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TRUST BUSINESSES IN FDIC-ASSISTED ACQUISITIONS: WINDFALLS, OPPORTUNITIES OR ICEBERGS?

WALLACE L. HEAD AND LORRAINE M. BUERGER

In this article, the authors describe the impact of and provide practical suggestions for dealing with the requirement that the Assuming Institution in an FDIC-assisted transaction assumes responsibility for the trust business of the Failed Bank, which may include significant assets in investment management and other types of accounts.

When a bank (the “Assuming Institution”) acquires a failed bank (the “Failed Bank”) in a Federal Deposit Insurance Corporation (“FDIC”)-assisted transaction, the Assuming Institution is required to assume responsibility for whatever trust business the Failed Bank had when it was placed into receivership (the “Bank Closing”). The Purchase & Assumption Agreement (“P&A”) documenting Whole Bank with Loss Share transactions between the FDIC (as receiver of the Failed Bank) and the Assuming Institution can be more than 200 pages in length, yet the entire “Agreement with Respect to Trust Business” consists of less than one page

Wallace (Wally) L. Head is founder and managing director of Personal Fiduciary Advisors, LLC, a consulting and management outsourcing firm that helps banks and trust companies with the acquisition, integration, improvement, and management of personal trust businesses. He may be contacted at whead@pfafirm.com. Lorraine (Lori) M. Buerger is an attorney at Schiff Hardin, LLP and member of the firm’s Financial Institutions Client Services Group where she concentrates her practice on corporate transactions, with a particular focus on banking regulation and FDIC-assisted transactions. She can be contacted at lbuerger@schiffhardin.com.

of text.¹ The P&A's definition of trust business includes myriad roles and responsibilities for the Assuming Institution.

Bids submitted to the FDIC do not reflect any attributed value for a target bank's trust business and the P&A does not provide the Assuming Institution any specific protection for costs related to the trust business that it incurs post-Bank Closing. It is fair to ask, therefore: Does acquisition of the trust business of the Failed Bank produce windfalls, opportunities or "icebergs" of lurking risks and costs for the Assuming Institution?

Before describing the impact of the P&A's treatment of trust-related issues and providing some suggestions for dealing with it, here are the potential answers to that question:

- It is possible, yet highly unlikely, that the acquisition of the Failed Bank's trust business will provide a windfall to the Assuming Institution.
- It is also possible, yet unlikely, that the acquisition of the Failed Bank's trust business will provide the Assuming Institution with no opportunities, but some obvious and many more hidden risks and costs.
- The most likely result is that the Assuming Institution will assume responsibility for an operating trust business that provides some business opportunities and a multitude of risks and costs — some obvious and some hidden.

The FDIC's Franchise Marketing system allows banks submitting bids in FDIC-assisted transactions very limited opportunity to conduct due diligence on the trust business of target banks. This lack of diligence heightens the hidden nature of some trust-related risks and costs. As a result, Assuming Institutions may be less enthusiastic about bidding for some target banks with trust businesses.

The challenge is obvious: How does an Assuming Institution maximize the opportunities and minimize, or at least control, the risks and costs involved with a trust business it assumes from a Failed Bank after conducting little or no due diligence?

BANK CLOSING AND IMMEDIATE POST-CLOSING ACTIVITIES ARE CRITICAL

The two “first” priorities for the team handling the Assuming Institution’s takeover of the Failed Bank’s trust business are: (1) managing risks that are inherent in the takeover; and (2) minimizing the loss of clients or customers (“clients”) and assets that the Assuming Institution wants to retain. It is important for this team to be led by someone who has participated in one or more FDIC-assisted transactions involving trust businesses. That leader should be onsite at the headquarters of the Failed Bank’s trust business for the Bank Closing, and a member of the team needs to be onsite at each location of the Failed Bank where trust files, a trust vault or trust employees are located.

The team leader needs to work closely with the FDIC trust specialist who will be onsite at the headquarters of the trust business on the night of the Bank Closing and for the subsequent two or more days, as the FDIC completes items on its trust business checklist. The team leader and the rest of the team need to calm and reassure employees of the Failed Bank’s trust business or department, recognizing that they are critical to accomplishing both of these priorities.

