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CAPITAL

As the lessons of the Panic of 2008 are identified and codified, all and sundry have relearned the importance of capital as a cushion against losses on loans and investments. By purchasing preferred stock in many banks, the U.S. Treasury prevented hundreds of banks from becoming undercapitalized or worse. The prompt corrective action regime enacted in 1989 worked as intended, forcing undercapitalized institutions to raise capital or be liquidated. In the words of one banker, “I have a new respect for the value of excess capital.”

The Basel Committee on Banking Supervision is advancing quickly a proposal which will require all banks subject to its jurisdiction to maintain higher minimum levels of equity capital. U.S. bank regulators have signaled their support for similar schemes aimed at banks they regulate. Meanwhile, as a political expedient, Congress and President Obama have offered community banks additional preferred stock investment by the U.S. Treasury on the condition that recipients use the capital to enlarge their small business loan portfolios.

Amid all the activity, however, signs are emerging that higher minimum capital requirements will have an adverse effect on segments of the banking industry. Community banks in particular are positioned poorly when it comes to raising new capital. Most of them have shareholder constituencies that own shares out of loyalty to the communities where the banks are located

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rather than out of desire for maximum return on equity. Raising capital in the public equity markets is difficult to impossible for community banks because their cost structures prevent them from achieving the return on investment that disinterested investors require. Recently published reports indicate many community banks do not have the resources to redeem the TARP preferred stock investments of 2008-09.

This installment of Regional Banking Outlook focuses on the issue of capital. Its availability and cost will determine the fate of many institutions over the next five years. And the disappearance of banks deprived of incremental capital will enable the rise of newer, more capital-efficient institutions whose business ethos will not be the seven deadly words, “We have always done it that way.”

NO GOOD DEED GOES UNPUNISHED

When the canary died and the methane gas of securitization exploded Wall Street’s money mine in 2008, the federal government provided unprecedented levels of liquidity to the banks most affected. Community banks complained. They reasoned that dangerous behavior of Citibank, Wachovia, Washington Mutual, National City and their peers caused the financial crisis. So why rescue the reckless, especially when the cost of the rescue would be spread across all banks in the form of additional deposit insurance assessments and other measures?

Sensitive to the criticism, President Obama and Congress in October 2010 rewarded community banks with their own, dedicated pool of low cost capital. The Small Business Jobs Act of 2010 (“Jobs Act”) created a \$30 billion Small Business Lending Fund (“SBLF”) administered by the U.S. Treasury. The source of the SBLF is proceeds of early redemptions of TARP preferred stock investments completed in 2008-09. Since the nation’s largest banks carried out most of those early redemptions, the funds are in effect being recycled as incremental capital for community banks. Banks whose assets are \$1 billion or less as of December 31, 2009, may obtain capital in an amount up to five percent of their risk weighted assets less any existing TARP preferred stock investment. Banks having assets >\$1 billion but <\$10 billion are limited to capital equal to three percent of risk weighted assets less exist-

ing TARP preferred stock investment. Banks having assets >\$10 billion are ineligible to participate.

SBLF preferred stock investments must be repaid at their 10th anniversary. The dividend rate payable to the U.S. Treasury on SBLF preferred stock is five percent. If during the two years after receiving an investment from the SBLF, a participating bank increases its lending to small businesses over the level of loans originated from October 1, 2009 – September 30, 2010, the dividend rate on Treasury's investment declines one percent for each two and one-half percent increase in the volume of small business loans, until a minimum dividend rate of one percent is reached. If a recipient bank fails to increase small business lending during the first two years after receiving the SBLF investment, the dividend rate rises to seven percent, or in some cases, nine percent. This provision was included to prevent banks doing what many of them did with TARP capital in 2008-09: use the money for purposes other than originating new loans.

The Jobs Act also created a pool of \$1.5 billion to fund state programs that promote small business lending, called State Small Business Credit Initiatives ("SSBCI"). States can use the funds to provide collateral support to small manufacturing businesses whose assets, especially real estate, have declined in value. Alternatively, funds may be used to make loans that match like commitments from commercial lenders or to guarantee portions of commercial bank loans. To receive funds from the pool, states must demonstrate that private loans and investments equal to ten times the federal funds are likely to result from the availability of the federal funds. Eligibility is based on the rate and volume of employment decline in 2008 and 2009. Consequently, California, Florida, Michigan, Illinois, New York, and Ohio are the largest beneficiaries of the program.

