KAYE, SCHOLER, FIRREA, AND THE DESIRABILITY OF EARLY CLOSURE: A VIEW OF THE KAYE, SCHOLER CASE FROM THE PERSPECTIVE OF BANK REGULATORY POLICY

JONATHAN R. MACEY*
& GEOFFREY P. MILLER**

I. INTRODUCTION

Most of the writing on the Kaye, Scholer imbroglio focuses on two issues. The first issue that has captured the attention of the pundits is whether Kaye, Scholer, Fierman, Hays & Handler really did anything wrong. To hear its defenders, Kaye, Scholer simply was defending the interests of an embattled client as zealously as it could.[1] The firm's detractors, on the other hand, insist it was involved in an ongoing and unethical conspiracy to assist a client in violating federal banking regulations.[2] Consistent with these concerns, the second issue involves the policy questions surrounding Kaye, Scholer's culpability in general and the propriety of the cease-and-desist order freezing the firm's assets in particular. The concern is that the aggressive actions of the Office of Thrift Supervision have harmed the attorney-client relationship or that they

* J. DuPratt White Professor of Law, Cornell Law School. B.A. 1977, Harvard; J.D. 1982, Yale.

** Kirkland & Ellis Professor of Law, the University of Chicago. A.B. 1973, Princeton; J.D. 1978, Columbia.

1. *Summary of the Expert Opinion of Geoffrey C. Hazard, Jr.* (Feb. 25, 1992), *in* THE ATTORNEY-CLIENT RELATIONSHIP AFTER KAYE, SCHOLER 396-402 (PLI Corp. Law & Practice Course Handbook Series No. B4-7009, 1992).

2. Steve France, *Just Deserts: Don't Cry for Kaye Scholer*, LEGAL TIMES, Apr. 6, 1992, at 28; *see also* Susan Beck & Michael Orey, *They Got What They Deserved*, AM. LAW., May 1992, at 68.

may prevent lawyers from vigorously representing the interests of their clients.[3]

This Article argues that, at bottom, the Kaye, Scholer case is not about legal ethics. Notwithstanding rules of professional responsibility, the underlying source of authority for the OTS' actions was a federal statute, the Financial Institutions Reform, Recovery and Enforcement Act,[4] which clearly gives the OTS the authority to do what it did.

Seen in this way, three important observations can be made. First, the apocalyptic cries from the bar that the attorney-client relationship has been jeopardized are clearly misplaced. Any new law or principles of practice established by the Kaye, Scholer affair are limited strictly to the banking context. Second, the argument that Kaye, Scholer did not violate the rules of professional responsibility appears to be wholly beside the point. The legal and ethical rules that govern lawyers' ethical conduct have their source in either state law or the rules of state bar associations. Federal law trumps both to the extent there is a conflict. Third, and most importantly, the legal issues in the Kaye, Scholer case must be analyzed with reference to the underlying purposes of banking law. In this respect it has been argued that regulators should impose liability on "gatekeepers," those "private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers,"[5] and encourage the activities of "whistleblowers," the parties who disclose misconduct directly to "enforcement officials or potential victims."[6] As David Wilkins observes, the notice of charges against Kaye, Scholer reflects a desire on the part of the OTC to pursue both strategies.[7]

However, the critical issue in the Kaye, Scholer case did not involve gatekeeper liability or whistleblower liability on the part of the lawyers representing Lincoln. The critical issue was the freeze placed on Kaye, Scholer's assets. Therefore, it is important to analyze the purposes and policies behind FIRREA and its grant of authority to the OTS to freeze the assets of lawyers, accountants, and others who participate in unsafe

3. Edward Brodsky, *The Kaye Scholer Case*, N.Y. L.J., May 22, 1992, at 1; *see also* David Margolick, *Lawyers Under Fire: With the U.S. Willing to Go After Law Firms, More Whistle-Blowing on Clients Is Likely*, N.Y. TIMES, Mar. 10, 1992, at A1.

4. Pub. L. No. 101-73, 103 Stat. 187 (1989) (codified as amended at 12 U.S.C. § 1818 (Supp. III 1991)).

5. Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORGANIZATION 53, 53 (1986).

6. *Id.* at 58.

7. David B. Wilkins, *Making Context Count: Regulating Lawyers After Kaye Scholer*, 66 S. CAL. L. REV. 1145, 1160-83 (1993).

and unsound banking practices. As will be seen, the relevant provisions of FIRREA authorizing freeze orders like the one imposed on Kaye, Scholer were designed to accomplish one purpose: to prevent the dissipation of assets of an insolvent depository institution caused by delays in closure.

This Article analyzes whether the freeze order imposed on Kaye, Scholer accomplished this purpose. The issue of freezing Kaye, Scholer's assets is distinguishable from the issue of whether liability should ultimately attach to Kaye, Scholer's actions. From this perspective, the critical question is not even whether Kaye, Scholer acted improperly. For purposes of this discussion, we assume that Kaye, Scholer was in violation of FIRREA and thus subject to the provisions authorizing the government to freeze its assets. However, the focus of this Article is on the purposes and policies behind the relevant provisions of FIRREA and on whether the OTS' actions furthered the goals of the statute.

The first part of this Article reviews the facts of the Kaye, Scholer case as well as the "spin" placed on those facts by the OTS in its notice of charges and by commentators evaluating the OTS' actions. The Article next examines the purposes and policies of FIRREA, focusing particular attention on the overall goals of the statute as well as on the particular provisions at issue in the Kaye, Scholer affair. The Article proceeds to show that the remedies provided by FIRREA are aimed at dealing with the problems of bank insolvencies, not lawyer misconduct. FIRREA was not designed to punish lawyers; it was designed to assist regulators in preserving the assets of insolvent thrift institutions by facilitating the early closure of such institutions. However, that design is flawed, and in this Article we show that the freeze mechanism employed by the OTS on Kaye, Scholer is not likely to achieve Congress' objectives. We explore alternative policies that are better suited to meeting these objectives.

Finally, this Article examines Congress' objective of early closure. While early closure is a reasonable policy objective, it is not a panacea for the problems facing the banking industry. In order to deal effectively with them it is critical that Congress impose structural reforms that address the core problems that have caused the banking crisis: insufficient diversification, excessive risk taking, and bad management. Seen against the backdrop of the mammoth problems facing the banking industry and the need for meaningful solutions, the Kaye, Scholer case can be viewed for what it really is: mere political maneuvering by regulators more interested in placating a restless public than in implementing the difficult reform programs necessary to save the industry.

II. THE FACTS AND THE SPIN

From the perspective of bank regulatory policy, clearly the single most critical fact in the Kaye, Scholer case is the precise date that Lincoln became insolvent. If a public policy favoring early closure is to be implemented, then banking regulators must be able to identify insolvent financial institutions and close them in a timely manner.

A. The Timing of Kaye, Scholer's Involvement

Charles Keating's American Continental Corporation acquired Lincoln Savings and Loan Association in February 1984.[8] The critical examination that brought Lincoln's problems to the surface was begun in January 1986 by the San Francisco office of the Federal Home Loan Bank Board, the agency that initially reviewed Lincoln's financial well-being. This examination ultimately resulted in a highly critical report of examination on Lincoln.[9] However, the Bank Board did not release this report until April 1987.[10] While impossible to determine the exact date, it seems clear that Lincoln had been insolvent for a very long time prior to the release of the 1986 report of examination. Indeed, it appears likely that Lincoln was insolvent as early as March 1986, if not much earlier.[11] Yet there was not a determination of insolvency until May 1987, when the San Francisco office of the FHLBB recommended that Lincoln be placed in conservatorship/receivership.[12] Moreover, Lincoln did not retain Kaye, Scholer as its counsel until June 1986.[13] Thus, the ineluctable facts are as follows: (1) By the time Kaye, Scholer became involved in the FHLBB's 1986 examination of Lincoln, the financial institution was already insolvent, and (2) the FHLBB knew of Lincoln's insolvency at least as early as April 1987. Yet the institution was not seized until April 1989, and the OTS did not sue Kaye, Scholer until March 1992.

