, at least, are often interpreted to be the same by the bank examiners.⁵³ Even within the residential lending category, the

bank’s financial strength. Consisting of the institution’s common stock and retained earnings, it also includes certain non-redeemable, non-cumulative preferred stock. “Tier 2 capital” consists of preferred stock with fixed maturities and long-term debt with maturities longer than five years. While each regulatory agency has the ability to impose its own supervisory requirements, U.S. bank regulators generally act under inter-agency common standards, and these are coordinated internationally through the “Basel I” and “Basel II” accords established through negotiations of representatives of the central banks of the most developed nations to promote the stability of the international banking system. See BANK FOR INTERNATIONAL SETTLEMENTS, <http://www.bis.org> (last visited Sept. 16, 2011).

⁵¹ Joseph Jude Norton, *Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities*, 49 OHIO ST. L.J. 1299, 1350 (1989).

⁵² As an indication of current desirable capital ratios, it was reported that no banks receiving Small Business Lending Fund funding had a Tier 1 leverage ratio of less than 7% and only two had a Tier 1 risk-based capital ratio of less than 10%, with average March 31, 2011, Tier 1 leverage and risk-based capital ratios of 10% and 13.3%, respectively. See Barry Hester, *A Statistical Look at SBLF Recipients to Date*, BRYAN CAVE LLP BLOG (Aug. 5, 2011), <http://www.bankbryancave.com/2011/08/a-statistical-look-at-sblf-recipients-to-date/>. See *infra* part VI.A for a discussion of the Small Business Lending Fund and related programs.

⁵³ Based upon an examination of a state-chartered non-Federal Reserve member bank client of the author. The attorney owner of the multi-unit real estate property had substantial net worth, and because his law offices were adjacent to the leased space, had the opportunity to closely monitor his tenant and to promptly find a replacement tenant if that became necessary, or to utilize the space himself. He had

rules are complicated and there are disparities. For example, Fannie Mae and Freddie Mac will not purchase “no cash outlay refinance” loans, even though the Veterans Administration and the Federal Housing Authority permit such loans. This means that homeowners cannot as easily refinance their loans to take advantage of lower rates and assist their cash flow. Many banks believe a refinancing would make the borrower stronger, thereby providing more protection, since the borrower’s guarantee is already in place, and no new funds are being advanced.

2. “*Troubled Banks*”

The Federal Deposit Insurance Corporation Improvement Act of 1991 provided enhanced enforcement authority to the FDIC and directed regulators to take “prompt regulatory action” when bank quality decreases.⁵⁴ As explained above, when a bank becomes undercapitalized by reference to the capital adequacy guidelines or in the view of the supervisory agencies, the regulators will take prompt action to remedy the situation. This generally involves development of a capital plan by the bank to obtain more capital and restricting the bank’s business to reduce risk. The effect on the bank’s customers is immediate, especially for small banks and small businesses. Once a community bank comes under stricter regulatory scrutiny, it has significantly less discretion in assisting its customers. During the recent economic recession, this often resulted in the bank’s inability to work with a stressed customer, even when the customer’s loans were not in default.⁵⁵

3. *Inability to Raise Capital*

The difficulty faced by smaller banks in raising capital during the 2008–2011 period cannot be overstated. As the economy worsened and asset values, particularly real estate asset values, plummeted, the difficulty in finding investors willing to take on new risk dramatically increased.

every incentive to remain current in his loan because, upon default, he would have to move his own offices, with the attendant business disruption and expense. Nevertheless, the examiner viewed the property in the same manner as if it were owned by an absentee landlord with no interest in the property other than as an investment.

⁵⁴ Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236.

⁵⁵ As an example, the following language was included in a Consent Order entered into by a state-chartered bank with the FDIC: “[D]uring the life of this Order, the Bank shall not extend, directly or indirectly, any additional credit to, or for the benefit of, any borrower who has a loan or other extension of credit from the Bank that has been classified, in whole or part, ‘Substandard.’” *In re Riverbank Spokane*, Washington, FDIC-11-385b, 9 (Aug. 29, 2011), available at <http://fdic.gov/bank/individual/enforcement/2011-08-10.pdf>.

Valuation of troubled loans became nearly impossible as unemployment spiked and consumer spending decreased. While seeking funds in these circumstances has been challenging for any business company, the situation has been exponentially worse for a banking institution because of the increasingly harsh regulation by the bank agencies.⁵⁶ To the question how much capital is enough, there has been no clear answer. If a bank was well-capitalized under the regulations (5%), and even under a customary MOU condition (e.g., 8%), the possibility that an Order would increase the required capital level to, for example, 11% has chilled investment.

An even larger impediment to raising capital has been, in the author's view, the manner in which the regulators have responded to the capital plight of the regulated institutions.⁵⁷ Although the FDIC has the authority to infuse funds into a depository institution to avoid losses, this remedy has been rarely used.⁵⁸ Typically, when a bank is on the verge of collapse, the FDIC supervises a "purchase and assumption" transaction whereby a healthy bank or investor group assumes the failing bank's assets, deposits and other liabilities.⁵⁹ The FDIC enters into a risk-sharing relationship with

⁵⁶ In December 2009, a bank client of the author raised nearly \$10.5 million in capital. In August 2011, one of the premier national financial institution investment bankers, on behalf of the same client, contacted over fifty potential investors or merger partners, including local, regional and international financial institutions, private equity firms and blind pools. Only ten firms indicated initial interest, fewer than six executed non-disclosure agreements and received confidential information on the bank, and only one expressed serious interest in a merger transaction. The bank's predicament was similar to many others in the author's recent experience.

⁵⁷ The lack of a realistic understanding of the capital markets by the regulators has, in itself, been a deterrent to capital-raising. For example, during the early stages of the financial crisis, private investor groups were forming to provide capital for the acquisition of troubled banks. In one such transaction, a financial firm with experienced bank executives on board to manage the target bank, organized a fund and entered into a letter of intent with an FDIC-insured state bank holding company represented by the author. The regulators insisted on early disclosure of the participants in the fund, failing to understand that investors would not commit to funding until after due diligence and the negotiation of a definitive agreement. Regulatory concern for investors "acting in concert" and which ones might own, directly or indirectly, 10% of the institution after closing effectively inhibited the process from gaining traction. The letter of intent expired, and no transaction was consummated. In this case, the new fund would have invested more than \$100 million in the bank, then operating under an MOU, and its current shareholders would have received a fair price for their stock.

⁵⁸ The Dodd-Frank Act has limited the ability of the FDIC to infuse capital into banks except where there is a systemic risk exemption. In other words, this tool is available only for banks deemed "too-big-to-fail." 12 U.S.C.A. § 1828(a) (2010).

