SHUTTS & BOWEN LLP

100 Years of Service

UNDERSTANDING AND DEALING WITH LUAs, DORs AND ADVERSE EXAMINATION FINDINGS

Or Knowing

When to hold 'em, When to fold 'em, When to walk away, and When to run

Prepared for the National Coalition of Firefighters Credit Unions Inc. Conference

Michael D. Lozoff
Credit Union Practice Group
SHUTTS & BOWEN LLP
1500 Miami Center
201 South Biscayne Boulevard
Miami, Florida 33131
mlozoff@shutts.com
fhenriquez@shutts.com
Website: www.shutts.com

UNDERSTANDING AND DEALING WITH LUAs, DORs AND ADVERSE EXAMINATION FINDINGS

CONSIDER THE FOLLOWING SCENARIO

YOUR EXAMINER SHOWS UP AT THE EXIT INTERVIEW WITH 5 COLLEAGUES, PRESENTS THE BOARD WITH A 15 PAGE DOR OR LUA, EXPLAINS THAT THE TERMS ARE NON-NEGOTIABLE, AND INFORMS THE BOARD THAT SHE WILL BE BACK IN AN HOUR BY WHICH TIME SHE EXPECTS THE DOCUMENT TO HAVE BEEN REVIEWED, DISCUSSED AND ADOPTED OR SIGNED BY EACH DIRECTOR. THE CEO IS CAUGHT OFF GUARD AND UTTERLY FLUMMOXED. THE SUPERVISORY COMMITTEE CHAIR IS BEWILDERED AND BEGINNING TO REGRET THAT SHE EVER VOLUNTEERED TO SERVE ON THE COMMITTEE.

AS A DIRECTOR OR COMMITTEE MEMBER, WHAT IS WRONG WITH THE ABOVE SCENARIO? DO YOU SEE RED FLAGS? WHAT WOULD YOU RECOMMEND TO THE BOARD? WOULD YOU URGE THAT THE BOARD:

a. COOPERATE WITH THE EXAMINERS BY REVIEWING THE DOCUMENT AND ADOPTING OR SIGNING IT IN ONE HOUR?

b. POLITELY DECLINE THE EXAMINER'S DEMAND AND HOPE FOR THE BEST?

c. RESIGN YOUR POST AND HEAD FOR THE NEAREST EXIT?

INTRODUCTION

This scenario is not uncommon, but effectively dealing with it will depend upon your understanding of your rights and responsibilities as officials of a federally insured credit union.

Federal credit unions are examined exclusively by the National Credit Union Administration (NCUA) while federally insured state-chartered credit unions face joint examinations by NCUA and state credit union regulators. For state charters, the state is the primary regulator while NCUA's involvement is limited to determining whether the credit union is operated safely and without undue risk to the National Credit Union Share Insurance Fund ("NCUSIF"). As a practical matter, however, in many states (for a variety of reasons) NCUA examination processes, protocols, and guidance set the course of the examination, and dictate the various types of tools, such as DORs and LUAs, that the examiners will use to address non-compliances and unsafe activities or practices.

A remarkable fact: Many, perhaps most, credit unions today operate under DORs and LUAs, tools originally created by NCUA but used by state and federal examiners. Indeed, several years ago, we asked an NCUA official if she could estimate how many credit unions were currently operating under either of these supervisory tools. Although many LUAs are "unpublished" and thus their numbers are not made public and DORs are never made public, the official said:

"*I would guesstimate mos*t."

The same official agreed that twenty years earlier, only about 10% of credit unions operated under a DOR or LUA. Why? Does this suggest that credit unions are performing more poorly today than in the past? The answer is "not really".

At least one important reason for the increase in the use of these tools is the federal commitment to more strictly enforce compliance with the Bank Secrecy Act (BSA). Several years ago, the Federal Financial Institutions Examination Council (FFIEC) published the new BSA manual. Although the manual was intended to clarify earlier confusions and help examiners assess the specific risk profiles of financial institutions they were examining, the overarching purpose of the new manual is to underscore the elevated federal commitment to <u>enforce</u> BSA going forward. The least intrusive and most practical regulatory tools for this purpose were determined to be DORs and LUAs, versus, say, an adverse finding or criticism in the examination report. This is because a BSA related noncompliance is more serious than an ordinary operational finding, and a DOR or, when applicable, an LUA, is more of an attention getter than is an ordinary finding. LUAs, of course, are more intrusive than DORs and present a greater risk of regulatory enforcement.