Immediately following the Bank Closing:

- All trust files need to be secured, including materials that may be located outside of where the official files are maintained, such as in employee offices.
- All trust vaults need to be secured and, as soon as reports listing assets they are supposed to contain are available, each vault needs to be inventoried with an FDIC representative present.
- Reports need to be generated from the trust accounting system showing all assets, cash positions, fee and other accruals, and pending trades in all trust accounts as of the Bank Closing.
- Access to trust files, trust vaults and the trust accounting system needs to be controlled, recognizing that the trust department employees of the Failed Bank will need to be relied upon to obtain information required

to complete items on the FDIC's trust business checklist and to continue providing seamless, uninterrupted services to trust department clients.

- All trust business-related litigation that was in process at the Bank Closing or, in the opinion of any trust department employee, has a reasonable possibility of being filed in the future based on activities prior to the Bank Closing, need to be identified and all physical and electronic files relating to actual or potential litigation need to be secured.
- All medallion stamp imprinters used in the Failed Bank's medallion guarantee program need to be collected and provided to the FDIC (which will destroy them).
- A clear message and answers to frequently asked questions need to be provided to trust department employees for their use in responding to inquiries from trust department clients and their advisors.

In addition, during the first few days following the Bank Closing, the team and the trust department employees need to remain focused on:

- Helping the FDIC complete its trust business checklist;
- Gathering materials and data that will be needed in connection with various deadlines during the next 90 days that impact the trust business, including a reconciled listing of all trust department assets as of the Bank Closing and copies of all vendor contracts and agreements that were in effect at that date;
- Organizing files related to any actual or potential litigation involving the Failed Bank's trust business and making those files available to the FDIC, since the Assuming Institution does not assume liability based on the misfeasance, malfeasance or nonfeasance of the Failed Bank, its directors, officers, employees or agents with respect to that business;
- Managing client relationships that are related to the litigation described above in a manner focused upon limiting the Assuming Institution's exposure for its management of these relationships post-Bank Closing;
- Arranging for medallion stamp imprinters from the Assuming Institution to be available to replace imprinters from the Failed Bank; and

- Quickly and competently addressing client service and retention issues that may arise, appreciating the natural uneasiness trust department clients may have as a result of events leading up to the Bank Closing and the likelihood that some clients were executives, directors and/or shareholders of the Failed Bank.

The resources the Assuming Institution will need to devote to handling these responsibilities immediately upon and during the first few days after the Bank Closing will depend on the size, structure and health of the Failed Bank's trust business. However, the necessary resources need to be available onsite almost full time during this period.

During the weeks immediately following the Bank Closing, senior management of the Assuming Institution should be kept aware of the tenor of client communications within the trust department and how trust department employees are handling the transition to the Assuming Institution. The trust department's best employees and clients can be especially vulnerable to solicitations from competitors during this period.

Pursuant to the P&A, the Assuming Institution has a 30-day period during which it may decide to assume or not assume certain contracts and agreements for services provided to or by the Failed Bank, and a 90-day period is applicable to contracts and agreements related to IT/data processing. These provisions do not apply to account agreements between the Failed Bank and clients of its trust business, which are assumed by the Assuming Institution as of the Bank Closing.² However, documentation regarding all other contracts and agreements for services to or by the trust business of the Failed Bank needs to be assembled and reviewed during these time periods. Decisions regarding some of these contracts and agreements will need to be coordinated with other segments of the Assuming Institution due to overlapping services or other business considerations. Many such contracts and agreements — especially those that are for longer terms, larger amounts or services that the Assuming Institution is receiving from other suppliers — should be rejected or renegotiated. This process requires a significant allocation of resources during these 30-day and 90-day periods.

Within 60 days of the Bank Closing, the Assuming Institution must provide the FDIC written verification of the assets held in connection with the

Failed Bank's trust business. This verification will be based on reports generated from the trust accounting system and otherwise as of the Bank Closing, including trust vault audits conducted at that time. Unless problems arise with the reconciliation of those reports and subsequent verifications of assets, this process will require only a moderate amount of resources.

Within the same 60 days, the Assuming Institution needs to inform the FDIC whether it has concluded that it will or may be unable to succeed to any of the Failed Bank's appointments as an executor, trustee, guardian or other fiduciary. For example, the Assuming Institution may be unable to succeed the Failed Bank when a trust agreement contains requirements for a corporate trustee that the Assuming Institution cannot satisfy. The governing documents for all such appointments need to be reviewed to determine whether any such situations exist, recognizing that many problems that are initially identified can be remediated. The resources required for this process of review and possible remediation will be determined by the number and complexity of the Failed Bank's appointments as a fiduciary.