⁵⁹ There are alternative ways in which the FDIC can proceed with a failed bank, including paying off insured deposits under 12 U.S.C.A. § 1821(f), marketing the institution under 12 U.S.C.A. § 1823(c), or a structured asset sale. In July 2010, a securitization pilot program was established for single-family mortgages whereby the FDIC retained a 15% interest in a \$400 million guaranteed pool. *See generally Roadmap to Financial and Housing Market Stabilization Plans*, TEXAS LAND TITLE ASSOC. (Oct. 17, 2010), available at <http://www.tlta.com/documents/hottopics/docs/RoadmapUpdate.pdf>. The most common transaction, however, is

the successor bank to provide it with an incentive to also take over the troubled assets of the closed institution. Under these arrangements, the FDIC will share, often as much as 50%, in the losses incurred by the successor bank on the assumed assets. These arrangements save the FDIC money at the time of a bank closing because the agency does not have to pay the successor institution as much money up front to honor the failed bank's deposits. If the failed bank's assets eventually are worth more than a party was willing to bid for the assets, the FDIC will have made a favorable investment. Of course, if the assets are worth less in the future than the discounted value agreed upon, the FDIC will be responsible for its percentage of the assets.⁶⁰

This "incentive" to the successor banks has, in fact, acted as a significant deterrent to private sector investors to invest in struggling banks. Investors, including other financial institutions, are reluctant to take the risk of investing in a troubled bank, thereby exposing themselves to 100% of the eventual loss on bad loans when they could wait until the bank fails and take as little as 50% of the risk. In fact, the risk in most of the failed bank cases is actually zero given the mathematics of the discount on the assets covered by the loss-share and the deposit premium. Most purchasers have booked immediate gains of millions of dollars on the day of closing because they cannot lose money unless they fail to administratively handle the portfolio properly according to the loan purchase agreement and loss-share agreement with the FDIC.

Based on the foregoing realities—particularly for a community bank with a limited geographic footprint—and little upside for the investor, capital-raising has come to a standstill. In the past, current shareholders would likely have bought additional stock in private offerings to shore up their community bank, avoid dilution and protect their investment. However, during the past several years, even current investors are increasingly reluctant to risk new funds. The availability of FDIC-assisted transactions has stifled traditional acquisition activity as buyers seek loss-sharing agreements to protect against future credit deterioration.⁶¹

This result is not surprising. Whether the more benign MOU or the more draconian Consent Order is the supervisory tool employed, a bank is

the purchase and assumption transition, generally with a loss-share agreement, described in the article. The FDIC has entered into loss share agreements with successor institutions covering more than \$180 billion.

⁶⁰ *Potential Mixed Messages*, *supra* note 27.

⁶¹ As an indication of the frequency with which this approach is employed in the Southeast, where most of the failures have occurred (53% of the total during the first nine months of 2011), there were thirty-eight FDIC-assisted transactions, only six (15.8%) of which did not have loss-share arrangements. *Quarterly Southeast M&A Report*, THE HOVDE GRP. (Sept. 30, 2011), <http://www.thehovdegroup.com/resources/publications> (follow "Nationwide M&A report - Q3 2011" hyperlink).

under severe restrictions. Smaller banks are forbidden to grow until they work their way out of their problems. While they can still make loans, they generally are not allowed to grow assets in a quarter more than their earnings.⁶² For many banks, particularly in the previously high-growth Sunbelt states, the poor economy and real estate values, if not the culprits, are certainly the roadblocks that impede recovery. These are the twin devils for banks, not bad management, incompetence or fraud. In the current economic environment of stagnant growth, low inflation and practically no new customers, the bank's troubled assets lose value with each new appraisal. A downward spiral inevitably results. Restrictions on growth and flexibility make it more difficult for the bank to work out of its current situation. The dilemma is that these same factors that led to the need for more capital make it nearly impossible to raise that capital. Even beyond the capital requirements and limitations on new loan growth, the amount of periodic reporting and administrative oversight required of troubled banks is unnecessarily burdensome, requiring the bank to increase its personnel and incur greater third party appraiser and legal costs in order to comply with its increased supervision.⁶³ The pressure on bank management, already thin to begin with in a community bank, and the negative impact on employee morale, leads to an untenable position for these smaller institutions.

⁶² As an example, the following language was included in a 2011 Consent Order entered into by a state-chartered bank with the FDIC:

While this Order is in effect, the Bank shall notify the Supervisory Authorities at least 60 days prior to undertaking asset growth that exceeds 10 percent or more per annum or initiating material changes in asset or liability composition. In no event shall asset growth result in noncompliance with the capital maintenance provisions of this Order unless the Bank receives prior written approval from the Supervisory Authorities.

Citizens Bank & Trust Company Eastman, Georgia, FDIC-11-150b (May 13, 2011), available at <http://fdic.gov/bank/individual/enforcement/2011-05-02.pdf>.

The effect of this restriction is that the bank must raise more capital to grow, .
⁶³ As an example, a 2010 Cease and Desist Order entered into with the OTS required a federally-chartered bank to, among other things, develop and submit to the regulator a capital plan, a business plan, revised policies, procedures and methodologies relating to allowances for loan and lease losses, a plan to reduce problem assets (including individual workout plans), a formal risk management plan, revised liquidity and funds management policies and procedures, a revised fair lending program and a revised consumer compliance program—and to provide quarterly or more frequent reports to the OTS with respect to each of these new or revised directives. Harrington Bank, FSB, Chapel Hill, North Carolina, OTS Docket No. 17910, SE-10-056 (Nov. 23, 2010), available at http://www.ots.treas.gov/_files/enforcement/97531.pdf.

IV. DIRECTORS AND OFFICERS UNDER FIRE

A. *The Regulatory Landscape*

The FDIC has the authority to impose enforcement remedies beyond the regulatory limitations discussed above, including the assessment of civil monetary penalties, removal of directors, officers or controlling shareholders and initiation of proceedings to terminate deposit insurance. It has been more than a decade since being a bank director was a plum to embellish a resume, but the risks of serving as a bank director today are real. Following good corporate process, keeping complete and accurate minutes and making decisions free from conflicts of interest and on the basis of sound credit underwriting are now, more than ever, essential. Diligence, close monitoring of management, using independent loan evaluators and ensuring legal compliance, all are crucial. Nevertheless, even a strong governance process and adherence to traditional banking practices may not be enough. If the bank is closed, the regulators will be scrutinizing the activities of the bank's board of directors and its executive officers. Since the number of bad loans, after all, has increased, additional reserves beyond those envisioned have been needed, which have eliminated earnings and sapped capital, and since the regulators have determined that the bank requires stricter supervision and is no longer operating in a safe and sound manner, it is extremely difficult for a director to assert that he or she has done an adequate job. A typical Order contains findings by the regulator that the bank already has violated banking regulations.⁶⁴ If the bank ultimately is closed, the FDIC now almost routinely sends letters to directors of the failed institution, seeking information and raising the specter of imposition of personal liability for the bank's losses.⁶⁵ Anecdotal information suggests that claim letters may be expected in 30% to 40% of all failed bank cases resulting from the financial meltdown.

Entry of a Supervisory Order requires the determination of an administrative law judge after a hearing and findings of specific facts. However, the full administrative review process rarely occurs. Before filing

⁶⁴ For example, earlier in 2011, to address bank holding company directors' concerns that the subsidiary bank was making admissions that were in dispute, the author attempted to revise the following provision in a proposed Order that would require the financial institution "to cease and desist from any action . . . for or toward causing, bring about, participating in, counseling, or the aiding and abetting of the unsafe or unsound banking practices that *resulted in*" a list of enumerated laws and regulations (emphasis added). The negotiations with the federal regulator to substitute the words *that may result in* for the words *resulted in* were unsuccessful.