8. Robert E. O'Malley, *Chronology of Key Events*, *in* ATTORNEYS' LIAB. ASSURANCE SOC'Y, THE KAYE, SCHOLER CASE AND OTHER SELECTED PROFESSIONAL LIABILITY AND ETHICS ISSUES 13 (Robert E. O'Malley et al. eds., 1992) [hereinafter KAYE, SCHOLER CASE].

9. *Id.*

10. *Id.*

11. The Federal Savings and Loan Insurance Corporation began its regular examination of Lincoln in January 1986 and started a special examination in March. It stands to reason that the special examination was begun because of acute concern on the part of regulators regarding Lincoln's insolvency.

12. *See* Federal Home Loan Bank Board, Recommendation and Statement of Supervisory Concerns (May 1, 1987), *cited in* Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 921 n.31 (D.D.C. 1990).

13. O'Malley, *supra* note 8, at 13.

These facts make it clear that bureaucratic timidity and ineptitude, rather than Kaye, Scholer's machinations, are primarily to blame for the unconscionable delays in closing Lincoln. At the very latest, Lincoln should have been closed in May 1987, when the FHLBB finally determined that Lincoln was insolvent. That the institution was not closed until April 1989 can hardly be blamed on Kaye, Scholer. And if Kaye, Scholer's actions did not delay the seizure of Lincoln, then the firm's actions did not harm taxpayers or upset the basic purposes of the underlying regulatory scheme.

Of course, just because Lincoln already was insolvent at the time Kaye, Scholer came onto the scene does not mean that the firm's aggressive activities on the part of its client did not make things worse. In fact, Kaye, Scholer's activities could have dramatically increased the costs of the Lincoln bailout by postponing the closure of that institution and thereby allowing losses to mount. On the other hand, it must be emphasized that Kaye, Scholer's aggressive lawyering was not all that prevented the timely closure of Lincoln.

While Keating worked with his attorneys at Kaye, Scholer, he also lobbied hard in Washington to ensure that Lincoln would be treated with kid gloves by regulators.[14] Indeed, it is clear that Keating's lobbying efforts were surprisingly successful. The five U.S. Senators who became known as the "Keating Five" interceded on behalf of Lincoln with federal regulators in April 1987.[15] And by May 1988, Keating also had succeeded in having jurisdiction over the investigation transferred to Washington from the FHLBB's San Francisco office.

Thus, in analyzing the extent of the damages caused by Kaye, Scholer's involvement in this affair, it is important not to give it too much credit or blame. After all, the firm might have been responsible for *some* of the delay in closure, but it is impossible to avoid the conclusion that *most* of the delay can be attributed to Keating's deft maneuvering in political circles—his generosity to politicians and other influential people—and to old-fashioned bureaucratic ineptitude and trepidation.

To reach any conclusions about how much of the delay in closing Lincoln was a result of Kaye, Scholer's activities, it is important to understand what the firm actually did. The section that follows reviews the charges against Kaye, Scholer for the purpose of determining how successful the firm was in buying time for Lincoln. In the final analysis,

14. *Id.* at 14.
15. *Id.*

one's assessment of the benefits of pursuing Kaye, Scholer rests on assumptions about the marginal costs of its improper behavior. Put another way, nobody disagrees with the proposition that if Kaye, Scholer had acted with perfect propriety under any standard, it still could have succeeded in obtaining at least some delay for Lincoln. Seen from this perspective, the relevant inquiry is how much *additional* time and taxpayer money were wasted as a result of Kaye, Scholer's *improper* activities.

B. Kaye, Scholer's Conduct

Reading the notice of charges brought by the OTS against Peter Fishbein and Kaye, Scholer, it appears that members of the firm were involved in an ongoing criminal conspiracy to conceal illegal practices at Lincoln, ACC, and other corporations controlled by Keating.[16] The notice of charges articulates what appears to be an ironclad argument that Kaye, Scholer "knowingly or recklessly participated" in a violation of the law or in an unsafe or unsound banking practice in violation of FIRREA.[17]

Apologists for Kaye, Scholer take one of two tacks. First, following Geoffrey Hazard's well-known (and well-remunerated) argument that Kaye, Scholer did not violate existing standards of ethical conduct, some argue that the relationship between attorneys and clients would be damaged if Kaye, Scholer were punished.[18] Alternatively, and more persuasively, others argue that Kaye, Scholer's due process rights may have been violated by the extraordinary unilateral power that the statute gives to the OTS to make the factual determinations necessary to support the sort of asset freeze used against Kaye, Scholer, and then to impose such a freeze without any outside authority (such as a judge) ruling on the propriety of the action.[19] Professor John C. Coffee has made a powerful argument that the procedures invoked by the regulators in the Kaye, Scholer affair give rise to serious constitutional questions regarding the prehearing deprivation of property imposed on several Kaye, Scholer partners.[20]

All in all, the response of the legal community was to circle the wagons round the campfire and praise the valiant attempts of Kaye,

16. *See generally id.* (considering the charges as a whole substantiates our claim).
17. 12 U.S.C. § 1818(a)(2)(C)(ii) (1988).
18. *See* Daniel Wise, *OTS's "Harball Tactic" Decried by Bar*, N.Y. L.J., Mar. 10, 1992, at 1.
19. *See* Brodsky, *supra* note 3, at 1.
20. John C. Coffee, Jr., *Due Process for Kaye, Scholer?*, LEGAL TIMES, Mar. 16, 1992, at 22.

Scholer and its senior partner, Peter Fishbein, to resist the government's attempts to destroy the adversarial system of justice in the United States. With regard to Fishbein, a lead story in the *Wall Street Journal* "painted a vivid picture of a proud warrior, leader of a proud law firm, forced by brutal government tactics to 'fall on his sword' rather than fight to defend his honor and the ancient ideal of 'unstinting loyalty to the client.'"[21]

Alternatively, supporters of the government's actions are quick to point out that in representing Lincoln, Kaye, Scholer was not acting as would a typical firm with a typical case. In a famous letter from Fishbein to B.J. Davis, Director of Examinations for the FHLBB, Fishbein asked that the Bank Board refrain from requesting documents or information about Lincoln from Lincoln itself and instead send such requests directly to Kaye, Scholer.[22] Some have argued that this put Kaye, Scholer in a difficult position in its attempts to provide legal advice to Lincoln. In particular, the firm became vulnerable to the charge that Fishbein had "interposed Kaye, Scholer between Lincoln and the FHLBB with respect to all factual matters"[23] and thereby became an institution-affiliated party, obligated to refrain from making false or misleading factual statements or omissions to regulators.[24] The firm potentially had become obligated to comply with federal regulations and to prevent Keating from abusing and looting Lincoln.[25]

This is a pretty weak argument. Kaye, Scholer's serving as a clearinghouse for incoming document requests does not seem so unusual, especially given that the FHLBB had hired outside counsel. It is by no means obvious why serving as a clearinghouse for documents sent *to* a client by a regulatory agency should increase a law firm's culpability for the information and documents that go *from* the client to the agency. After all, it would seem to make no difference whether requests for documents and information went directly to Kaye, Scholer or were routed to the firm by the client. Moreover, if one examines Kaye, Scholer's request from the perspective of the underlying purposes of FIRREA, it appears that Kaye, Scholer simply was trying to expedite the review process by providing a centralized clearinghouse for the FHLBB's document

21. France, *supra* note 2, at 28.

22. Letter from Peter Fishbein, Senior Partner, Kaye, Scholer, to B.J. Davis, Director of Examinations, FHLBB (July 15, 1986) (on file with author).