States have embraced SSBCI warmly. Within a month of the legislation's enactment, individual state allocations were set and many states announced eligibility and enrollment requirements. Community bankers, however, have reacted coolly to SBLF, even though many of their banks are pressed for capital and capital markets remain closed to them. Skepticism surfaced as soon as the concept was publicly announced in late 2009. Early opponents included Monadnock Community Bank of Peterborough, New Hampshire, Capital Pacific Bancorp in Portland, Oregon, and North Jersey Community Bank in Engle-

wood Cliffs, New Jersey. All three banks said they would not be interested in additional direct government funding due to negative experiences with the TARP program.¹ Devon Bank and First Eagle Bank, both of Chicago, Illinois, stated that they would take a “wait and see” approach to any lending program.²

Press reports since passage of the Jobs Act reflect outright hostility to the idea that inexpensive public capital is good for community banks and for the general economy. “I don’t even know if we’re eligible for it,” said one banker. “We haven’t looked at it, and the reason is very simple: We’re going to make every good loan that we can make, with or without the fund. So we’re not going to mess with a government program.”³ Banks that have said publicly that they will not participate include State Bank of Long Island, in Jericho, New York, Cardinal Bank of McLean, Virginia, and Alexandria, Virginia-based Burke and Herbert Bank and Trust.⁴ The same is true of Pendleton Community Bank in Franklin, West Virginia.⁵ A survey of press reports as of mid-November 2010, showed only one bank in the United States, Heritage Bancshares, had signaled its plan to participate. Several others said they might join the effort, but hedged their position, saying they wanted to review implementing regulations before making any decision.⁶

PRIDE AND PREJUDICE

To understand the paradox of banker hostility toward public capital at a time when capital is scarce, one must consider the attitudes that prevail among community bankers. Generalizations are risky and there are exceptions to be sure; but most community bankers share a belief system that informs their actions.

Commitment to Enterprise and System. Community bankers exhibit strong belief in the economic utility of their work. They are loyal to the banks for which they work, the communities they serve and the banking system in general. Like lawyers, they are rule-oriented. They believe in following the rules that apply to them and their enterprise, and think others should do so too.

Charged to Allocate Capital Prudently. Bankers, especially community bankers, are keenly aware that their business runs on financial leverage. They

know that every large loan they make is a potential career ending opportunity. The perils of credit mistakes and the modest, spread-based financial returns of their business reinforce a psychology of risk-avoidance, even at the cost of losing compelling opportunities that are outside the mainstream.

At Home on Mt. Olympus. Like most people in Western cultures, and especially like members of the learned professions, bankers occupy an elevated place in the social order. Their responsibility to disburse and recoup capital at a profit, or at least without suffering losses, confers on them the power to say “yes” or “no” to a never ending parade of supplicants, potential and actual borrowers from their bank. As a result, bankers can fall victim to delusions of grandeur. As a banker client remarked 20 years ago, “People forget that when their middle name is no longer Mellon and they no longer have money to lend, customers who fawn over them today will not care one whit about their fate.”

The beliefs identified above can coalesce to create prejudice against “government interference” in the banking system, such as the SBLF created under the Jobs Act. The legislation’s detractors lament what they claim is politicization of the banking system and the imposition of burdens that inhibit unfettered, rational business decision-making. They liken the SBLF to the Community Reinvestment Act, which they view as original sin in the realm of the federal government directing bank activities to achieve political aims.⁷

The risks the critics identify deserve attention. The error of the critics’ argument, however, is their premise that the American banking system has ever been anything but political in its ways and means. Early Americans skirmished for more than 50 years over whether there would be a central bank or not, whether states or the federal government would grant bank charters and whether banks or the government would issue currency. The exigencies of financing the Civil War led to the Legal Tender Act of 1862 (declaring paper currency to be legal tender) and the National Bank Act of 1863 (providing for banks chartered by the federal government). When the Supreme Court held the Legal Tender Act unconstitutional, President Grant used the opportunity of two vacancies on the Court to name justices who cast their votes in later cases to reverse that result. Political conflict between Eastern bankers and

Western farmers and ranchers simmered for the balance of the 19th century, famously erupting at the 1896 Democratic Convention where William Jennings Bryan delivered his “Cross of Gold” address, the most famous speech in American political history.