⁶⁵ Craig McCrohan & Aaron Stanton, *FDIC Seeking to Recoup Bank Losses From Bank Directors*, BUS. L. TODAY (Mar. 17, 2011), <http://apps.americanbar.org/buslaw/blt/content/2011/02/article-mccrohan-stanton.shtml>.

an administrative complaint against a bank to impose greater restrictions and supervision on the institution, the regulators provide the bank the opportunity to enter into a "stipulation to the entry of a Consent Order." Prior to entry of the order, each of the members of the board of directors is required to sign the stipulation.⁶⁶ These stipulations include standard language that the consent to issuance of the order is made "solely for the purpose of this proceeding and without admitting or denying any of the alleged charges of unsafe or unsound banking practices and any violations of law and/or regulations," and thus are not legally admissions by those who sign it that the bank already has violated banking regulations. This, however, may be small solace at a future date. In fact, by entering into the stipulation, the bank expressly has waived receipt of a written notice or complaint, all defenses to the charges that would be set forth in that complaint and a hearing before an administrative law judge for the purpose of taking evidence regarding those allegations. Further, the bank waives the right to file exceptions and briefs with respect to the recommended decision or order of the administrative law judge if the bank disagrees with his or her findings.

At the same time that the bank is presented with a proposed Consent Order, its directors are provided individual notice of the proceeding, reminded of their responsibilities as directors and advised to consult with their counsel about their obligations and responsibilities.⁶⁷ For the typical community bank director, receipt of such a letter is a sobering and unsettling experience, and for some directors it is downright frightening. These letters underscore that the director can be held liable for losses caused by the actions taken—or lack of actions taken—by the board of directors. The letters may explicitly state that the FDIC has sued directors for failure to properly supervise the affairs of the bank.

Even given the heightened awareness of their own personal liability, the bank directors, often after much anguish and discussion with bank counsel and their own attorneys, almost inevitably agree to the stipulation and entry of the Order. The alternative—a formal administrative proceeding, tremendous legal expense and management distraction—is not tenable. As a practical matter, without negotiating leverage with the regulatory agency, adequate financial resources or resolve to engage in a protracted and

⁶⁶ While signatures of only a majority of the members of the Board of Directors are required, the regulators are generally insistent that all directors sign the Order, even if they were not present at the board meeting where agency officials and attorneys presented the Order and proposed stipulation.

⁶⁷ A director of an FDIC-insured, state-chartered bank received a letter contemporaneously with the delivery to the bank of a proposed Consent Order, which contained the language described in the article, and included an admonition that failure to take corrective action in a prompt and prudent manner could result in civil money penalties or more severe enforcement actions being recommended to the FDIC Board of Directors.

expensive administrative proceeding, entry into the stipulation and Order is the only viable choice.

B. *Directors and Officers at Risk*

As a bank moves through the supervisory stages—routine inspections, reports of examination, resolutions, Memorandum of Understanding and Consent Order—its officers and directors understandably become more concerned about the risk of potential exposure to personal liability. Two high profile lawsuits, against officers of IndyMac in July 2010 and directors and officers of Heritage Community Bank in November 2010, raised the awareness of the risks of serving on bank boards of directors.⁶⁸ As of September 13, 2011, the FDIC had authorized the filing of lawsuits against 294 individuals affiliated with 32 failed institutions, asserting damage claims of at least \$7.2 billion. This includes 14 filed lawsuits (one of which has settled) naming 103 former directors and officers.⁶⁹ The FDIC also has authorized 20 fidelity bond, attorney malpractice and appraiser malpractice lawsuits in addition to the 175 residential malpractice and mortgage fraud lawsuits currently pending, and cooperates with the Department of Justice in criminal investigations into the activities of former bank employees, including officers and directors.⁷⁰

Directors and officers, as well as controlling shareholders, are included within the definition of “institution-affiliated parties” who may have personal responsibility and liability for their reckless actions or knowing conduct that caused significant losses to the bank or had a significant adverse impact on the bank.⁷¹ The most common situation in which liability

⁶⁸ Complaint, F.D.I.C. v. Van Dellen, No. 2:10-cv-04915-DSF (C.D. Cal. July 2, 2010); F.D.I.C. v. Saphir, No. 10 C 7009, 2011 WL 3876918 (N.D. Ill. Sept. 1, 2011). In the savings and loan crisis of the late 1980s, the FDIC is believed to have instituted claims against directors and officers of nearly one-quarter of the failed institutions. To date, there have not been a significant number of civil actions filed against former bank directors and officers as a result of bank failures during the past four years.

⁶⁹ See *Professional Liability Lawsuits*, FED. DEPOSIT INS. CORP., <http://www.fdic.gov/bank/individual/failed/pls> (last visited Mar. 27, 2012).

⁷⁰ *Id.* The Federal Deposit Insurance Act, 12 U.S.C. § 1811 (2006), sets forth an expansive list of persons for whom liability may exist.

⁷¹ The Financial Institutions Reform, Recovery and Enforcement Act of 1989 established gross negligence as a national minimum standard of liability. 12 U.S.C. § 1821(k).

A director or officer of an insured depository institution may be held personally liable for monetary damages in any civil action by, on behalf of, or at the request or direction of [the FDIC] . . . acting as conservator or receiver . . . for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortuous conduct, as such terms are defined

is explored is in the context of a bank failure and litigation by the FDIC as receiver in a civil action for monetary damages.⁷²

Following a bank's failure, its former directors and executive officers may receive a letter from the FDIC with a demand for payment of civil money damages. While not generally made public, these demand letters typically allege breach of fiduciary duties to the institution and that the individual acted in a negligent or grossly negligent manner in conducting the business of the bank.⁷³ The classified or foreclosed loans generally form the basis of damages and the purpose of the demand letter is to constitute a "claim" under the bank's directors and officers' liability insurance policy. Subpoenas may be served to seek documents and testimony from the directors and officers.⁷⁴ These discovery requests generally extend beyond a review of the bank's classified assets to include whether the former director or officer has the resources to satisfy a judgment and whether there have been recent asset transfers to put the individuals' assets beyond the reach of creditors. This is done because the FDIC has a duty to attempt to achieve the maximum recovery possible and, in determining whether to initiate a lawsuit, the agency evaluates the likelihood of success and the cost-benefit of pursuing particular defendants.⁷⁵

The FDIC is also authorized to pursue claims under a lesser standard if permissible under state law, but most state laws impose liability on bank officers and directors only for gross negligence. These fiduciaries are

and determined under applicable State law. Nothing in this paragraph shall impair or affect any right of the Corporation under other applicable law.

Id.

⁷² 12 U.S.C. § 1818(k) authorizes civil actions by the FDIC as receiver for acts alleged to constitute gross negligence. The bank regulators have used the authority set forth in Section 1818(c) to justify asset freezes against institution-affiliated persons during the pendency of an administrative proceeding. *See* United States v. Thomas Spiegel, 995 F.2d 138 (9th Cir. 1993); *Lenz v. F.D.I.C.*, 251 F. Supp. 2d 121 (D.D.C. 2003); *F.D.I.C. v. Lenz*, 323 F. Supp. 2d 342, 344 (D. Conn. 2004). 12 U.S.C. § 1818(b)(6)(A) provides for restitution or indemnification; Section 1818(i)(2) provides for civil money penalties against institution-affiliated parties from \$5000 per day up to a maximum of \$1 million.

⁷³ *See In re Bank United Fin. Corp.*, 442 B.R. 49 (Bankr. S.D. Fla. 2010).

⁷⁴ Lawsuits are often not filed for two or more years after a bank failure. Former directors and officers will have difficulty responding to claims regarding the losses with respect to identified individual loans because access to bank documents is restricted.