23. *In re* Fishbein, OTS AP-92-19, para. 45 (Dep't Treasury 1992) (Mar. 1 notice of charges against Kaye, Scholer, Fierman, Hays & Handler and three partners).

24. France, *supra* note 2.

25. *Id.*

requests. Indeed, Fishbein's infamous letter of July 15, 1986, to the FHLBB in San Francisco made it clear that he wanted the examination speeded up, not slowed down.

But the OTS charges were not without substance. Most of the charges consisted of allegations that Kaye, Scholer either knowingly made misrepresentations or omitted facts material to Lincoln's financial status and activities. This was the essence of eight of the ten claims in the OTS notice of charges.[26] The other two claims concerned (1) the quality of the advice Kaye, Scholer provided to Lincoln, and (2) Kaye, Scholer's reckless failure to fulfill its fiduciary duties to Lincoln and its "unethical and improper professional conduct."[27]

C. Claim One: The Quality of Kaye, Scholer's Advice

Perhaps the most serious charge concerned whether Kaye, Scholer knowingly disregarded material facts when it advised Lincoln that its direct investments were legally grandfathered. On January 30, 1985, the FHLBB issued a final rule on direct investments by insured thrift institutions.[28] Under this rule, thrifts that held more than ten percent of their assets in direct investments were prohibited from making any further direct investments without the approval of the FHLBB.[29] However, this so-called direct investment rule contained a grandfather clause that permitted direct investments for which there was a "legal commitment" before December 10, 1984.[30] The grandfather clause also permitted thrifts to complete projects pursuant to definitive plans in existence on that date.[31]

Kaye, Scholer advised Lincoln that $750 million in direct investments was legally grandfathered under the direct investment rule. According to the OTS, Kaye, Scholer knew that the Lincoln board of directors had not taken the steps necessary to approve the direct investments, and thereby make them "definitive plans," before the deadline.[32] The OTS argued that Kaye, Scholer also knew that the Lincoln board of directors had backdated the approvals necessary to authorize the

26. *In re* Fishbein, OTS AP-92-19, claims 2, 3, 5-10 (dealing directly with these issues).

27. These allegations are the subjects of *id.* claim 1 and *id.* claim 5, respectively.

28. *See* 12 C.F.R. § 563.9-8 (expired Jan. 1, 1987, by terms of sunset provision).

29. *Id.* § 563.9-8(C)(2).

30. *Id.* § 563.9-8(f).

31. *Id.*

32. *In re* Fishbein, OTS AP-92-19, paras. 28, 32.

grandfathered investments to make them appear as if they had been completed before December 10.[33] The OTS also claimed that Kaye, Scholer knew that Lincoln relied on these backdated documents as evidence of the "definitive plans" that permitted grandfathered direct investments.[34]

On the basis of these facts, the OTS claimed in its notice of charges that Kaye, Scholer recklessly provided legal advice to Lincoln in disregard of Lincoln's backdating of the documents.[35] The OTS did not suggest that Kaye, Scholer was obliged to blow the whistle on Lincoln about the backdating. Rather, the OTS argued only that Kaye, Scholer should have advised Lincoln that it was acting illegally.[36] But suppose that Kaye, Scholer did what the OTS wanted it to have done. That is, suppose Kaye, Scholer had advised Lincoln that for certain of its direct investments it was not entitled to the exemptions from restrictions. Is it clear that Lincoln would have refrained from making these investments? Certainly not. Rather, judging from Lincoln's behavior in other contexts, it seems clear that Lincoln would have continued to make these investments. And even if it had refrained from making the investments, it seems clear that the money would have been wasted by Lincoln in some other way. Thus, Lincoln's backdating may have been unlawful, but Kaye, Scholer's conduct in the backdating affair probably did not raise the marginal costs of the bailout by an appreciable amount.

D. The Disclosure Claims: Two, Three, and Five Through Ten

In what may be its best-known allegation, the OTS argued that Kaye, Scholer failed to disclose to the OTS the real reason that Arthur Andersen & Co. resigned as Lincoln's independent auditor in late 1986.[37] The OTS contended that Arthur Andersen resigned because Lincoln was too risky.[38] Kaye, Scholer reported to the FHLBB on an SEC Form 8-K that Arthur Andersen's resignation "was not the result of any concern by [Arthur Andersen] with [Lincoln's] operations . . . or asset/liability management."[39] A careful review of the facts indicates that Kaye, Scholer was not acting improperly, at least in this context. Arthur Andersen

33. *Id.* paras. 32-33, 35.
34. *Id.* para. 28 (claim 1).
35. *Id.* para. 35(a).
36. *Id.* para. 183.
37. *Id.* paras. 41-42.
38. *Id.*
39. SEC Form 8-K (Oct. 1, 1986), *quoted in* Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 921 (D.D.C. 1990).

resigned because it was concerned that Lincoln's extremely aggressive business practices, while legal, would disturb regulators.[40] This was disclosed by Kaye, Scholer in the Form 8-K. The document specifically said that Lincoln's rate of growth and asset mix were likely to be of concern to regulators and that this bothered the accounting firm, particularly "in view of the very litigious environment controlled to a large degree by regulators."[41] In other words, because the omissions did not concern any information not already known to regulators, it does not appear that Kaye, Scholer failed to disclose any material fact relating to the resignation of Arthur Andersen.

Several of Kaye, Scholer's other alleged misrepresentations and omissions deserve attention here as well. These allegations, which are summarized in the OTS' third claim and detailed in claims five through ten, essentially charge that Kaye, Scholer falsified or omitted to disclose material facts that would have demonstrated that Lincoln was in weak financial condition. In its fifth claim the OTS charged that Kaye, Scholer misrepresented certain real estate transactions in which Lincoln had either (1) overstated the prices for which such real estate was sold, (2) fabricated records for property sales that never took place, or (3) engaged in swaps, known as "linked" transactions, in which Lincoln purchased property at artificially inflated prices on the condition that the seller agree to buy other property from Lincoln at artificially inflated prices.[42] Kaye, Scholer was not charged with participating in these fraudulent practices, but rather with having knowledge of these practices and failing to report the information to the OTS.[43]

Even assuming that the allegations were true, something about these charges still doesn't make sense. The OTS admitted in the fifth claim that "[a]s a result of the 1986 Examination, the examiners determined that *as of September 30, 1986*, Lincoln's regulatory net worth was substantially less that [sic] its required minimum due to adjustments to Lincoln's income that the examiners deemed necessary."[44] The fifth claim also made clear that any misrepresentations by Kaye, Scholer did not occur until the summer of 1987.[45] Thus, the OTS appears to have admitted that it was not fooled by Kaye, Scholer's misrepresentations, at least with respect to the matters at issue in its fifth claim. As was suggested

40. *In re* Fishbein, OTS AP-92-19, para. 39.
41. SEC Form 8-K, *supra* note 39.
42. *In re* Fishbein, OTS AP-92-19, para. 64.
43. *Id.* paras. 66, 71.
44. *Id.* para. 58 (claim 5) (emphasis added).
45. *Id.* paras. 62, 63.

earlier, if regulators knew in September 1986 that Lincoln was insolvent in general and that its regulatory net worth was substantially less than the required minimum, the institution should have been closed then, not in April 1989.[46] It is impossible to escape the conclusion that something besides Kaye, Scholer's aggressive lawyering and alleged misdeeds kept Lincoln open long after it should have been closed.