The increased use of DORs and LUAs for BSA purposes led, in turn, to an increase in the use of these instruments for general regulatory purposes as well, perhaps under the "all-under-one-umbrella" principle, but particularly to address adverse findings that were not timely or effectively addressed. As a result, an examiner's adverse findings or recommendations which, years earlier, might have remained in the more benign "findings" section of your examination reports, are now often folded into DORs (particularly if they pertain to areas of risk which the examiner believes are not being adequately recognized or controlled by management). From a regulatory perspective, this regulatory practice promotes economy of effort: If DORs (and LUAs) are effective in inducing compliance with BSA standards they should be effective when used in other areas as well.

GENERAL COMMENTS AND DEFINITIONS

Before we discuss how to deal with DORs and LUAs when presented, it is important to have an understanding of what these tools really are and – importantly – <u>what they are not</u>.

A. Documents of Resolution ("DOR"). A DOR, whether issued by a state or federal regulator, is, simply speaking, the least intrusive supervisory tool to induce and monitor compliance. It is a baby step beyond the remedial recommendations contained in the findings section of an examination report. Essentially, it is a set of written objectives proposed by

examiners and, if acceptable, adopted by the board of directors. It is intended to focus the credit union's attention on addressing the more serious problems cited in the examination report. Typically, a DOR addresses findings which, in the view of the examiner, reflect unacceptable operational risks. An "unacceptable risk" is defined in NCUA's Examiner's Guide as an area of activity "*for which management does not have the proper structure for identifying, measuring, monitoring, controlling, and reporting risk.*"

The distinction between a DOR and the adverse findings section of the examiner's report is that (1) a DOR is a separate document with a defined purpose; and (2) a DOR sets forth specific time frames and allocates responsibility (either to board, management or both) for addressing each item of concern. A DOR does not rise to the level of a contract with the government, as does an LUA.

B. Letters of Understanding and Agreement ("LUA"). An LUA is a more formal supervisory tool. It is a contract with the government, signed by each director and/or adopted by a majority vote of a credit union's board. It is to be taken seriously. LUAs generally are used in situations (1) in which the violations cited by examiners are more serious, or (2) in which a credit union has either ignored, or failed to adequately or timely comply with, the terms of a previously issued DOR.

Unlike DORs, once an LUA is signed, its terms, if breached, can be enforced through prompt and sometimes severe administrative action. Therefore, before signing an LUA, or voting on a resolution to accept it, a board of directors is well advised to carefully review it, to seek clarifications if needed, to seek the advice of counsel, and to be confident that its terms are not only in the best interests of the credit union but are in fact achievable. It is also important to determine whether there is a reasonable alternative to any term of an LUA that would make more sense to your credit union.

C. Cease and Desist Letters and Beyond. DORs and LUAs, if not complied with, can result in more formalized and severe regulatory action. Although non-compliance with a DOR often results in the imposition of an LUA, non-compliance with an LUA, or repeated non-compliance with a DOR, can also result in a "cease and desist" letter, or an "emergency cease and desist," depending upon the materiality and significance of the violations involved. Chronic non-compliance can also result in administrative orders requiring the removal of officials, the termination of staff, or even conservatorship. In effect, with an LUA, the government has broad authority to take any action it deems necessary to protect the solvency of the credit union and, therefore, safeguard the assets of (NCUSIF) including, where applicable, the assessment of civil money penalties against officials. Therefore, while DORs should be taken seriously and addressed effectively, the issuance of an LUA should be taken as a clear and loud warning of the potential consequences of noncompliance.