⁷⁵ Claims are pursued based on a two-part test: The claim must be (i) sound on its merits and the receiver must be more than likely to succeed in any litigation necessary to collect on the claim and (ii) cost-effective, considering liability insurance coverage and personal assets held by the defendant. FDIC, *MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE* 266 (1998).

protected under the business judgment rule.⁷⁶ The FDIC acknowledges this standard and will not bring claims against officers and directors “who fulfill their responsibilities, including the duties of loyalty and care, and who make reasonable business judgments on a fully informed basis and after proper deliberation.”⁷⁷ There is a three-year statute of limitations but the FDIC generally moves rapidly with its demand letter, which is sent through its outside counsel.

The FDIC's Rules of Procedure require the agency to consider mitigating factors, such as the financial resources of the individual, his or her good faith conduct, if any, the gravity of the underlying conduct and alleged violations and any previous enforcement actions or violations.⁷⁸ Where board minutes or other records reflect that the director or officer acted affirmatively to correct unsound practices or ensure regulatory compliance, this documentation would serve to help protect him or her from liability.

Claims from shareholders and the bankruptcy trustee of the holding company for a closed bank represent additional risks to bank officers and directors.⁷⁹ While the allegations usually relate to securities fraud claims for failure to adequately disclose the extent of the bank's true financial condition, claims also are routinely made against directors for breach of their fiduciary duties, gross mismanagement and corporate waste. A jury rendered a verdict in late 2010 against the officers and directors of BankAtlantic Bancorp of Fort Lauderdale, Florida, for misrepresenting the value and risk of the bank's real estate loan portfolio.⁸⁰ There also have been actions filed under ERISA. For example, the directors and members of certain committees responsible for oversight of Colonial Bancgroup's profit-sharing plan were sued in early 2010.⁸¹ In this litigation, the

⁷⁶ *Statement Concerning the Responsibilities of Bank Directors and Officers*, FED. DEPOSIT INS. CORP. (Dec. 3, 1992), <http://www.fdic.gov/regulations/laws/rules/5000-3300.html#fdic5000statementct>.

⁷⁷ ANTON R. VALUKAS, EXAMINER'S REPORT, IN RE LEHMAN BROS. HOLDINGS INC. 16, 22, available at <http://lehmanreport.jenner.com/VOLUME%201.pdf>. The examiner in that case concluded that, while management made “a series of business decisions [that] had left it with heavy concentrations of illiquid assets with deteriorating values,” they amount to only “poor judgment” and were within the protection of the business judgment rule. *Id.*

⁷⁸ *Statement Concerning the Responsibilities of Bank Directors and Officers*, *supra* note 76.

⁷⁹ The standing of third parties is limited because the FDIC, as receiver, succeeds to “all rights, titles, powers, and privileges of the insured depository institution and of any stockholder, member, accountholder, depositor, officer or director of such institution with respect to the institution and the assets of the institution.” 12 U.S.C. § 1821(d)(2)(A) (2006).

⁸⁰ *In re BankAtlantic Bancorp, Inc.*, No. 07-61542-CIV, 2011 WL 1585605 (S.D. Fla. Apr. 25, 2011).

⁸¹ Amended Complaint, *In re Colonial Bancgroup, Inc.*, No. 2:09-cv-792-MHT-WC (M.D. Ala. Jan. 11, 2010) (No. 99).

plaintiffs' alleged failure to investigate the improper business practices of Colonial Bank, the principal operating subsidiary of the company and further that, as the bank's condition worsened, these defendants knew or should have known that the holding company stock was an unduly risky investment option for the company's 401(k) retirement plan.⁸²

C. *Legal Claims and Insurance*

The ability to recover against bank directors and officers liability insurance policies, as noted above, is a driver for the FDIC in its evaluation of whether to initiate civil litigation against institution-affiliated persons. The risk of loss has led to a tightening of available coverage and increased premiums for directors of troubled institutions. If insurance is available, the "regulatory exclusion" in the policies may make the benefits of insurance illusory. When a bank fails, an FDIC attorney routinely reviews and evaluates possible claims against the failed bank's directors. Whether the agency sues an individual director may depend on whether there is insurance and whether a judgment against the director would be collectible. Proving a claim may not be the impediment a director would expect because the nature of the potential claims are often broad and generic, for example, failure to adhere to policies or proper documentation of exceptions to policies. The risk of liability and a legitimate concern that insurance is inadequate could deprive smaller banks of the independent judgment and business experience of its outside directors at precisely the time the institution most needs those individuals for advice and guidance in difficult decision-making.⁸³

D. *Officers Under the Microscope*

Officers of a financial institution are in an even less enviable position than directors if the regulators believe they were "responsible" for the problems of a closed institution. In an effort to recover part of the losses to the Deposit Insurance Fund from 2008 through mid-2011 of more than \$75 billion, the FDIC is reportedly actively pursuing more than fifty bank executives. "These investigations are now beginning to produce results, and we anticipate that many more will be authorized," said FDIC Chair Sheila

⁸² *Id.*

⁸³ "Despite the fact that they had nothing to do with the financial crisis, community banks are already having great difficulty in attracting and retaining qualified directors given the perceived hostile regulatory environment and the prospect of FDIC litigation and personal liability for directors of failed banks." Memorandum from Christopher Cole, Senior Vice President and Senior Regulatory Counsel, Indep. Cmty. Bankers of Am., to the 29th Annual SEC Gov't-Bus. Forum on Small Bus. Cap. Formation (Nov. 18, 2010), available at <http://www.sec.gov/info/smallbus/2010gbforum/2010gbforum-icba.pdf>.

C. Bair in a statement on October 8, 2011.⁸⁴ In the FDIC lawsuit against IndyMac Bancorp, recovery of over \$300 million in damages is sought from four executives.⁸⁵

Under the category of adding insult to injury, officers who are terminated without cause can fall within the FDIC's "golden parachute" policy and be denied their contractual rights to severance under employment agreements, even an agreement entered into long before the bank experienced capital or other difficulties.⁸⁶ If an institution is "troubled" (defined by the FDIC as banks with a CAMELS rating of 4 or 5 or that meet other defined criteria), it cannot make a "golden parachute" payment without approval. Unless the officer was *not* "substantially responsible" for the insolvency or troubled condition of the bank, such regulatory approval will not be forthcoming.⁸⁷ Therefore, to be paid severance under a pre-existing employment agreement, even one that was entered into years before the bank was "troubled," the former officer must demonstrate that he or she was not "substantially responsible" for the insolvency or troubled condition of the bank. It is unlikely, in such circumstances, that the bank would stipulate that one of its former key executive officers was not substantially responsible, alone or with others, for the current condition of the bank. Therefore, the likelihood that the former key executive would prevail in his or her claim is extremely low.

A bank officer is also subject to risk of repayment of past compensation. On July 6, 2011, the FDIC adopted a final rule to implement the Orderly Liquidation Authority contained in Title II of the Dodd-Frank Act, including how compensation will be recouped from senior executives and directors who are "substantially responsible" for the failure of a depository institution.⁸⁸ Under the new rule, the FDIC as receiver will

⁸⁴ Peter Whoriskey, *FDIC to Sue Bank Officials in Effort to Recoup \$1 Billion in Losses*, THE WASHINGTON POST, Oct. 9, 2010, at A16. Chairman Bair also said, "As a matter of policy, the FDIC believes strongly in accountability for directors and officers whose personal misconduct led to a bank's failure." *Id.*

⁸⁵ The FDIC's acting general counsel Richard Osterman was quoted as saying recently that "[w]hen these banks fail, people don't come in and say, 'We did something wrong, here's the money' We're continuing to review cases. We're still fairly early in this crisis." *Id.*

⁸⁶ 12 C.F.R. §§ 359.0–359.7 (2011).