Kaye, Scholer also was charged with failing to disclose facts about Lincoln's underwriting practices and about the documentation of its loans.[47] Specifically, the OTS charged that adverse documents were removed and favorable documents added to Kaye, Scholer's loan file and that Kaye, Scholer knew of deficiencies in Lincoln's loan files.[48]

These charges appear to go to the heart of the Kaye, Scholer matter because the misrepresentations and omissions would have impeded the efforts of regulators to determine the quality of Lincoln's loan portfolio. However, on closer inspection these charges appear to be among the more ambiguous of the allegations against Kaye, Scholer. The charge that Kaye, Scholer added and subtracted documents must be read in light of the Kaye, Scholer internal memorandum stating that "prior to the [1986] Board Examination, ACC's [sic, actually Lincoln's] loan files ran the spectrum from disaster to non-existent. Before the [FHLBB] examination began, [Arthur] Andersen sent in a team of five people to assemble the files and get underwriting data."[49]

The OTS characterized Lincoln's activities as an attempt "to mask the deficiencies in its underwriting files."[50] But another way of characterizing Lincoln's efforts (or at least the efforts of Kaye, Scholer and Arthur Andersen) is as an attempt to improve the quality of these files in order to bring them into compliance with the applicable regulations. Seen in this way, Kaye, Scholer's knowledge of certain deficiencies in Lincoln's loan files is far from nefarious. Clearly, one salutary role that banking lawyers and accountants can play is to bring loan files into regulatory compliance.

It appears certain that Lincoln thought that some of the steps required to bring loans into compliance with applicable regulations were a waste of time. Obviously, Lincoln made a lot of bad loans. Lincoln

46. *See supra* text accompanying notes 6-9.

47. *In re* Fishbein, OTS AP-92-19, para. 75 (claim 6).

48. *Id.* para. 76.

49. *Id.* claim 6 (quoting internal Kaye, Scholer memorandum (Aug. 1988)).

50. *Id.* para. 77.

prepared loan underwriting "summaries," which were memoranda created after the fact (that is, after loans had already been made) in order to bring the loan files into regulatory compliance by providing necessary information about the feasibility of the loans made.[51] The regulators concluded that the "repayment analysis" contained in these summaries (which purported to analyze the borrowers' ability to repay the loans) was not based on any independent information and was otherwise unreliable.[52]

The OTS appears to have concluded that these documents were unreliable on their face. Perhaps this was so. And perhaps Kaye, Scholer acted improperly. But if this was the case, it is hard to see what harm was done given that the regulators were not fooled by what Kaye, Scholer did. In fact, Kaye, Scholer admitted that there were deficiencies in Lincoln's documentation. Its defense was that Lincoln's files did not "reflect the full extent of the underwriting process" and that "the number of loans cited as having documentation deficiencies is *overstated*."[53]

At times the sixth claim in the OTS notice of charges appears to be trying to have it both ways. It criticizes Kaye, Scholer for failing to provide independent verification for loan files[54] and for having investment files prepared after the fact, "in some cases by outside accountants at Lincoln's request."[55] In the portion of the sixth claim that accuses Kaye, Scholer of knowingly omitting material facts, the OTS provided excerpts of a Kaye, Scholer internal memorandum in which one of the firm's lawyers was directed to speak to Andre Niebling, Lincoln's president, about how to "show Lincoln's underwriting in its best possible light."[56] This suggests that Kaye, Scholer was trying to remain within the bounds of truthful disclosure. After all, depicting something in its most favorable light is much different from depicting something in a false light.

The seventh claim in the notice of charges relates to the direct investment issue. It charged that Kaye, Scholer knew that several transactions between Lincoln and the Wolfswinkel Group that were characterized as loans were really direct investments because they were joint ventures between Lincoln and Conley Wolfswinkel, the owner of the

51. *Id.* para. 84.

52. *Id.* para. 85.

53. *See* KAYE, SCHOLER CASE, *supra* note 8, at 51 (citing response of Kaye, Scholer to the 1986 examination (June 26, 1987)).

54. *In re* Fishbein, OTS AP-92-19, para. 85.

55. *Id.* para. 95.

56. *See* KAYE, SCHOLER CASE, *supra* note 8, at 52.

Wolfswinkel Group.[57] Moreover, it charged Kaye, Scholer with knowing that Conley Wolfswinkel did not have sufficient resources to meet his personal obligations to Lincoln in connection with the guarantees he had made on Lincoln's investments in the Wolfswinkel Group.[58] Here the arguments are clearly and unambiguously consistent with the overall import of the OTS' notice of charges. Kaye, Scholer appears to have tried to muddy the waters for the regulators by allowing Lincoln's accountants to base their conclusions about Lincoln's relationship with Wolfswinkel on false assumptions about Conley Wolfswinkel's financial status and Lincoln's management of properties owned by the Wolfswinkel Group. However, Kaye, Scholer was not alleged to have had this information until late August 1986, a bare month before the regulators knew Lincoln was insolvent.[59] Thus, while Kaye, Scholer may have aided and abetted Lincoln in its misrepresentations and omissions to lawmakers, it is not obvious what real harm was caused by the firm's obstructionist activities given that the regulators would know Lincoln was insolvent one month later.

The eighth claim in the notice of charges relates to the same underlying problem that is the subject of the first claim, the grandfathering of certain of Lincoln's direct investments. In particular, this claim alleged that Kaye, Scholer failed to disclose to the OTS that certain documents were backdated.[60] Such backdating was critical to Lincoln's attempts to have these investments grandfathered. Kaye, Scholer's response to this charge was that the date of the documents was immaterial because what mattered was the date on which the relevant decision took place, not the date of the documents.[61] This is an extremely weak argument. Obviously, people put dates on documents for a reason. With respect to transactional documents, there is a presumption that the dates on the documents correspond to the dates on which the decisions memorialized therein were made. Thus the OTS was correct in its assessment that Kaye, Scholer should have disclosed this backdating to the OTS.

However, in a careful analysis of the Kaye, Scholer affair, it is important to put Kaye, Scholer's professional lapses in perspective. Clearly, Kaye, Scholer's cover-up of Lincoln's backdating was a serious breach of professional standards, including the FHLBB's prohibition

57. *In re* Fishbein, OTS AP-92-19, para. 107.

58. *Id.* para. 133.

59. *Id.* paras. 113-16.

60. *Id.* para. 149.

61. *Id.* para. 142.

against engaging "in any dilatory, obstructionist, egregious, contemptuous, contumacious or other unethical or improper professional conduct before the Board."[62] But how much harm did this breach cause the FHLBB's regulatory effort? The actual investments made by Lincoln were not hidden from the FHLBB. Nor did Kaye, Scholer conceal that Lincoln's investments were direct investments rather than loans. All that was concealed was the date on which Lincoln committed itself to make these investments.[63] For technical regulatory reasons Lincoln wanted to make it appear to the FHLBB that it had committed to these investments earlier than it actually had.[64] The regulators should have made a determination of the safety and soundness of these investments regardless of when Lincoln had committed to them. Thus, it is not at all clear how the backdating that is the subject of the first and seventh of the OTS' claims impeded the FHLBB's basic objective of evaluating Lincoln's financial condition.

The ninth claim in the OTS notice of charges pertains to Lincoln's participation in the financing of a personal tax shelter for Charles Keating and other investors in Lincoln's holding company, American Continental Corporation. Lincoln's funding of this tax shelter was illegal because the tax shelter vehicle, an entity called the Hotel Ponchartrain Limited Partnership, was an affiliate of Lincoln.[65] Hence, loans from Lincoln to the limited partnership involved conflicts of interest and were prohibited as affiliated transactions. But as with certain of the other claims made by the OTS, the critical issue is when Kaye, Scholer knew that false and misleading information was being supplied by Lincoln to the FHLBB.