D. How to deal with a DOR or LUA. As noted above, a DOR is neither a contract nor an administrative order. It is a set of recommendations proposed by an examiner to the credit union, intended to focus the credit union's attention on the importance of addressing the risks or problems cited. However, in approaching your handling of a DOR, you should bear in mind that examiners are civil servants, not CEO's or directors of a credit union. Their expertise lies in

their ability to spot safety and soundness issues, analyze financial data and detect regulatory violations. Although their recommendations may be made in good faith and for good purpose, they are not necessarily sufficiently informed in the market conditions or membership considerations you must take into account in developing a sound and competitive business plan for your credit union in your community. That is why a DOR, when initially presented (whether by a state or federal examiner, or both) should always be considered a draft – not a final – document, and why it is important that you evaluate the terms of the DOR and weigh in on any term your board believes either does not reflect the best interests of the credit union or is not achievable. A good DOR is one that contains terms that everyone agrees are necessary to improve the safety and financial health of the credit union.

An LUA, unlike a DOR, is a contract. It is neither binding nor enforceable unless and until it has been executed and/or adopted by a vote of the directors. Like a DOR, but with even greater significance, an LUA should be considered a draft proposal when first presented. Accordingly, upon receiving a proposed LUA from an examiner, the credit union should refrain from a hasty execution and make sure it takes the time necessary to properly evaluate its terms and, if necessary, to submit a response or counterproposal.

GENERAL RULES AND RECOMMENDATIONS: the following steps and recommendations should be generally followed when handling DORs or LUAs:

1. DORs and LUAs should not be signed when they are presented. It is imperative that credit union officials have the opportunity to review and discuss the proposed draft with management, outside auditors and legal counsel. Examiners may sometimes sound adamant that the initial draft be signed "as is" and when presented. And there are times when that approach is reasonable. However, it is important to understand that applicable rules and guidelines permit you – indeed, compel you – to carefully review and understand the document before you execute or adopt it.

2. The terms of DORs and LUAs can be negotiated. State and federal authorities encourage their examiners to be flexible in determining the terms of DORs and LUAs. Thus, once a draft document is issued, you should, upon the completion of your review, contact your regulator to discuss needed modifications, clarifications or even counterproposals. Thoughtful, well supported counterproposals are often accepted. Therefore, in evaluating a DOR or LUA, you should isolate each term you believe is unachievable or harmful to the credit union, promptly notify NCUA or your state regulator that your credit union agrees with the remaining terms, and propose a reasonable alternative for each item you believe is harmful or not achievable, providing all necessary support.

3. Duty Not To Execute. Credit union officials have a duty not to adopt DORs or execute or adopt LUAs containing terms they believe are unachievable as drafted, or harmful to the credit union.

4. DORs and LUAs should never be ignored. You should review a DOR or LUA and formulate your response as promptly as possible. The purpose of providing you with an advance draft is to give the credit union a chance to review the document and propose tweaks

or modifications where needed. If you fail to respond to a draft DOR or LUA prior to the time of your next meeting with your regulator, your regulator will assume (often justifiably) that your board intends to adopt and/or execute the draft document at its next meeting with the regulator.

5. It is management's job to keep the Board and Committee current on any controversial issues or adverse findings pending between the credit union and its regulators. Officials attending an exit interview with their credit union's examiners should never be caught off guard or taken by surprise. Instead, they should fully discuss issues of importance with management and, at the exit interview, be prepared to discuss the issues in question.

6. You should familiarize yourself with the regulatory consequences which can occur if the credit union ignores, or fails to substantially comply, with the agreed terms in a DOR or LUA. An LUA can be of great concern if it is breached, as it can expose credit union officials and institution affiliated parties to personal liability.

E. Examiner's Guidelines. Chapters 20 and 21 of the Federal Examiner's Guide contains explicit instructions to examiners to work cooperatively with credit unions in fashioning the terms of DORs and LUAs. The guidelines, which state regulators generally follow as well, specifically anticipate that some credit unions will reject DORs and LUAs outright, and sanctions for such rejection are not necessarily inevitable. Consider the following excerpts from the Guide:

> *The willingness of the examiner to adjust or revise recommendations during the joint conference can directly affect the plan's effectiveness.*
> Guide. 21-5.