⁸⁷ 12 C.F.R. § 359.4(4)(ii). Under Section 359.4(4), the officer further cannot have (a) committed any fraudulent act or omission, breach of trust or fiduciary duty or insider abuse with regard to the depository institution or its holding company that has had or is likely to have a material adverse effect on either entity; (b) materially violated any applicable federal or state banking law or regulation that has had or is likely to have a material effect on either entity; or (c) violated or conspired to violate specified other statutes. *Id.*

⁸⁸ Certain Orderly Liquidation Authority Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 41626-0 (July 15, 2011) (codified at 12 C.F.R. pt. 380). The rule became effective on August 15, 2011.

consider whether the senior executive performed his or her responsibilities with the degree of skill and care that an ordinarily prudent person in a like position would exercise under similar circumstances, and whether the individual caused a loss that materially contributed to the failure of the financial company. The final rule clarified that the standard of care that would trigger the recovery of previously-paid compensation is negligence and that gross negligence is not required.

From the viewpoint of the bank officer or director, the most chilling aspect of the proposed rule is that the individual has the burden of proof to establish that he or she exercised his or her business judgment. State business judgment rules and insulating statutes will not shift the burden of proof to the FDIC.⁸⁹ Even more frightening is that the FDIC rule contains in “certain limited circumstances” a *presumption* that the senior executive officer or director was substantially responsible and, therefore, subject to a claw-back of up to two years of compensation.⁹⁰ As the FDIC explained:

Substantial responsibility shall be presumed when the senior executive or director is the chairman of the board of directors, chief executive officer, president, chief financial officer, or acts in any other similar role regardless of his or her title if in this role he or she had responsibility for the strategic, policymaking, or company-wide operational decisions of the covered financial company. The FDIC as receiver also will presume the substantial responsibility of a senior executive or director who has been adjudged by a court or tribunal to have breached his or her duty of loyalty to the covered financial company. Finally, in order to ensure consistency this presumption also extends to a senior executive or director who has been removed from his or her position with a covered financial company under section 206(4) or section 206(5) of the Act.⁹¹

While an exception is created for senior executives and directors recently hired by the financial company specifically for improving its

⁸⁹ 76 Fed. Reg. 136, 41629 (July 15, 2011).

⁹⁰ 76 Fed. Reg. 136, 41631 (July 15, 2011). The compensation recoupment period is unlimited in the case of fraud.

⁹¹ *Id.* While a number of commentators on the proposed rule objected to the use of the rebuttable presumption in these circumstances, the FDIC perfunctorily stated that “the use of rebuttable presumptions for those individuals under the limited circumstances described in the Proposed Rule is aligned with the intent shown in the statutory language; thus, the presumptions remain unchanged in the Final Rule”. *Id.*

condition, this is of no assistance to the existing officers and directors who now have the burden to prove their innocence.⁹²

V. THE IMPACT OF DODD-FRANK ON SMALL FINANCIAL INSTITUTIONS

The expansive scope and reach of the Dodd-Frank Act is acknowledged but, given its comprehensive reach, not well understood. At roughly 2300 pages, the Act requires 243 rulemakings, 67 one-time reports or studies and 22 new periodic reports. While the SEC bears the brunt of the new requirements (with 95 mandated new rulemakings, 17 studies and 5 new periodic reports), the Federal Reserve and the FDIC have, combined, been directed to promulgate 54 new rulemakings.⁹³ These three agencies and the other regulators required to undertake these studies, reports and rulemakings will be under the watchful eye of the General Accounting Office, which itself is directed by the Dodd-Frank Act to make twenty-five reports and studies.

It is not the purpose of this article to discuss the numerous and far-reaching effects of the Dodd-Frank Act on small business.⁹⁴ Therefore, with the purpose of merely selecting a handful of issues that are non-obvious to the general reader, the author hopes to provide a small insight into the disproportionate burdens placed on smaller entities by comprehensive

⁹² 12 C.F.R. 380.7(b)(3)(i)–(ii) (2011). This Section applies to senior officers or directors who were hired or joined the board within the two years prior to the appointment of the FDIC as receiver. *Id.*

⁹³ Mary L. Schapiro, SEC Chairman, remarked publicly that the agency needed to add 800 employees to carry out the mandates of the Dodd-Frank Act. ABIGAIL ARMS ET. AL., *HOT ISSUES IN SECURITIES LAW 2010: DISCLOSURE DOCUMENTS AND TRENDS*, PRACTISING LAW INST. (2010).

⁹⁴ SEC. EXCH. COMM'N, 2010 ANNUAL SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION FINAL REPORT 116 (2011). For example, Section 413 of the Dodd-Frank Act modifies the "accredited investor" net worth test standard for individual investors, effective immediately upon enactment to \$1 million, *excluding* the value of the investor's primary residence. Letter from Richard B. Chess, President Real Estate Investment Securities Association, William H. Winn, Legislative/Regulatory Chair REISA, & Deborah S. Froling, Legislative/Regulatory Task Force REISA, to Gerald J. Laporte, Chief Office of Small Business Policy, Division of Corporation Policy (Nov. 12, 2010), <http://www.sec.gov/info/smallbus.shtml>. Although the dollar threshold for the net worth test was not increased, by excluding the value of an investor's primary residence, the Act effectively tightened the eligibility standards for individuals to meet the test for accredited investors. *Id.* On January 25, 2011, the SEC issued proposed rules, adding the statutory language, noting that, while 9.04% of U.S. households qualified for accredited investor status on the basis of the net worth standard before it was modified by Section 413(a), only 6.55% would have qualified on the modified standard—a difference and elimination of 2,891,938 investors. *Id.* The impact on smaller companies seeking private financing is immense. *Id.* The Real Estate Investment Securities Association estimated that this provision would exclude potentially one out of every two investors in the Regulation D private offering market. *Id.*

legislation directed primarily at larger institutions. The burdens and costs may not have been intended by Congress or the regulatory agencies that must implement the new legislation, but the impact is immediate and real. Therefore, for purposes of illustration only, the following Dodd-Frank issues are identified for brief mention as to their effect on smaller financial institutions.

A. *The Durbin Amendment*

Under the Dodd-Frank Act and the proposed debit interchange implementing rule, community banks are not effectively carved out by the statutory exemption for debit cards issued by institutions with less than \$10 billion assets. This would, according to the Independent Community Bankers of America (ICBA) “fundamentally alter the economics of consumer banking.”⁹⁵ This would occur because under proposed regulations and the merchant card system under discussion, granting retailers the ability to route debit card transactions over the network of their choice, where the card issuer currently designates the network on which the card is routed, will allow retailers to bypass the two-tier system. Large retailers, according to the ICBA, will be able to incentivize customers to use the rate-controlled cards issued by the largest banks, discriminating against community banks and their customers.

B. *Consumer Financial Protection Bureau*

The new Consumer Financial Protection Bureau (CFPB) mandated by the Dodd-Frank Act is focused on the largest institutions, yet it will have extremely broad powers. A year after enactment of the Dodd-Frank Act, the agency was still in formation and its authority and operation still under political attack.⁹⁶ While the federal bank regulators over the years have developed expertise in balancing the safety and soundness of banking operations with consumer protection against unfair and harmful practices, their influence over the new CFPB regulations through the Financial Stability Oversight Council is circumscribed. The Council has veto power, but it can be exercised only by a finding, demonstrated by a two-thirds vote, that the regulation “puts at risk safety and soundness of the banking system or the stability of the financial system”—an incredibly high standard. The CFPB rules likely will add to the costs community banks already spend on consumer protection.