Here it appears that the critical date is October 18, 1988, the date of an internal Kaye, Scholer memorandum in which the firm conceded that it was "disingenuous to fail to deduct management fees, real estate taxes and similar items on computing the appropriate profit particularly when the relevant figures are so easily obtainable."[66] But prior to that, on September 6, 1988, a joint examination of files from Lincoln's holding company conducted by the FHLBB and the California Department of Savings and Loan concluded that the $20 million extension of credit from a Lincoln subsidiary to the Hotel Ponchartrain Limited Partnership

62. At the time of the Kaye, Scholer affair, these prohibitions were listed in 12 C.F.R. § 513.4(a)(3) (1986).

63. *In re* Fishbein, OTS AP-92-19, para. 28.

64. *Id.* para. 24.

65. *Id.* para. 159.

66. *Id.* para. 167 (quoting Kaye, Scholer memorandum (Oct. 18, 1988)).

was a "loss, unsafe and unsound, and [a] flagrant conflict of interest."[67] Thus, Kaye, Scholer was not as effective as the OTS would have people believe, nor were the regulators as easily duped. Again, the point is not to apologize for Kaye, Scholer or to portray its actions as anything other than egregious. Rather, the point is to suggest that factors other than Kaye, Scholer's misconduct account for the failure by regulators to close Lincoln in a timely fashion.

As part of its tenth claim against Kaye, Scholer, the OTS questioned a transaction between Lincoln and a partner in Kaye, Scholer named Lynn Toby Fisher. Fisher received a $675,000 loan from Lincoln, secured by a mortgage on real estate appraised at $700,000 and a pledge of securities.[68] At the time, she was serving as securities counsel for Lincoln's holding company, with responsibility for preparing and reviewing the prospectuses filed by Lincoln and its holding company with the Securities and Exchange Commission and the FHLBB.[69] It is hard to know exactly what to make of this claim. It is not unreasonable for a lending institution to make a fully collateralized $675,000 loan to a partner at a major New York law firm. Nor does it appear that any federal regulations were violated in this transaction. However, the OTS claimed that the transaction between Fisher and Lincoln violated 12 C.F.R. § 513(a)(4),[70] which permits the FHLBB, after providing notice and the opportunity for a hearing, to deny lawyers the privilege to practice before it if they have "willfully violated, or willfully aided and abetted the violation of, any provision of the laws administered by the Board or the rules and regulations promulgated thereunder."[71]

E. Kaye, Scholer's Fiduciary Duties to Lincoln: The Fourth Claim

Perhaps the most controversial claim brought by the OTS against Kaye, Scholer is the fourth claim, in which the firm was accused of failing to fulfill its fiduciary duties to Lincoln and of engaging in unethical and improper professional conduct. The premise behind this charge is that Kaye, Scholer knew of the "high risk nature of Lincoln's real estate development business," of the deficiencies in Lincoln's real estate underwriting and appraisal business, of Lincoln's efforts to conceal its violations of the limitations on direct investment, of transactions between

67. *Id.* para. 164.
68. *Id.* paras. 172, 176.
69. *Id.* para. 178.
70. *Id.* para. 181.
71. 12 C.F.R. § 513.4(a)(4) (1986).

Lincoln and its affiliates that were unfair to Lincoln, and of a variety of problems with Lincoln's real estate business.[72]

Despite a complete absence of support in law or established practice or procedure,[73] the OTS claimed that Lincoln owed fiduciary duties to its depositors and to the deposit insurance fund and that Kaye, Scholer was at fault for failing to advise Lincoln that it was in violation of these duties.[74] Harris Weinstein, Chief Counsel to the OTS at the time it brought charges against Kaye, Scholer, invented the idea that thrift directors owe fiduciary duties to federally administered deposit insurance funds. In a series of well-publicized speeches, Weinstein argued that directors of federally insured financial institutions

> are *not* legally free to view themselves as having duties only to common shareholders. So truncated a view would result in a complete disregard of the duty owed to the true party in interest. The reason is that the directors owe a fiduciary duty to the federal government, whose interest in the institution exceeds that of any other person, and who insures the deposits, holds the unlimited equity risk, and is the primary creditor in insolvency.[75]

In addition to having no basis in law, the OTS' claim that thrift directors owe fiduciary duties to the deposit insurance fund had no basis in established agency practice and was of questionable merit as a policy matter. Under the circumstances, it is nothing short of incredible for the OTS to argue that Kaye, Scholer was not rendering competent legal advice when it failed to advise the Lincoln directors of legal obligations that, in fact, did not really exist.

The charges by the OTS that Kaye, Scholer knew that officers and directors of Lincoln were violating federal regulations have only slightly more merit. If anything in the Lincoln case is clear, it is that these officers and directors were aware that they were violating such regulations. That is why they were ultimately prosecuted by the authorities. Indeed, if key directors and officers of Lincoln had not thought they were violating federal banking regulations, they never would have hired Kaye, Scholer in the first place. Thus, it is a bit disingenuous for the OTS to charge that Kaye, Scholer was obligated to tell its client something that the client already knew.

72. *In re* Fishbein, OTS AP-92-19, para. 53.

73. Andrew J. Nussbaum, *Like Money in the Bank? An Economic Analysis of Fiduciary Duties to Protect the S&L Deposit Insurance Fund*, 44 ADMIN. L. REV. 355, 358 (1992).

74. *In re* Fishbein, OTS AP-92-19, para. 54.

75. Harris Weinstein, OTS Chief Counsel, Remarks at Southern Methodist University (Sept. 13, 1990), *quoted in* Nussbaum, *supra* note 73, at 383.

Finally, the OTS' fourth claim charged that Kaye, Scholer knew that the interests of its client ACC were adverse to those of another of its clients, namely, Lincoln. Kaye, Scholer was charged with failing to advise these clients of its conflict of interest or, alternatively, failing to seek the consent of Lincoln's board to represent both ACC and Lincoln.[76] This claim ignores two critical facts about Kaye, Scholer's joint representation of ACC and Lincoln. The first is that ACC owned 100% of Lincoln's stock.[77] ACC's complete ownership of Lincoln necessarily meant that what was good for Lincoln was good for ACC, and vice versa. Second, the OTS ignored that, unlike in most conflict-of-interest situations, both of Kaye, Scholer's clients were fully aware of the firm's double representation. Consequently, it is far from clear that disclosure was necessary under the circumstances.

F. The Claims Against Kaye, Scholer: Summary and Conclusions

The purpose of the preceding discussion is not to defend Kaye, Scholer. Rather, our purpose is to provide better understanding of the marginal benefit of the Kaye, Scholer prosecution from the perspective of bank regulatory policy. Thus, we wish to emphasize that we do not dispute that Kaye, Scholer did something wrong and that the firm probably should have been sanctioned for what it did. For example, Kaye Scholer's cover-up of Lincoln's backdated documents[78] was a breach of professional standards, as were the firm's misrepresentations regarding Lincoln's financial condition.[79]

Having said that, however, it also is worth emphasizing that the prosecution of Kaye, Scholer did nothing to improve the safety and soundness of the nation's banking system or to improve the quality of regulatory oversight received by federally insured financial institutions. From the perspective of bank regulatory policy, the critical issues are as follows: (1) whether the sort of enforcement action brought by the OTS against Kaye, Scholer will result in more soundly managed federally insured financial institutions, and (2) whether this sort of enforcement action is likely to provide regulators with information about the financial condition of troubled depository institutions in a more timely manner.

76. *In re* Fishbein, OTS AP-92-19, para. 56.

77. *Id.* para. 4.

78. *See supra* text accompanying note 43.

79. *See supra* text accompanying notes 26-28.

The preceding discussion should have made clear that the enforcement action against Kaye, Scholer is unlikely to produce these sorts of results.

Perhaps the most disturbing aspect of the Kaye, Scholer affair is that the federal banking regulators were aware of Lincoln's insolvency even before most of Kaye, Scholer's wrongdoing occurred. Even in those instances when Kaye, Scholer assisted Lincoln prior to the regulators' learning of Lincoln's insolvency, the regulators were already aware of the particular problems that the firm may have attempted to obfuscate. For example, the claim that Kaye, Scholer assisted Lincoln in presenting incomplete or inadequate files to regulators is hardly a claim that the firm hid things from the regulators with the effect of delaying the discovery of Lincoln's insolvency. Thus, the argument that Kaye, Scholer's actions somehow enabled Lincoln to remain open after it was insolvent is false.