> *If the officials recommend a reasonable alternative method of resolving a problem, examiners should give strong consideration to accepting the recommendation.*
> Guide. 21-5.

> *Examiners should strive to reach agreements with officials on needed corrective action. If the officials will not agree to a DOR, the examiner should work with them to develop alternative solutions or give them additional time to develop acceptable plans of their own.*
> Guide. 20-4.

> *In instances where the officials did not adopt the DOR, the (examiner) should explain why. . . . In rare instances, the directors do not agree to the DOR nor do they offer acceptable alternate plans . . . In these cases, the examiner should consider the nature of the DOR and discuss the course of action with the supervisory examiner. . . The examiner may consider drafting a Regional Director Letter urging the officials to formulate an acceptable plan. . .*
> Guide. 20-4, 20-5.

In our experience, many credit unions have successfully fended off terms contained in DORs and LUAs that they believed were harmful or unachievable by negotiating in good faith and providing the examiners with constructive alternatives. In instances where an examiner seems intransigent in his/her insistence on certain corrective actions, a respectful appeal letter outlining the credit union's position and/or alternative proposal can be effective. In all cases you should understand that the acceptance of an LUA by the credit union is the acceptance of the obligation to substantially comply with its terms within the time frames specified. Accordingly, once signed and in place, an LUA should form a core component of the credit union's business plan going forward. The consequences of ignoring or breaching the terms of an LUA can be severe.

The excerpts contained in the following appendix were taken verbatim from NCUA's Examiners Guide and should help to explain the severity of the potential consequences of ignoring or refusing to comply with a DOR or LUA.

APPENDIX

Excerpts from NCUA Examiners' Guide

LETTERS OF UNDERSTANDING AND AGREEMENT EXAMINER'S GUIDE

Chapter 29 - Definitions

Letters of Understanding and Agreement (LUAs) serve as supervisory tools. Regional offices sometimes use LUAs as informal administrative actions because other administrative actions often enforce violations of the terms of the LUAs.

An LUA is essentially a contract between NCUA and a credit union. The credit union agrees to take, or not take, certain specified actions. Regional directors issue LUAs when credit unions have not adequately responded to less severe measures, such as Documents of Resolution. NCUA also requires LUAs for newly chartered credit unions and to grant permanent special assistance.

Delegation of Authority SUP 16 authorizes regional directors to enter into LUAs with elected and appointed officials of FCUs and FISCUs. Regional directors discuss and negotiate publication of LUAs with the credit unions to prevent unfair surprises to credit unions and their officials. The regional directors will address the issue of publication in every LUA between NCUA and a federal credit union by including one of the following three provisions:

1. This LUA will not be published;

2. This LUA will be published; or

3. The regional director is reserving for a reasonable time the right to publish this LUA.

Specific and clear language in the LUA enables all parties to understand the expectations. As appropriate, examiners or the regional office staff prepares the proposed LUAs and tailors them to each case.

(Note to Examiners): Refer to the Special Assistance Manual for additional LUA details, guidance on LUA language, and procedures for publication.

In credit unions with outstanding LUAs, the examiner must determine compliance with the LUA and document compliance within the examination report. The examiner or credit union should support recommended changes to the LUA by attaching appropriate supporting work papers and documentation for the regional office. For credit unions with special assistance, the regional director must approve material modifications to LUAs that affect the workout period or amount of assistance. Depending on the amount and terms, the modification may require concurrence and approval of the NCUA Board or the Office of Examination and Insurance.

Once the credit union has corrected the problem areas addressed by the LUA, the regional director removes the LUA.

Published LUA

The Federal Credit Union Act requires the NCUA Board to publish and make available to the public "any written agreement or other written statement for which a violation may be enforced by the Board unless the Board, in its discretion, determines that publication would be contrary to public interest." The NCUA Board will publish an LUA if the Board can legally enforce the violations.

The NCUA Board may take administrative actions against credit unions or officials that fail to meet terms of published LUAs. Violations of the terms of a published LUA alone constitute grounds for administrative actions and, although not required, the LUA may include language to that effect. This provides evidence that the officials know, or should know, of the consequences of noncompliance.