⁹⁵ *The Effect of Dodd-Frank of Small Financial Institutions and Small Businesses: Hearing Before the Subcomm. on Fin. Serv. and Consumer Credit of the H. Comm. of Fin. Servs.*, 112th Cong. 116, 118 (2011) (statement of James D. MacPhee, Chairman, Indep. Cmty. Bankers of Am.).

⁹⁶ President Obama did not nominate Richard Cordray to be the CFPB’s first Director until July 2011 and, as of October 2011, Mr. Cordray still had not been confirmed by the Senate.

C. Risk Retention

Section 941 of the Dodd-Frank Act requires mortgage originators to retain credit risk on non-qualified residential mortgages—but the definition may be implemented too narrowly, according to the Independent Community Bankers of America.⁹⁷ In testimony before Congress, the ICBA cautioned that credit could be severely limited to many borrowers if the rules are overly restrictive and, community banks will be disadvantaged because of their lack of access to the increased capital needed to offset risk retention requirements. Furthermore, the association warned that community banks in rural communities would be driven out of the market by Farm Credit System direct lenders that have an exemption for loans that they make, insure, guarantee or purchase.

D. Escrows for Taxes and Insurance

While escrowing funds for taxes and insurance is generally a sound practice, it can be particularly costly for small lenders. This is because many of them with small lending volumes outsource their escrow services and do not qualify for volume discounts. These additional costs may encourage many community banks to reduce or eliminate their mortgage businesses. Particularly for loans collateralized by rural properties, which do not lend themselves to securitization, some commentators believe that mandating escrows in all circumstances is unnecessary.⁹⁸

VI. BRIGHT SPOTS FOR SMALLER FINANCIAL INSTITUTIONS

A. Small Business Lending Fund

In his State of the Union address in January 2010, President Obama proposed the idea of providing additional capital to community banks to spur lending for community banks to broad acclaim from both political parties. On September 27, 2010, President Obama signed into law the Small

⁹⁷ *The Effect of Dodd-Frank of Small Financial Institutions and Small Businesses: Hearing Before the Subcomm. on Fin. Serv. and Consumer Credit of the H. Comm. of Fin. Servs.*, *supra* note 95.

⁹⁸ *Id.* There are various other provisions of the Dodd-Frank Act that disproportionately affect smaller banks. In his testimony, James D. MacPhee cited the provisions requiring the regulatory agencies to replace all references to “credit ratings” with an “appropriate standard for measuring creditworthiness.” Certainly, the credit rating agencies did not meet the expectations of independence, diligence and sound analysis that were expected of them. Nevertheless, since community banks lack the resources to independently analyze credit quality, the Independent Community Bankers of America suggests that they be entitled to use credit ratings with appropriate regulatory authority to confirm those ratings in situations where additional credit analysis is warranted.

Business Jobs Act of 2010 (Jobs Act).⁹⁹ By the end of the year, the U.S. Department of the Treasury released a term sheet and application for the new \$30 billion Small Business Lending Fund (SBLF) established by the Jobs Act to encourage lending to small businesses by providing Tier 1 capital to qualified community banks with assets of less than \$10 billion.¹⁰⁰ As stated by the Treasury in its release, through the SBLF “Main Street banks and small business can work together to help create jobs and promote economic growth in local communities across the nation.”¹⁰¹

Through this initiative, the Treasury was expected to provide banks with capital by purchasing Tier 1 qualifying preferred stock or equivalents in each bank.¹⁰² The dividend rate on SBLF funding is reduced as a participating community bank increases its lending to small businesses. The initial dividend rate to the Treasury is, at most, 5%. If the bank’s small business lending increases by 10% or more, then the rate falls to as low as 1%. The program criteria are quite flexible, and businesses with up to \$50 million in annual revenues were eligible to apply for loans of up to \$10 million for commercial and industrial purposes, nonresidential real estate loans, loans to finance agricultural production and other loans to farmers. The program requires the funds to be made available through insured depository institutions with assets of less than \$10 billion. Banks that have total assets of \$1 billion or less could apply for SBLF funding of up to 5% of risk-weighted assets. Banks with assets of more than \$1 billion, but less than \$10 billion, could apply for SBLF funding that equals up to 3% of risk-weighted assets. Institutions that were on the FDIC’s problem bank list, or similar list, or had been removed from such lists within the previous ninety days were ineligible for SBLF funding. Generally, this disqualified banks with a composite CAMELS rating of 4 or 5. This program offered great promise for providing badly needed financing for small businesses. The reality was quite different from the expectation.

⁹⁹ Small Business Jobs Act of 2010, Pub. L. No. 111-240 (codified at 15 U.S.C. § 636) (2011).

¹⁰⁰ See *Small Business Lending Fund*, U.S. DEPT. OF THE TREASURY, <http://www.treasury.gov/resource-center/sb-programs/Pages/Small-Business-Lending-Fund.aspx> (last visited Mar. 27, 2012).

¹⁰¹ *Id.*

¹⁰² Capital Adequacy Guidelines; Small Bank Holding Company Policy Statement: Treatment of Subordinated Securities Issued to the United States Treasury Under the Emergency Economic Stabilization Act of 2008 and the Small Business Jobs Act of 2010, 12 C.F.R. § 225 (2012). For Sub-S or mutual bank holding companies, the SBLF funds qualify as Tier 2 capital. However, for these types of institutions, pursuant to an interim final rule published on June 13, 2011, by the Federal Reserve, small bank holding companies (those with less than \$500 million in consolidated assets) can downstream the funds as Tier 1 capital into their subsidiary banks. Robert Klingler, *Fed Confirms Tier 2 Treatment for Sub S SBLF Funds*, BRYAN CAVE LLP BLOG (June 13, 2011), <http://bankbryancave.com/2011/06/fed-confirms-tier-2-treatment-for-sub-s-sblf-funds-2/>.

According to Timothy Massad, Acting Assistant Secretary for Financial Stability, in testimony before Congress on February 28, 2011, the Treasury was close to announcing its first round of investments in community banks. This was received with great relief because, as with much of the federal stimulus money in 2009, there was widespread disappointment that the actual stimulus dollars were not rapidly deployed. Unfortunately, the SBLF experienced the same bureaucratic delays as the earlier stimulus funds.

On March 30, 2011, the day before the application deadline for banks taxed as C corporations to apply for the SBLF, the deadline was extended to May 16, 2011, and as of that date, the approximately 600 banks that had already applied were still awaiting meaningful feedback from the Treasury. On May 26, 2011, after the application deadline, the Treasury placed further restrictions on the eligibility of participants, providing that only institutions without any dividend restrictions could participate in the SBLF. In going beyond the eligibility standards imposed by the enabling statute, the Treasury limited the number of eligible institutions and effectively eliminated *de novo* institutions from the program.

Finally, on July 7, 2011, the Treasury announced that four holding companies in Alabama, Louisiana, Michigan and Washington and two community banks in Texas and Virginia had received the first \$123 million in SBLF funds, ranging from \$3 million to \$48.3 million. Seventeen more banks and holding companies received \$214 million in SBLF funding on July 20, 2011. While "better late than never," it is beyond understanding why a highly heralded program focused on small business took nearly ten months to get off the ground. While a great number of jobs could have been created with \$30 billion, it took ten months to deploy \$123 million, and the promise of new jobs proved greater than the end result.