AN OBJECTIVE "SWOT" ASSESSMENT WITH RECOMMENDATIONS NEEDS TO BE COMPLETED SOON AFTER THE BANK CLOSING

The two "second" priorities for the team leading the Assuming Institution's assimilation of the Failed Bank's trust business are: (1) objectively assessing its strengths, weaknesses, opportunities and threats ("SWOT"); and, (2) developing recommendations for changes that are practical, prioritized and have accompanying timelines. This process requires the personal involvement of one or more individuals with relevant experience and objectivity, and should be integrated with responses to the 30-day, 60-day and 90-day deadlines noted above.

The subject matter that needs to be included in the SWOT assessment of the Failed Bank's trust business includes:

- Personnel information, position descriptions, functional reporting structure, compensation plans and performance evaluations;

- Past actual, current budgeted and forecast financial performance;
- Previous regulatory examination reports, internal audit reports, and external audit and consulting firm reports;
- Minutes and lists of open items for the Trust, Trust Acceptance and Trust Investment Committees;
- Marketing, sales and client servicing materials and activities;
- Evidence of the trust department's reputation externally with clients and their advisors and internally with employees in other parts of the bank;
- Data regarding recently added new business and the current new business pipeline;
- Fee schedules and practices, including discounting;
- Descriptions of all investment management services and resources; and
- Documentation for all technology, systems and vendor relationships.

During the first 180 days post-Bank Closing, the Assuming Institution will face a multiple of decisions and time-sensitive deadlines. Decisions and recommendations likely to require implementation in the first 180 days include:

- Vendor contracts to be assumed, renegotiated or rejected;
- Clients who will be transitioned to different service arrangements, fee schedules or service providers;
- Marketing materials and activities to be eliminated, revised or created;
- Fee schedules and practices to be revised or created;
- Service agreements to be revised or created;
- Technology, systems (including the trust accounting system) and vendor relationships to be modified, upgraded or replaced;
- Investment management services to be eliminated, revised or added, which may require new investment policy statements for all accounts;
- Policies and procedures — including those governing new account ac-

ceptances, administrative reviews, investment reviews and the exercise of discretion — to be revised or created;

- Risk management procedures and reporting to be revised or created;
- Internal audits and regulatory examinations to be scheduled and re-sourced; and
- Staffing, position descriptions, compensation, reporting relationships and restrictions on post-employment activities to be revised.

HOW DO THE OPPORTUNITIES COMPARE TO THE RISKS AND COSTS?

This is a very important question and its answer depends on many factors. The transaction that created the opportunities, risks and costs associated with the Failed Bank's trust business probably occurred with little or no consideration or due diligence regarding the trust business. Consequently, the Assuming Institution's bid for the Failed Bank probably did not explicitly include any payment related to the trust business.

The comparison thus depends on other factors, such as: the "health" of both the Failed Bank's and the Acquiring Institution's trust businesses, the "fit" of the two trust businesses, the effort and cost required to integrate and manage them, and the Assuming Institution's ability to leverage the combined trust business to increase its enterprise value through a combination of higher fee revenue, increased profitability and cross-selling of other services and products.

How costly could it be for the Assuming Institution to assume and fully and successfully integrate the Failed Bank's trust business? The Assuming Institution is protected against the costs of litigation based on misfeasance, malfeasance or nonfeasance prior to the Bank Closing. However, litigation risk is inherent in the trust business generally and a single case based on post-Bank Closing activity, even if it is settled, can more than offset benefits produced by the trust business for the Assuming Institution. This reality, combined with a lack of due diligence prior to the "shot-gun" wedding that occurs at the Bank Closing, makes it critical for the Assuming Institution to devote adequate resources to assessing and managing litigation-related risks

post-Bank Closing.

Normal transition-related costs are very difficult to estimate prior to the Bank Closing due to a lack of due diligence. Such costs may include fees and expenses paid to external advisors and vendors, direct costs of the time spent and expenses incurred by personnel in the trust businesses of both the Failed Bank and the Assuming Institution, as well as the opportunity costs of having these personnel devoted to the transition process. These costs evolve and become easier to estimate following the Bank Closing as the transition team learns about the Failed Bank's trust business, but some of them will continue for at least a year. Systems-related conversion and integration expenses can constitute the single largest category of these costs.