Non-Published LUA

NCUA may take an administrative action, even when it has not published the LUA if the credit union (1) fails to comply with the terms of the LUA, and (2) conducts itself in a way that constitutes a safety and soundness violation or violation of law or regulation.

Chapter 30 - Administrative Actions

First tier. Any credit union or institution-affiliated party that violates a law or regulation, a final order of the NCUA Board, a published agreement with the Board (such as a Letter of Understanding and Agreement), or a condition imposed in a published writing by the Board in connection with the granting of any application (such as the Insurance Agreement), may receive a fine of not more than $5,000 for each day of the violation. First tier penalties may apply to credit unions that, even after warnings, repeatedly submit late or substantially inaccurate call reports.

Second tier. If the credit union or institution-affiliated party commits a first tier violation, and exhibits reckless conduct or a breach of fiduciary duty, and the violation, practice or breach is part of a pattern of misconduct, or causes more than a minimal loss to the credit union, or results in a monetary gain or other benefit to the institution-affiliated party, then the NCUA Board may assess a civil money penalty of not more than $25,000 per day for each day of the violation.

Third tier. Any credit union or institution-affiliated party that knowingly commits the first tier violations, knowingly engages in unsafe or unsound practices, knowingly breaches any fiduciary duty, or knowingly or recklessly causes a substantial loss to the credit union or a substantial monetary gain or other benefit to a party because of the violation, breach, or practice, may receive assessment of a civil money penalty of not more than $1,000,000 per day for each day of the violation, or in the case of a credit union, 1 percent of assets, whichever is less.

The normal administrative procedure for a civil money penalty action is as follows:

The NCUA Board issues a Notice of Assessment, setting forth a statement of the law and facts on which it bases the assessment.

The assessed party has 90 days to make payment, but may request a hearing within 20 days. An administrative law judge will hold a formal hearing if requested.

After the administrative hearing, the administrative law judge submits a recommended decision to the NCUA Board.

The NCUA Board issues its final order.

An institution-affiliated party or credit union may appeal to the U.S. Court of Appeals within 20 days of receipt of the final order.

Removal of Officials

12 U.S.C. §1786(g) contains NCUA's authority to issue a removal order; 12 C.F.R. 747, Subpart A contains the rules and regulations governing removal administrative hearings. The administrative action to remove directors, officers, or committee members as provided in §206(g) of the FCU Act is available as an initial course of action or as a continuation of a cease and desist order if the officials refuse to comply as directed. Whether this enforcement action is an initial course or a continuation of a cease and desist order, it is separate and has its own applicability to particular situations.

In some cases involving a breach of fiduciary duty on the part of the director, the officer, or the committee member, discharge of the responsible person is an internal matter performed by the board of directors. On occasion, the director, the officer, or the committee member will voluntarily resign. It may be necessary to initiate formal removal proceedings, however, when internal or voluntary solutions do not work.

Removal of a director, an officer, or a committee member is not anticipatory in nature as in the cease and desist action. Removal is appropriate only when an official committed an act that constitutes grounds for removal, i.e., it cannot be imposed for future or threatened conduct. Removal can follow only if NCUA has issued a Notice of Intent to Remove or a Notice of Suspension and Intent to Remove and after completion of the appropriate administrative proceedings as provided in the FCU Act and NCUA Rules and Regulations.

NCUA may remove a person who voluntarily withdraws or whose services the credit union terminated. A removal action may be brought any time up to six years after resignation, termination of employment, liquidation, or any other termination of a relationship with the credit union (see §206(k)(3), 12 U.S.C. 1786(k)(3)).

Any party who has been removed or suspended from office is also automatically removed, suspended, and prohibited from participating in the affairs of any federally insured financial institution without the express written consent of the appropriate regulatory authority.