For myriad reasons, including the complexity of the legal documentation required, banks' concerns over increasing regulatory supervision and intrusion, and real or perceived questions over eligibility, fewer than 1000 of the nation's 7000 community banks applied for SBLF funding. The aggregate amount of requested funds was slightly less than \$12 billion, one-third of the federal funds available. Yet, of the requested funds, only \$692 million had been approved. In other words, a \$30 billion cornerstone federal program to help small businesses, delivered less than \$1 billion (only 6% of the funds applied for) to the marketplace. The program expired on September 27, 2011, and, by any objective measure, cannot be deemed a success.¹⁰³

¹⁰³ While the Department of the Treasury has commented that many of the bank applications were not worthy of funding, the author is familiar with at least one application in which a healthy community bank, notwithstanding support from its primary federal regulator, was denied SBLF funding without explanation.

B. Other Small Business Credit Initiatives and Tax Incentive Programs

The State Small Business Credit Initiative (SSBCI), a key part of the Small Business Jobs Act, allocates \$1.5 billion to new and existing state programs that will leverage private financing to spur \$15 billion in new lending to small businesses and small manufacturers. A total of fifty-four states and territories applied to take part in the SSBCI, and sixteen states had had their applications approved for \$570 million in SSBCI funding by June 20, 2011. On August 16, 2011, the Department of the Treasury announced the approval of SSBCI applications for funding from eleven states and Washington, D.C. With a total of \$360 million in SSBCI funds, the Treasury expects these states and Washington, D.C. to generate a minimum of at least \$10 in new private lending for every \$1 in federal funding, or more than \$3.6 billion in new private lending.¹⁰⁴ The deadline for applications under the SSBCI was September 27, 2011, and it appears that the full \$1.5 billion provided by the Jobs Act of 2010 was not allocated.

The Obama Administration by its admission has supported seventeen direct tax breaks that provide tax relief of more than \$50 billion for small businesses. These programs were designed to support job creation and retention, entrepreneurship, investment and growth. The Administration has also reported that it has worked with Congress to extend and expand Small Business Administration loan programs that helped put more than \$42 billion in loans to small businesses. Whether these efforts served to spur job creation or improve the economy is subject to debate. The U.S. economy did expand at an annual rate of 1.3% in the April–June quarter of 2011 but, even so, the economy grew at an annual rate of only 0.9% for the first half of the year, the weakest six-month performance since the end of the recession in June 2009.

C. Advanced Capital Adequacy Framework—Basel II

A substantial contributing factor to the capital difficulties experienced by the larger “too-big-to-fail” banks was that they were able to determine their own minimum capital requirements subject to regulatory agency review rather than a standard established by the banking agencies that applied to all sizes of institution. The bifurcated risk-based capital framework embodied in the advanced risk-based capital adequacy standards (advanced approaches rules) implemented on a transition basis in December 2007 (ironically, December 7) established a series of transitional floors and limits that allowed larger banks to operate with lower minimum risk-based capital requirements. Section 171(b) of the Dodd-Frank Act requires the

¹⁰⁴ Press Release, U.S. Dep’t. of the Treasury, U.S. Department of the Treasury Announces Funds to Spur \$3.6 Billion in New Lending to Small Businesses, Help Create Jobs (Aug. 16, 2011), available at <http://www.treasury.gov/press-center/press-releases/Pages/tg1278.aspx>.

bank regulatory agencies to establish minimum risk-based capital requirements for all insured depository institutions, depository institution holding companies supervised by the Federal Reserve and non-bank financial companies supervised by the Federal Reserve at not less than the “generally applicable” capital requirements in effect for insured depository institutions as of the date of enactment of the Dodd-Frank Act (4% Tier 1 and 8% total risk-based). This would level the playing field according to the Independent Community Bankers Association.¹⁰⁵

VII. BANK FINANCING FOR SMALL BUSINESSES IN THE FUTURE

Since community banks provide the lion’s share of financing for America’s small businesses, the health of community banks is critical to our national recovery. Unfortunately, smaller banks are severely ailing. For example, in Florida, for many years the leader in new bank organization, 247 banking institutions lost a combined \$1.505 billion in 2010. That followed combined losses for Florida banks of \$2.224 billion in 2009 and \$2.766 billion in 2008.¹⁰⁶ On a national scale, those numbers pale as U.S. financial losses from the credit crisis have been predicted to rise as high as \$3.6 trillion.¹⁰⁷ From a high of 14,000 institutions, the number of U.S. banks had declined to 7574 by August 2011 and that number could drop to around 5000 over the next two years. There were 157 bank failures in 2010 and already 64 through August 12, 2011, with another nearly 900 institutions on the FDIC Problem Bank list.

The overall banking industry is improving as indicated by recent profits at the nation’s largest banks. Pre-tax profits for the industry were more than \$125 billion in 2010 and \$84 billion through the second quarter of 2011.¹⁰⁸

¹⁰⁵ Letter from Christopher Cole, Senior Vice President and Senior Regulatory Counsel, Indep. Cmty. Bank. of Am., to the Off. of Comptroller of the Currency, Bd. of Governors Fed. Reserve Sys. and Fed. Deposit Ins. Corp. (Feb. 28, 2011), available at <http://www.fdic.gov/regulations/laws/federal/2010/10c11Dec30.PDF>.

¹⁰⁶ At June 30, 2011, while Florida banks with assets less than \$100 million were still in a loss position, all insured institutions in the state as a group generated YTD net income of \$76 million. FDIC State Banking Performance Summary, FED. DEPOSIT INS. CORP., <http://www2.fdic.gov/qbp> (follow “State Banking Performance Summary” hyperlink; then select “Florida” for “Geographical Area,” “Jun. 30, 2011” for “Report Date”; then follow “All Insured Institutions” hyperlink).

¹⁰⁷ Patrick Kuo, *Bond Risk Rises After State Street Reports Fixed-Income Losses*, BLOOMBERG (Jan. 20, 2009), http://www.bloomberg.com/apps/news?pid=conewsstory&refer=conews&tkr=STT:US&sid=aLBzcfce_BS9M. New York University Professor Nouriel Roubini in early 2009 predicted that U.S. financial losses from the credit crisis could reach \$3.6 trillion. Since approximately one-half of that amount was in the hands of banks and broker-dealers, that collectively only had capital of \$1.4 trillion, Professor Roubini said the U.S. banking system was “effectively insolvent.” *Id.*

¹⁰⁸ Gandel, *supra* note 10, at 45.

The condition of the Deposit Insurance Fund has improved over the past several quarters and, at June 30, 2011, achieved its first positive quarter-end balance (\$4.9 billion) since June 30, 2009.¹⁰⁹ However, FDIC Chairman Sheila Bair recently expressed concern that the banking recovery reflected primarily the significant drop in loan-loss provisions, while bank lending and operating revenue continued to drop.¹¹⁰ Further, while loans to commercial and industrial borrowers increased by \$18.1 billion in the first quarter of 2011, nearly half of the growth was in loans to foreign borrowers.¹¹¹

Community banks may soon return to profitability according to Carson Medlin, a leading small and middle-market investment banking firm. In a recent report, the firm noted that most small banks have historically high reserve levels (SIBR average of 2.38%) and have experienced abnormally high charge-offs for nearly three years and, at some point, high provision expenses will no longer be justified. While funding costs have also declined, the report concluded, “we don’t think future profitability will resemble what was experienced in the past due to the rising cost of doing business, primarily compliance related.”¹¹² The Carson-Medlin report continued that these factors will drive increased consolidation in the industry. The view that the Dodd-Frank Act will lead to accelerated consolidation was echoed in a recent *Harvard Forum* article attributing this trend to more stringent capital requirements as well as more limitations on business activities, increased compliance costs and emphasis on “systemically important financial institutions,” among other factors.¹¹³

¹⁰⁹ *Quarterly Banking Profile*, *supra* note 39, at 14.