Most trust departments do not use any time tracking system, so the full cost to transition and successfully integrate a Failed Bank's trust business can be difficult if not impossible to determine. It is important, however, to segregate these costs wherever possible from the operating financials of the trust businesses of both the Failed Bank and the Assuming Institution. Otherwise, these significant costs could distort period-over-period comparisons and the ability to assess the individual or combined profitability of these businesses.

Of course, the Assuming Institution may incur more meaningful costs in the form of lost banking business and regulatory problems if the Failed Bank's trust business is not transitioned smoothly and effectively. These costs could manifest themselves as clients leaving the Assuming Institution due to client servicing problems with the trust business, prospective clients avoiding the Assuming Institution due to a negative reputation attributable to the trust business, competitors winning new business based in part on the relative strength of their trust business, or regulatory examinations of the trust business contributing to less favorable CAMELS ratings for the Assuming Institution.

The best way to minimize these costs is to avoid, as much as possible, diverting key resources from ongoing sales, servicing, operations and management activities in the trust businesses. This will likely require the use of external resources, which also can lessen the tendency for conflicts to arise between personnel in the two trust businesses as they are being integrated. The costs of quality external resources can seem significant in the short term, but the intermediate and long-term benefits of a smooth and effective transition

should dwarf the amount of these initial investments.

Assuming no meaningful litigation-related costs, the total costs of assuming and integrating a Failed Bank's trust business could be 50 percent or more of the first year's fee revenue produced by that trust business. This relationship will depend on the previously described health, fit and leveragability of the two trust businesses, as well as the amount of the Failed Bank's trust business that the Assuming Institution retains. As high as this cost might be, however, the Failed Bank's trust business can be very valuable if the transition adds scale, synergies and enhancements to the Assuming Bank's overall enterprise.

THE BOTTOM LINE

In FDIC-assisted transactions involving a Failed Bank with a trust business, the Assuming Institution is required to assume responsibility for that trust business. In most such transactions, the Assuming Institution will pay little or, in some cases, nothing for the Failed Bank's trust business. Accordingly, so long as the Assuming Institution devotes the resources that are necessary to avoid the icebergs of litigation, lost banking business and regulatory problems, it has the opportunity to significantly enhance its enterprise value by assuming responsibility for that trust business.

The Assuming Institution can take advantage of this opportunity by retaining, successfully transitioning and appropriately integrating the Failed Bank's trust business into its own business model. The total cost of this process can be significant, but handled properly it will allow the Assuming Institution to grow its fee revenue, maintain or improve operating margins of its trust business, and effectively cross-sell other bank products and services. These benefits should increase the Assuming Institution's enterprise value by far more than the cost of the process, making its assumption of the Failed Bank's trust business an attractive aspect of the FDIC-assisted transaction.

NOTES

¹ P&A, Version 3.01, 4.5. Trust Business.

(a) Assuming Institution as Successor. The Assuming Institution shall, without

further transfer, substitution, act or deed, to the full extent permitted by law, succeed to the rights, obligations, properties, assets, investments, deposits, agreements, and trusts of the Failed Bank under trusts, executorships, administrations, guardianships, and agencies, and other fiduciary or representative capacities, all to the same extent as though the Assuming Institution had assumed the same from the Failed Bank prior to the Bank Closing Date; provided, that any liability based on the misfeasance, malfeasance or nonfeasance of the Failed Bank, its directors, officers, employees or agents with respect to the trust business is not assumed hereunder.

(b) Wills and Appointments. The Assuming Institution shall, to the full extent permitted by law, succeed to, and be entitled to take and execute, the appointment to all executorships, trusteeships, guardianships and other fiduciary or representative capacities to which the Failed Bank is or may be named in wills, whenever probated, or to which the Failed Bank is or may be named or appointed by any other instrument.

(c) Transfer of Trust Business. In the event additional proceedings of any kind are necessary to accomplish the transfer of such trust business, the Assuming Institution agrees that, at its own expense, it will take whatever action is necessary to accomplish such transfer. The Receiver agrees to use reasonable efforts to assist the Assuming Institution in accomplishing such transfer.

(d) Verification of Assets. The Assuming Institution shall provide to the Receiver written verification of the assets held in connection with the Failed Bank's trust business within sixty (60) days after the Bank Closing Date.

² See P&A, Section 4.5(a), *supra* note 1.