Grounds

NCUA can remove from office directors, officers, or committee members when they have:

Directly or indirectly violated:

A statute or regulation; or

A provision of a final cease and desist order (but not a provision of an immediate, temporary cease and desist order); or

Any condition imposed in writing by the NCUA Board regarding the granting of any application or other request by the credit union (e.g., an application for insurance or 208 Assistance); or

Any published, written agreement between the credit union and the NCUA Board; or

if they have Engaged or participated in any unsafe or unsound practice in connection with the credit union; or

Committed or engaged in any act, omission, or practice which constitutes a breach of fiduciary duty; and

Because of the violation, practice, or breach described above:

The credit union has or will suffer financial loss or other damage; or

The interests of the members have or could be prejudiced; or

The party receives financial gain or others benefit because of the violation, practice, or breach; and

Such violation, practice, or breach:

Involves personal dishonesty by the party; or

Demonstrates the party's unfitness to serve the credit union or to participate in its affairs.

An official's past or current violation of the Depositary Institution Management Interlocks Act is an additional ground for removal.

Following are the administrative procedures for removal: The NCUA Board issues a Notice of Intent to Remove.

If the official or employee does not resign or consent, a hearing is held before an administrative law judge 30 to 60 days after service of the order.

The administrative law judge sends the recommended decision and the hearing record to the NCUA Board.

The NCUA Board issues a final order.

The respondent may appeal to U.S. Court of Appeals, but the final order remains in effect unless modified by the NCUA Board or the court.

Notice of Intent to Remove

The notice to remove an official from office contains a statement of facts constituting the grounds for removal and will establish a time and a place for holding a hearing before an administrative law judge, normally, between 30 days and 60 days serving the notice.

The rules and the procedures contained in Part 747, Subpart A of the NCUA Rules and Regulations apply to suspension and removal actions. The examiner should inform the official upon delivery of the notice that unless the official personally or an authorized representative appears at the hearing, the judge deems that the official has consented to the issuance of an Order of Removal. The party may also consent to the issuance of a removal order to save the time and expense of hiring counsel or appearing at the hearing. In this case, rather than holding an administrative hearing, the matter will go directly to the NCUA Board for issuance of a final order of removal.

Immediate Suspension of an Official

An immediate suspension is similar to a temporary cease and desist order. If necessary to protect the credit union or the interests of its members, NCUA can immediately suspend an official from all official duties pending completion of the administrative hearing. This would be appropriate, for example, when it appears that the individual, once served with a notice, likely will cause further loss to the credit union or destroy credit union records before completion of the hearing or the issuance of the NCUA Board's final Order of Removal. Like a temporary cease and desist order, an Immediate Suspension will usually be a part of or will be served simultaneously with the Notice of Intent to Remove, although it may be served any time after the notice. It, too, becomes effective immediately upon service and remains in effect until dismissed or until the NCUA Board issues a final order. The official may challenge it in court within 10 days of service, and the NCUA Board may enforce the order by suing in US. District Court or by assessing civil money penalties.

Prohibitions

12 U.S.C. §1786(g) contains NCUA's authority to issue a prohibition order; 12 C.F.R. 747, Subpart A contains the rules and regulations governing prohibition hearings. A prohibition action is similar to, but broader in scope, than a removal proceeding. A removal action removes a person from a specified official position in a credit union, while a prohibition action stops any institution-affiliated party from participating in the affairs of a credit union. Because institution-affiliated parties are not always elected or appointed officials of an insured credit union, they

may not always be removed as directors, officers, or committee members. Instead, NCUA must prohibit them from further participation in the affairs of an insured credit union.

The examiner prepares a recommendation for prohibition in the same manner as other administrative actions. The recommendation includes:

Recipient of the prohibition action, i.e., name of the person, business address, and position with the company, group or enterprise (including name of the proprietorship, partnership, or corporation) and the relationship with the credit union;

Sufficient evidence to establish the grounds necessary for a prohibition action; and

Specifics of the prohibition action, e.g., events causing the insured credit union's (or the other business enterprise's) realized or probable financial loss (or other damage) or events that allowed the institution-affiliated party to profit.

Prohibition of a person, like the removal of an official, is not anticipatory in nature as in a cease and desist action. Prohibition can follow only if NCUA issued a Notice of Intent to Prohibit and completed the appropriate administrative proceedings or the institution-affiliated party consented. NCUA may combine proceedings for removal and prohibition if appropriate. The procedures for a prohibition action are essentially the same as those for a removal action.