Twentieth century political conflicts over banking began with the Panic of 1907. When only J.P. Morgan & Co. was financially large and solvent enough to stem the panic, consensus emerged that the nation needed a government-sponsored central bank. Politics shaped the number and locations of Federal Reserve Banks. The Wilson Administration created the Fourth District of the Federal Reserve System. As the situs of the new bank, Wilson selected Cleveland, which consistently voted Democratic, unlike Pittsburgh, the other city in contention. More recent conflicts are more widely known to current banking industry participants.

So the question is not whether or not to permit government involvement in the banking industry, but what modes of involvement best serve the general welfare. Where bank capital is concerned, many of the federal government’s actions over the last 30 years have damaged community financial institutions. Examples include loan and deposit rate deregulation, removal of geographic market limitations, policies that have promoted industry consolidation, policies that have fostered competition from non-bank financial intermediaries on unequal terms, increases in the volume and complexity of legal and financial regulation, and endorsement of technology-driven changes in industry operations that favor large institutions.

Community banks understandably feel besieged. Making matters worse is the fact that the shareholder base of many community banks remains essentially the same as it was before the era of deregulation began in the late 1970s. The typical community bank shareholder resides within a 25 mile radius of the bank, counts quarterly cash dividends as an important component of her/his annual income, has little financial capacity to increase her/his position in the bank’s stock and reacts with alarm to any news of reduced earnings or losses. Many community banks issued shares to the public years ago in an effort to broaden their constituency and achieve greater liquidity. As a result, they bear the costs of federal and state securities law compliance but have attained minimal benefits from having registered shares. The combination of all of these forces creates an acute conflict. Competitive condi-

tions require reinvestment of earnings or the franchise cannot survive. Yet the franchise owners are unwilling to suffer the reinvestment needed to remain competitive. So stalemate ensues, competitive position erodes, the economic value of capital declines, and cost cutting rather than building franchise value becomes the order of the day.

RE-ENVISIONING COMMUNITY BANK CAPITAL

The working premise of this column is that to support capital formation by privately owned enterprises the nation needs strong banks in addition to those deemed “systemically important.” The May 2010 installment of this column offered historical, empirical and anecdotal evidence in support of this premise. The unhappy experience many Americans have recently had with national originators and servicers of consumer loans lends further credence to this view. Yet attracting capital to banks having assets <\$10 billion remains difficult. The high-cost characteristics of the community bank business model make it hard to attract institutional investors. Other share issuances offer better risk-reward profiles. Community investors represent a limited pool of capital, one whose demographics discourage long-term investment horizons when it comes to deployment of shareholder capital. Bankers’ belief systems make it difficult to win their participation in government capital programs like SBLF, even when the economic terms are attractive. They would rather hold firm in their beliefs and be outgunned by the competition than accept aid that they need so they can live to fight another day. Clearly, another approach is needed to form the capital that community banks need. Herewith is offered the conceptual framework for one such approach.

One of the great strengths of the American democracy is the way in which citizens mobilize resources in the face of a public emergency. The most recent example of this phenomenon is the more than \$1 billion contributed to relief funds in support of victims of the 2001 World Trade Center calamity.⁸ The financial crisis of the last several years is different in kind, but it has affected a much larger number of citizens. Suppose that as an adjunct to the SBLF and the federal government’s \$30 billion sponsorship of it, a method was created by which community banks could raise capital from citizens in amounts as small as \$200?

A prototype for widely distributed share ownership of community banks already exists. In 1974, concern over the solvency of the Social Security system led Congress to enact legislation that enabled creation of employee stock ownership plans. Large industrial companies used ESOP's to divest unwanted business units to the employees who worked for the business units. For ease of administration, the law provided for ESOP trusts to own and vote the shares in the divested business. The trust borrowed funds to purchase assets or stock of the divested business. Employees earned shares as they contributed a portion of their earnings to acquire shares through the ESOP trust.

Benefits of an ESOP-like structure to facilitate wider ownership of bank shares would be several. Most fundamentally, community banks could raise capital where they are otherwise precluded from doing so by the size and structure of their business. Wider ownership would increase the number of citizens in a community who believe, and act as if, they have a stake in the outcome of the bank's business. Shareholder demographics would become more favorable as younger people invested the smaller amounts permitted under the ESOP-like structure. Those same younger investors would learn first-hand the benefits of saving and investing, a much needed change in the psychology of the American consumer. Repeat investors could be rewarded in the manner of airline and hotel rewards programs. In the process, consumers' perceptions of banks could be recast from one where banks are scorned for charging consumers fees at every opportunity to one where banks are recognized for rewarding prudent personal financial behavior.