With respect to the remaining allegations against Kaye, Scholer, the preceding analysis indicates that some of Lincoln's activities did not require the involvement of lawyers in the first place. In particular, while Kaye, Scholer was aware that Lincoln backdated certain documents in order to increase its direct investments, there was no allegation that the law firm participated or assisted in such backdating. Thus, it seems clear that the backdating would have occurred without Kaye, Scholer's involvement. Indeed, without Kaye, Scholer's involvement, the backdating probably never would have been detected.

III. FIRREA, REGULATORY SUBTERFUGE, AND THE REAL REASON KAYE, SCHOLER WAS PURSUED BY THE OTS

The preceding discussion was intended to show that the prosecution of Kaye, Scholer did not improve the quality of the bank regulatory system because even if Kaye, Scholer had acted in precisely the manner demanded by the regulators and had not engaged in any improper conduct, the price tag for Lincoln's failure would have remained the same: $2 billion. In other words, while Kaye, Scholer may have acted improperly, its actions did not delay the closure of Lincoln. Thus, the publicity surrounding the Kaye, Scholer case has obscured the most important policy question: What really caused the delay in closing Lincoln?

Locating the cause of the delay in closing Lincoln is important because delays in closing federally insured depository institutions are extremely costly. When dealing with insolvent banks, good timing by regulators is critical to controlling costs. In fact, at some level virtually all of the losses to deposit insurance funds can be attributed to bad timing on the part of regulators. After all, if a depository institution could be closed at the exact moment of insolvency (i.e., at the moment when the present value of the troubled bank's assets exactly equals the present value of its liabilities),[80] the losses to the deposit insurance fund would be zero.

Moreover, delays in closing failed financial institutions dramatically increase the losses suffered by fixed claimants, including the FDIC:

> [I]f a failed bank remains open after it is economically insolvent, the shareholders, who have nothing more to lose if the bank continues its downhill slide, have a strong incentive to "roll the dice one more time" or, in other words, to take extremely high risks in hope of a huge payoff that will restore the value of their equity.[81]

Unfortunately, the decision to close an insolvent bank rests with banking regulators, who do not personally internalize the costs of delay. Regulators who prematurely close a solvent financial institution will offend the shareholders, managers, employees, and depositors of that institution. But regulators who permit an insolvent financial institution to remain open after it should be closed rarely are blamed because the costs of keeping such institutions open are widely dispersed among taxpayers, who must provide the funds necessary to bail out the deposit insurance funds.

And, if one examines the peculiar incentives facing banking regulators, one finds that there are strong incentives for regulators to delay closing insolvent financial institutions. In fact, banking regulators have strong incentives to delay identifying problem banks, to deny the severity of the banking crisis generally, and to postpone meaningful action for as long as possible regardless of the cost.

Regulators are not residual claimants. They do not benefit by saving money in the resolution process. Moreover, federally sponsored deposit insurance creates a situation in which bank depositors, who constitute what is by far the largest group of bank creditors, are deprived of any reason to become concerned about bank solvency. The banking crisis, even though it has reached epic proportions, still is not a major political issue. Candidates for major office can avoid it because the public, made

80. Liabilities include the sums owed to depositors (including those that are federally insured) and the administrative costs of the insolvency itself.

81. Jonathan R. Macey, *The Political Science of Regulating Bank Risk*, 49 OHIO ST. L.J. 1277, 1294 (1989).

rationally ignorant by federal deposit insurance, has not forced them to confront the issue.

Another factor that influences regnlators' incentives is that they have short-term horizons. They often do not expect to stay in their job for very long,[82] and they are evaluated on the basis of a bizarre set of criteria. The FDIC is generally thought to have performed well if the number of bank failures in any given year is small, if the size of the deposit insurance fund does not shrink during a particular period, and if the taxpayers are not called upon to ante up money to assist in the bailout. These criteria create a set of overwhelming incentives for regulators to delay recognition of a crisis by keeping insolvent institutions operating and by avoiding liquidations of insolvent institutions. Regulators are willing to accept huge long-term losses rather than face relatively small short-term losses because their incentive system allows them to pass the political consequences of long-term losses onto subsequent regulators. This is a natural and inevitable consequence of the fact that the deposit insurance fund has no residual claimants.

When Congress enacted FIRREA in 1989, it recognized that insolvent depository institutions must be closed in a more timely manner. Unfortunately, Congress did not seem to recognize that the perverse incentives facing bank regulators made such regulators part of the problem rather than part of the solution. Thus, FIRREA reflects the flawed assumption that giving bank regulators more power and greater access to information will lower the costs of administering the nation's failing banks by insuring that such banks are closed in a more timely fashion.

FIRREA gave the newly created OTS additional authority to promulgate a variety of capital requirements for thrifts,[83] and it gave the FDIC broad new powers to conduct special examinations of thrifts[84] and to appoint receivers for state-chartered, federally insured thrifts.[85] In all likelihood the reason the FDIC was given particularly broad powers to appoint receivers for state-chartered thrifts was that Congress thought

82. Political appointees are generally removed when administrations change, and the higher pay offered by private-sector employers causes rapid turnover among political appointees as well. Jonathan R. Macey, *It's Time for Bush to Pay the Piper on the S&L Bailout*, L.A. TIMES, Apr. 22, 1990.

83. Pub. L. No. 101-73, § 301(S)(2), 103 Stat. 183, 302 (1989) (codified as amended at 12 U.S.C. § 1464(d)(2) (Supp. II 1990)).

84. *Id.* § 210(a) (codified as amended at 12 U.S.C. § 1820(b)).

85. *Id.* § 212 (codified as amended at 12 U.S.C. § 1821(c)-(j)).

that state regulators had incentives to keep insolvent financial institutions open in order to benefit local interests at national expense.[86]

Unfortunately, when Congress enacted FIRREA, it apparently did not recognize that federal regulators have incentives to keep insolvent institutions open as well. FIRREA attempts to ensure that regulators will be able to effectuate the early closure of insured depository institutions by imposing stiff penalties for institutions that fail to make reports to bank regulatory agencies or that file false or misleading reports with such agencies.[87]

FIRREA also recognizes that early closure may not be enough in some circumstances. Early closure may not be enough because, even under the best circumstances, regulators need time to assemble sufficient evidence to permit them to close an insured depository institution. As Professor Coffee has observed, much of FIRREA is best understood as a reflection of "congressional concern about delay in the closing of an insolvent institution until legally adequate evidence could be gathered. . . . [M]inutes count in such a fast-moving context when financial assets can disappear without a trace."[88]

It was for this reason that FIRREA gave the OTS the extraordinary power to issue cease-and-desist orders, not only against insured depository institutions, but also against "institution-affiliated parties," such as lawyers and accountants.[89] However, it is not at all clear that FIRREA can be read to permit the actions taken by the OTS against Kaye, Scholer. The relevant provisions of the statute make it clear that directors, officers, consultants, attorneys, appraisers, and accountants face the prospect of a freeze order only for engaging in activities that are likely to result in adverse effects on insured financial institutions.[90] The critical section of the U.S. Code provides,

> [W]herever the violation or threatened violation or the unsafe or unsound practice or practices . . . or the continuation thereof, is likely to cause insolvency or significant dissipation of earnings *of the depository institution*, or is likely to weaken the condition of the depository institution or otherwise prejudice the interests of its depositors . . . the

86. The perverse incentives of state bank regulators have been well documented. *See* JONATHAN R. MACEY & GEOFFREY P. MILLER, BANKING LAW AND REGULATION 129 (1992); Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677 (1988).