¹¹⁰ *Legal Update*, PRACTICAL LAW CO. (May 24, 2011) (on file with author). Chairman Bair’s comments were underscored by her successor, Acting FDIC Chairman Martin Gruenberg:

[R]eductions in loan-loss provisions—the money banks set aside against expected loan losses—account for most of the improvement in industry earnings. As the levels of loan-loss provisions approach their historic norms, the prospects of earnings improvement from further reductions diminish.

Increased lending will be essential for future revenue growth.

Martin J. Gruenberg, Remarks to the American Banker Regulatory Symposium (Sept. 19, 2011), available at <http://fdic.gov/news/news/speeches/chairman/spsep1911.html>.

¹¹¹ *Quarterly Banking Profile: First Quarter 2011*, *supra* note 39.

¹¹² CARSON MEDLIN, *Southeastern Independent Bank Review Second Quarter 2011*, (Sept. 10, 2011), available at <http://www.monroesecurities.com/wp-content/uploads/2011/08/Southeastern-Independent-Bank-Review-2nd-Quarter-2011.pdf>.

¹¹³ Lee A. Meyerson, *Reflections on Dodd-Frank: A Look Back and a Look Forward*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Sept. 10, 2011, 2:57 PM), <http://blogs.law.harvard.edu/corpgov>.

VIII. EPILOGUE?

As happens repeatedly throughout our history, we end where we began. Approaching retirement after more than eighteen years as the head of the Federal Reserve Bank of Kansas City, Thomas Hoenig in August 2011 again criticized the regulatory focus on “systemically important financial institutions,” or SIFIs. Hoenig asserted these too-big-to-fail firms are “fundamentally inconsistent with capitalism.”¹¹⁴ Hoenig cautioned that, “[s]o long as the concept of a [sic] SIFI exists, and there are institutions so powerful and considered so important that they require special support and different rules, the future of capitalism is at risk and our market economy is in peril.”

Noting that until as late as 1980, the U.S. banking industry was relatively unconcentrated, with 14,000 commercial banks and the assets of the five largest institutions amounting to 29% of total banking organization assets and only 14% of GDP, he decried the fact that currently the five largest institutions control more than 50% of the industry’s assets, which is equal to almost 60% of GDP. He emphasized that this far more concentrated sector has led to a less competitive banking system, with the largest twenty banking institutions controlling 80% of the industry’s assets—or approximately 86% of GDP.

This result is disastrous for smaller businesses. While community banks currently represent less than 11% of all bank assets, they support nearly 40% of bank loans under \$1 million to small business and farms.¹¹⁵ The regulators recognize this. “Community banks, which comprise the vast majority of FDIC-supervised banks, play a vital role in credit creation across the country, especially for small businesses,” FDIC Chair Sheila Bair testified recently.¹¹⁶ Yet, she also acknowledged that some bankers had expressed concern that examinations were being conducted in an overly conservative manner.

Over-regulation, the specter of liability for bank directors and unwillingness to recognize the difficulties in raising capital and dealing with classified assets must be addressed if smaller banks are to survive and play their traditional role in small business growth and job creation. One healthy and profitable community bank recently decided that the future for small banks was so poor that it would simply get out of the banking business. In August 2011, Main Street Bank of Kingwood, Texas decided to voluntarily surrender its charter and sell its four branches to another bank.

¹¹⁴ Thomas M. Hoenig, President and Chief Exec. Officer, Fed. Res. Bank of Kansas City, *Do SIFIs Have a Future?*, PEW FIN. REFORM PROJECT & N.Y. UNIV. STERN SCH. OF BUS. “DODD-FRANK ONE YEAR ON” (June 27, 2011).

¹¹⁵ *Potential Mixed Messages*, *supra* note 27.

¹¹⁶ *Id.*

The 27-year-old institution, which lent most of its funds to small businesses, cited a “tightening regulatory noose” for the decision to exit the banking system.¹¹⁷ According to the bank’s chairman, nearly all of its \$175 million in loans, which average \$100,000, were to local customers with annual revenues of less than \$1 million.

Main Street Bank is undoubtedly an outlier but the facts speak for themselves. From 2002 to the second quarter of 2011, the number of insured institutions with assets of less than \$1 billion has declined from 8798 to 6846, while the number of institutions with assets greater than \$1 billion has increased from 450 to 561—and the number with assets greater than \$10 billion remained 106.¹¹⁸ This is true during a time period when the number of bank assets grew from \$8.4 trillion to \$13.6 trillion. The message should not be ignored.

There may, in fact, be some good news on the horizon. FDIC Acting Chairman Martin J. Gruenberg, in remarks to the American Banker Regulatory Symposium in Washington, D.C. on September 19, 2011, emphasized that, community banks play a “critical” and a “unique” role not only in the financial system, but also in the U.S. economy as a whole. He went on to note, however, “the financial crisis and ensuing recession have taken a serious toll on community banks. Of the 395 FDIC-insured institutions that have failed during the crisis, more than 300 have been community banks.”¹¹⁹

Acting Chairman Gruenberg stated that the FDIC would undertake a number of initiatives to further its understanding of the challenges and opportunities for community banks going forward by holding a conference early in 2012 on the future of community banking and “reviewing key challenges facing community banks such as raising capital, keeping up with technology, attracting qualified personnel, and meeting regulatory obligations.” He concluded his remarks by stating that, “This overall effort in regard to community banks will be a major priority for the FDIC over the coming year.”¹²⁰

Hopefully, this will be the case so that smaller banks will again be able to sustain their historic role of driving the economy by providing loans to smaller businesses in local communities throughout the country. “[U]ntil

¹¹⁷ Robin Sidel, *Fed Up: A Texas Bank Is Calling It Quits*, WALL ST. J., Aug. 10, 2011, at C1.

¹¹⁸ FED. DEPOSIT INS. CORP., www.fdic.gov.

¹¹⁹ See Gruenberg, *supra* note 110.

¹²⁰ Acting Chairman Gruenberg further indicated that the FDIC was reviewing its risk-management and compliance supervision practices to see if there were ways to make the process more efficient. He stated that the FDIC would continue to have direct outreach and an open dialogue with community bankers, hold a series of regional roundtables with community bankers across the country to get their input and continue its Advisory Committee on Community Banking.

the bank regulatory agencies and Congressional leaders recognize that the focus on 'too big to fail' institutions will only hasten the failure of smaller banks and their small business customers, the recovery will remain anemic and job creation sluggish."¹²¹

¹²¹ Luis A. Aguilar, Sec. & Exch. Comm'n Comm'r Address at the Council of Institutional Investors Spring Meeting (Apr. 4, 2011) (transcript available at <http://www.sec.gov/news/speech/2011/spch040411laa.htm>). Commissioner Aguilar described the recovery as "anemic" in his remarks. *Id.* The number of full-time jobs in the banking sector alone, declined from 2,215,029 in 2007 to 2,104,698 at the end of the second quarter of 2011 (a decrease of 5%). *Id.*