The idea may seem far-fetched. Yet banks have long used incentive stock option awards to motivate employees; a limited number have sold shares to ESOPs for the same reason. Likely the biggest hurdle to implementing such an undertaking is the mindset of many community bankers. "We don't need it," one can hear them saying in unison. In their hearts, however, they know otherwise. Community banks face extinction in the next 20 years if they do not adapt to changes in their environment. Here, the secret to winning bankers' support lies in the psychology of the situation. When food giant General Mills introduced boxed cake mixes in the 1950s, public acceptance fell far short of what the company had projected. The convenience of the product, just add water, was indisputable; but consumers did not buy it. So General Mills tasked Dr. Ernest Dichter, a pioneer in the application of psychology to

business, to identify and solve the problem. Dichter reasoned that consumer resistance was rooted in feelings of guilt, that it was simply too easy to make a cake using a mix. He encouraged General Mills to change the mix formula to require consumers to add an egg as well as water to the recipe. This, he believed, would cause consumers to feel they had contributed something to the success of the recipe and assuage any guilt they felt about the ease of baking a cake the new, modern way. The company adopted Dichter's suggestion, sales of mixes soared, and eggs are still required to be added to cake mixes.

If bankers can similarly be made to feel that their capital raising initiatives are rooted in community support for the institution and that government is simply augmenting that support, the prospects for their adding meaningful amounts of capital can improve in like manner.

CONCLUSION

Banks having assets <\$10 million risk further marginalization in the face of larger, better capitalized competitors, both banks and non-banks. To remain competitive, these banks must be able to attract capital from investors other than their traditional shareholder base. The SBLF represents congressional recognition of the problem and a first step toward a solution. A more durable solution, less dependent on government largesse, is needed. Rather than public capital made available to ameliorate a national economic crisis, community banks need access to private capital from consumers in the markets they serve. The existing legal construct of ESOP's offers a prototype of how such investment might be structured. The ESOP model includes ways to minimize administrative and securities law burdens while attracting the widest possible audience of potential investors. Community banks' great strength is the democracy of their constituencies, whether customers, shareholders or employees. It is high time they put that democracy into action to assure their future in the American banking system.

NOTES

¹ Catherine Clifford, *Banks leery of Treasury's small business lending plan*, CNNMONEY.COM, November 12, 2009, http://money.cnn.com/2009/11/12/smallbusiness/small_

business_lending_tarp_plan; Carol Lawrence, *Bankers divide over whether program would motivate more small business lending*, THE RECORD, June 13, 2010, http://www.northjersey.com/news/96236394_Relief_bill_aimed_at_community_banks.html.

² Malathia Nayak, *Community banks express concern over some aspects of Obama's lending fund*, MEDILL REPORTS: CHICAGO, February 3, 2010, <http://news.medill.northwestern.edu/chicago/news.aspx?id=155522>.

³ See http://www.americanbanker.com/issues/175_196/lenders-balk-at-fund-for-sbl-1026974-1.html.

⁴ Kate Davidson, *Banks Twice Shy on Biz Loan Fund*, AMERICAN BANKER: COMMUNITY BANKER, Pg. 1 Vol. 175 No. 157, October 13, 2010; Bryant Ruiz Switzky, *Washington-area bankers wary of small business lending fund*, WASHINGTON BUSINESS JOURNAL, October 4, 2010, <http://www.bizjournals.com/washington/stories/2010/10/04/story4.html>.

⁵ Kevin Turner, *Area Bankers mixed on Obama's lending plan*, THE FLORIDA-TIMES UNION, September 25, 2010, <http://jacksonville.com/business/2010-09-25/story/area-bankers-mixed-obama%E2%80%99s-lending-plan>.

⁶ Turner, *id.*; Switzky, *id.*; Davidson, *id.*

⁷ NATIONAL REVIEW, July 27, 2010, available at <http://www.nationalreview.com/articles/243552/small-business-lending-fund-son-tarp-stephen-sprueill>.

⁸ See <http://query.nytimes.com/gst/fullpage.html?res=9505E3DB1030F93BA25752C1A9649C8B63>.