87. § 301(u)(4)-(8), 103 Stat. at 312 (codified as amended at 12 U.S.C. § 1464(v)(4)-(8)).

88. *See* Coffee, *supra* note 20, at 22.

89. § 901, 103 Stat. at 446 (codified as amended in scattered sections of 12 U.S.C.).

90. 12 U.S.C. § 1786(r) (Supp. 1989).

> agency may issue a temporary order requiring the depository institution or such party to cease and desist from any such violation or practice and to take affirmative action to prevent or remedy such insolvency, dissipation, condition, or prejudice pending completion of such proceedings.[91]

Lincoln was seized by the FDIC in April 1989. The OTS did not bring suit against Kaye, Scholer until March 1992. Thus, by the time Kaye, Scholer was sued, the firm's actions could no longer be said to be "likely to cause insolvency or significant dissipation of earnings" of Lincoln or "to weaken the condition" of Lincoln or "to otherwise prejudice the interests of its depositors" within the meaning of the statute.

Thus, it appears that the OTS may have lacked statutory authority to freeze the assets of Kaye, Scholer when it did. At best, the agency's authority to issue the order was unclear. One begins to wonder why the agency decided to issue the freeze order in the first place. Earlier we showed that regulators have strong incentives to delay the closing of insured financial institutions even though the public suffers mightily from such delays.[92] These perverse incentives go a long way toward explaining why the regnlators took so long to close Lincoln. The political pressures applied by Charles Keating, who hired lobbyists and enlisted the help of at least five U.S. Senators, complete the picture.

The delay in closing Lincoln is one issue; the extraordinary actions taken against Kaye, Scholer almost three years later are quite another. To understand the motivations of the OTS, one must recoguize the political environment at the OTS and its predecessor agency, the FHLBB. First, even before FIRREA was enacted, the FHLBB was viewed as a failed administrative agency, corrupt at worst and at best riddled with conflicts of interest and wholly captured by the industry it was supposed to regulate.[93] For this reason the FHLBB was abolished and its functions were divided among the FDIC and two newly created entities, the Resolution Trust Corporation and the OTS.[94]

Second, FIRREA, wlrich was heralded as a major legislative triumph for the Bush Administration, quickly came to be viewed as a major failure. FIRREA denied the severity of the crisis, did notlring to correct bureaucratic incentives that failed to ensure that depository institutions

91. 12 U.S.C. § 1818(c)(1) (Supp. 1990) (emphasis added).

92. *See supra* text accompanying notes 56-59.

93. Jonathan R. Macey, *The Politics of Denying an S&L Crisis*, L.A. TIMES, Dec. 10, 1989, at M3.

94. MACEY & MILLER, *supra* note 86, at 35.

would be closed in a timely fashion, and perpetuated the flaws in the pricing of FDIC insurance that led to the crisis in the first place.[95] The newly created OTS and RTC quickly became mired in controversy.

The reputation of the OTS was doomed from the start because it was forced by powerful special interests in Congress to accept as its Chairman the infamous M. Danny Wall, the inept Chairman of the FHLBB.[96] Wall was widely considered to have behaved in an ethically questionable manner because the outrageously low estimates of the costs of the savings and loan bailout issued by him in 1988 were perceived to have been contrived to help George Bush win the 1988 presidential election.[97] More to the point, as head of the FHLBB, Wall sided with Charles Keating in the dispute between Keating and the examiners from the San Francisco Federal Home Loan Bank over auditors' recommendations about Lincoln's investment portfolio. In this dispute, Wall not only interfered with the actions of the local regulators and sided against his colleagues at the FHLBB, he also ultimately took the unprecedented step of removing the San Francisco regulators and transferring regulatory authority over Lincoln to Washington, D.C.[98] This act on behalf of the politically well-connected Keating delayed Lincoln's closure by almost two years and cost taxpayers literally billions of dollars.[99]

By the time the OTS took regulatory action against Kaye, Scholer, blame for the banking crisis had shifted. In the early days of the crisis, many believed that fraud, incompetence, and corruption within the banking industry were to blame.[100] But by 1991, it was clear to all that the regulatory system itself was at fault. The fact that regulators were unable or unwilling to detect $500 billion in losses and the virtual bankruptcy of the entire industry could not be blamed solely on incompetence and corruption within the savings and loan institutions.

The passage of the Federal Deposit Insurance Corporation Improvement Act[101] in November 1991 provides some evidence of how disreputable the bank regulatory agencies had become by the time the enforcement

95. Macey, *supra* note 93.

96. *Id.*

97. *Id.*

98. *Id.*

99. *Id.*

100. Some estimate that fraud and self-dealing have been "apparent" in as many as one third of today's bank failures. Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures*, 88 COLUM. L. REV. 1153, 1166 (1988).

101. Pub. L. No. 102-242, § 141, 105 Stat. 2236, 2273 (1991) (codified as amended in scattered sections of 12 U.S.C.).

action was brought against Kaye, Scholer in March 1992. For the first time, Congress recognized that the federal bank regulatory agencies were handling bank failures ineptly and were not closing insolvent institutions in a timely manner. Thus the FDICIA was designed to remove regulatory discretion from the agencies with respect to the issue of how to deal with insolvent financial institutions. The agencies were given even clearer instructions about early closure and about what procedure to use in handling insolvent institutions.

Before the Act was passed, the FDIC could resolve failed banks in any manner it wanted, so long as the strategy it employed was no more costly than liquidating the bank by directly paying depositors the amount of their insured deposits and then disposing of the bank's assets.[102] Under the FDICIA, however, the FDIC is required to resolve failed depository institutions in the manner that is the least costly "of all possible methods for meeting the corporation's obligations"[103] (unless there is a determination by the Secretary of the Treasury, in consultation with the President, that the least costly strategy would "have serious adverse effects on economic conditions or financial stability").[104] Moreover, in a move clearly designed to deprive the FDIC of unfettered discretion, it is now required to provide documentation of its resolution decisions.[105]

In light of all of this background, the real purpose behind the Kaye, Scholer enforcement action seems clear. The OTS—under new and considerably more competent management than its predecessor, the FHLBB—needed a convenient, unpopular scapegoat that it could confront with a dramatic gesture designed to help it regain its prestige. In this context, the selection of Kaye, Scholer was nothing short of brilliant. By focusing attention on the law firm's representation of Keating and Lincoln, the agency was able to purge the taint caused by the actions of its former chairman on behalf of Lincoln. Of equal importance, the OTS enforcement action was carefully designed to create the impression that the law firm's improprieties, rather than the regulator's own political corruption and ineptitude, were to blame for the unconscionable delay in closing Lincoln.

Finally, the OTS managed to improve its image by creating the impression that the enforcement action against Lincoln represented a

102. MACEY & MILLER, *supra* note 86, at 279.

103. § 141(a), 105 Stat. at 2273.

104. *Id.* at 2275.

105. *Id.* § 131 (codified as amended at 12 U.S.C. § 1831O(h) (Supp. 1991)). The Act added the documentation requirement to § 38(h) of the former FDIA.

great victory for a small bureaucracy in its holy war against the large, well-funded Goliaths of the legal profession. By targeting lawyers, the OTS managed to do battle with a group even less popular than itself and to create the impression that it was not to blame for the continuing crisis in the banking industry.

IV. TOWARD A SOLUTION OF THE CONTINUING CRISIS

Over the past two decades Congress has gradually and grudgingly become aware that deep and pervasive structural problems plague the banking industry and that the regulators have played a larger role in causing the problem than in fashioning a solution. The enactment of FIRREA in 1989 reflects a recognition by Congress that the FHLBB could not continue to regulate the thrift industry and that the thrift industry could not continue to postpone acknowledging that the industry itself was largely defunct.

Nevertheless, the enactment of FIRREA continued the perception that the regulatory process had failed only because the regulators had been given *too little* power. Congress still did not understand that the problem was not a *lack* of power but a lack of appropriate incentives. Thus, while the regulators had sufficient power to close institutions like Lincoln in a timely fashion, their incentives were to delay closure, not only to maximize political support from corrupt politicians like the Keating Five but also to maintain the appearance of regulatory success by keeping the enormous size of the crisis hidden from public view.

The passage of the FDICIA was a strong sigual that Congress finally recoguized that regulators were not prepared to deal with the problems of the banking industry on their own. Thus, while FIRREA attempted to deal with the problems by expanding regulatory power, FDICIA attempted to deal with these problems by reducing agency discretion. It did this in a number of ways: most notably, by compelling the FDIC to implement risk-based deposit insurance premiums on insured depository institutions, by attempting to reduce agency discretion of how to administer bank failures, and by requiring the agencies to impose new restrictions on banks that failed to meet capital guidelines.

The OTS' aggressive actions against Kaye, Scholer should be viewed as a rational response by an administrative agency to a new political environment in Congress. For a time the bank administrative agencies cooperated with Congress in its efforts to postpone recognition of the banking crisis in general and Lincoln's failure in particular. But when public sentiment turned against Congress, a scapegoat was needed, and the OTS found one in Kaye, Scholer. In other words, somebody had to take the blame for the outrageous delay in closing Lincoln. The real culprits, of course, were members of Congress, particularly the Keating Five, and regulators, such as Danny Wall, who succumbed to political pressure and agreed to delay closing Lincoln long after it had become insolvent. Above all, however, it was the perverse structure of incentives embodied in federal banking law that was to blame.

V. CONCLUSION

It is unlikely that the shift from the regulatory discretion model of FIRREA to the command-and-control model of FDICIA will improve the way financial institutions in the United States are regulated. The banking industry is too complex and the nature of the decisions required of regulators too subjective to permit a centrally planned, command-and-control strategy to succeed. For example, as explained earlier, it is clear that if banks could be closed at the exact moment when they become insolvent, then bank failures would not be the public burden they are today. But the decision to close a bank is inevitably subjective. It involves immensely complicated judgments about the quality of a bank's assets that simply cannot be reduced to regulatory generality.

Thus, the command-and-control model reflected in FDICIA is no improvement over the broad delegation model of FIRREA. Instead of meaningful reform, we get highly publicized events like the prosecution of Kaye, Scholer. The only alternative to the broad delegation model of FIRREA and the command-and-control model of FDICIA is a market model in which industry participants themselves are induced by market forces to manage banks prudently.

Under the current system two sorts of perverse incentives exist. First, regulators have perverse incentives to deny and obfuscate the severity of the banking crisis and to avoid meaningful solutions to the ongoing problems in the industry by shifting the blame for the industry's problems to entities like Kaye, Scholer. Second, market forces are not allowed to supplement the regulatory system's efforts to prevent excessive risk taking by banks. In particular, deposit insurance creates a perverse incentive for bank shareholders to use their control to cause banks to engage in increasingly risky activities in order to transfer wealth from creditors, depositors, and, ultimately, the deposit insurance fund itself to themselves, shareholders of FDIC-insured banks.[106]

While fixed claimants, such as depositors, always face the prospect that shareholders will attempt to transfer wealth away from them by increasing the riskiness of the firms in which they have invested ex post (that is, after the fixed claimants have made their initial investments),

> [w]hat makes banks fundamentally different from other types of firms . . . is the lack of significant discipline from other fixed claimants. FDIC insurance removes any incentive that insured depositors have to control excessive risk taking because their funds are protected regardless of the outcomes of the investment strategies that the banks select. In a world without deposit insurance, depositors would demand that banks refrain from engaging in risky investment strategies or else would demand that they be compensated in the form of a higher interest rate for the extra risk.[107]

Thus, under the current system of bank regulation, not only do regulators lack incentives to deal with the problems facing the industry, but market forces are not operating, either. For market forces to be brought to bear on the crisis, three things must happen:

First, assuming the continuance of the deposit insurance system, banks that offer federally insured deposit accounts must pay insurance premiums that are set by market forces rather than by regulators. The FDICIA requires risk-based deposit insurance premiums, but it allows bank regulators to set those premiums.[108] Those regulators have neither the capacity nor the incentives to determine what premiums to charge. Instead, banks should be offered a menu of alternative market-pricing mechanisms for their deposit insurance. One option, suggested by Professor Kenneth Scott of Stanford Law School[109] and, independently, Douglas Evanoff of the Federal Reserve Bank of Chicago,[110] would be to allow insured depository institutions to sell uninsured, unsecured subordinated debentures in the capital markets and to tie a bank's insurance premiums to the interest rates applied by the markets to these debentures. Alternatively, other banks, particularly smaller banks lacking ready access to the capital markets, could obtain private coinsurance

106. Macey & Miller, *supra* note 100, at 1165.

107. *Id.*

108. 12 U.S.C. § 1817(b)(1)(A) (Supp. 1992).

109. Kenneth Scott, *Deposit Insurance and Bank Regulation: The Policy Choices*, 44 BUS. LAW. 907 (1989).

110. Douglas Evanoff, *Subordinated Debt: The Overloaded Solution for Banking*, CHI. FED. LETTER, May 1991, at 1.

from insurance companies or consortiums of fellow banks. The rates set by these private insurers or consortiums could be used to set the price charged by the government for FDIC insurance. Market-based premiums for deposit insurance would provide banks with a strong incentive to engage in prudent banking practices because they could not continue to pass the costs of engaging in risky activities on to the government. As of now, banks like Lincoln can engage in excessively risky activities, knowing that their shareholders will capture all the gains in the event of success while the costs of failure will be borne largely by taxpayers.

Second, banks must be required to balance their insured deposits by keeping uninsured debentures or uninsured depository accounts in amounts equal in face value to their insured deposits. Allowing these debenture holders and uninsured depositors to force insolvent banks into bankruptcy would ensure that all insured depository institutions were continuously monitored by a group of investors with strong incentives to ensure prompt closure in the event of insolvency.

Finally, shareholders should be given expanded incentives to run their banks safely and soundly. Prior to the introduction of federally sponsored deposit insurance in the 1930s, bank shareholders faced double liability to depositors in the event of insolvency.[111] Under that system, if a bank failed, the receiver of the failed bank would determine the extent of the insolvency and then assess shareholders an amount up to and including the par value of their stock. This system of double liability transformed bank shareholders from investors seeking to gain advantage by increasing the riskiness of their banks to investors who benefited by decreasing the riskiness of those firms.[112]

The great irony behind the OTS enforcement action against Kaye, Scholer is that the reason Congress gave the OTS such broad enforcement power was to enable it to act quickly to prevent the dissipation of assets of insolvent financial institutions. By the time the OTS began to use this power, however, Congress had finally come to recognize that giving the OTS and other bank regulatory agencies broad enforcement powers was not the solution to the problem. The OTS action against Kaye, Scholer, coming almost three years after Lincoln had been shut down, proved that Congress was right.

111. Jonathan Macey & Geoffrey Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31 (1992).

112. *Id.* at 33.

The enforcement action against Kaye, Scholer was a desperate, and ultimately unsuccessful, attempt by the OTS to shift blame for the ongoing crisis in the banking industry and deflect the public's attention from the regulators' own ineptitude. Unfortunately for the OTS, its actions against Kaye, Scholer were too little and too late. The FDICIA reflects Congress' lack of trust in the bank regulatory agencies. Unfortunately, the centrally planned, command-and-control model reflected in FDICIA is not an improvement over the broad delegation strategy embraced by FIRREA. Perhaps Congress will turn to a market-based solution while there is still an industry left to regulate.