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THE KAYE, SCHOLER ASSET FREEZE: THE WRONG FREEZE AGAINST THE WRONG PARTY

ERIC R. LEVINE*

Prior to my return to private practice in November 1992, I spent two years as a senior trial attorney with the Office of Thrift Supervision ("OTS"), Enforcement and Litigation-East Division located in Jersey City, New Jersey. This division was created to investigate and prosecute "insider abuse" in the wake of the savings and loan crisis. Part of our marching orders from Washington was to test the outer limits of the then recently enacted Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA")[1] as it related to the breadth of OTS's jurisdictional authority and ability to sanction those over whom the agency could establish such jurisdiction. In particular, we were encouraged to focus on the abuse of attorneys and other professionals, such as appraisers and accountants.

No case better exemplified OTS's attempts to test these limits than the action brought against Peter M. Fishbein, Karen E. Katzman, Lynn Toby Fisher ("individual respondents"), and their law firm Kaye, Scholer, Fierman, Hays & Handler ("Kaye, Scholer").[2] Without doubt, the most controversial aspect of the case was that OTS imposed an asset freeze over Kaye, Scholer; the individual respondents; their partners; and their respective family members. Some critics of the asset freeze, including the New York City Bar Association, believed that freezes of this sort were being used by the government to "obtain an unfair advantage."[3] In addition, I regularly heard allegations from lawyers and lay people, that such freezes evidenced a level of contempt for due process and the

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[1] 12 U.S.C. § 1833 (1992).

[2] *In re* Fishbein, OTS AP No. 92-19 (Mar. 1, 1992).

[3] *See* Daniel J. Capra, *Attachment of Law Firm Assets by Federal Regulatory Agencies: A Report of the Committee on Professional Responsibility of the Association of the Bar of the City of New York*, WALL ST. J., Mar. 13, 1992, at 10.

American system of jurisprudence which was unacceptable for a federal agency to possess. While there is some merit to these criticisms, it seems that the asset freeze was a mistake for other reasons. Particularly: (i) as a matter of tactics, the asset freeze successfully shifted the focus away from the respondent's alleged violations, and caused the public debate to revolve around OTS's conduct; and (ii) as a matter of law, the all important legal question of OTS's ability to exercise jurisdiction over and impose sanctions upon the respondents was never addressed.

Prior to trial, Kaye, Scholer entered into a consent decree with OTS, which outlined the agency's position concerning the duty owed by an attorney to a savings and loan association.[4] However, as a result of the settlement, there was no opportunity for a court to find as a matter of law that OTS properly exercised its jurisdiction, imposed appropriate sanctions, and properly defined the duty owed by an attorney to a financial institution.[5] Such judicial findings would have been important to the industry because bank insiders in general, and attorneys in particular, need to know precisely what is expected of them as a matter of law if they are to satisfactorily fulfill their fiduciary duties. Moreover, the regulators must appear to be fair, consistent, and thoughtful if they are to build the public confidence necessary to help keep the American banking system strong and competitive. To the extent that the regulators can cite to legal opinions to support their positions, the more force these positions will have and the less criticism and suspicion they will generate.

While the Kaye, Scholer case raised a plethora of issues, this article will analyze two important questions. In particular, whether: (i) OTS had jurisdiction over the respondents; and (ii) under what circumstances should an asset freeze be imposed?

As will be discussed in greater detail below, these topics are intertwined. OTS and the other bank regulatory agencies may only impose sanctions, such as an asset freeze, if they have jurisdiction over the parties.

[4] *See* Order to Cease and Desist for Affirmative Relief From Kaye, Scholer, Fierman, Hays & Handler, OTS AP No. 92-24 (Mar. 1, 1992) [hereinafter Final Order].

[5] *See* 12 U.S.C. § 1818(h) (1992) (providing for hearings and judicial review). The statutory scheme provides that at the completion of the administrative process, a respondent may file an appeal with the circuit court in which the home office of the depository institution is located, or in the United States Court of Appeals for the District of Columbia. *Id.*

I. OTS Lacked Jurisdiction Over the Respondents

An important issue that received little debate during the Kaye, Scholer explosion, was the ramifications of Congress extending the jurisdiction of the regulators pursuant to section 204(c) of FIRREA to include independent contractors, specifically attorneys.[6] Prior to FIRREA, banking regulators had jurisdiction over and the authority to enforce cease-and-desist orders[7] against a bank, director, officer, employee, agent, or other person participating in the conduct of the affairs of such bank.[8]

With the passage of FIRREA, the concept of an institution-affiliated party was created to define the individuals over whom regulators could exercise jurisdiction, thereby invoking their cease-and-desist powers.[9] An "institution-affiliated party" is:

> (1) any director, officer, employee, or controlling stockholder . . . of, or agent for, and insured depository institution;
>
> . . . .
>
> (4) any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in—
> (A) any violation of any law or regulation;
> (B) any breach of fiduciary duty; or
> (C) any unsafe or unsound practice,
>
> *which causes or is likely to cause more than a minimal finan-*

[6] *See* 12 U.S.C. § 1813(u)(4) (1992). This provision explicitly provides that an "independent contractor" includes any attorney. *Id.*

[7] It is pursuant to these cease-and-desist powers that the OTS issued the asset freeze against Kaye, Scholer.

[8] *See* 12 U.S.C. § 1818(b) (1992). This section provides in pertinent part:

> (1) If, in the opinion of the appropriate Federal banking agency, any insured depository institution which has insured deposits, or any institution-affiliated party is engaging or has engaged, or the agency has reasonable cause to believe that the depository institution or any institution-affiliated party is about to engage, in an unsafe or unsound practice in conducting the business of such depository institution, or is violating or has violated, or the agency has reasonable cause to believe that the depository institution or any institution-affiliated party is about to violate, a law, rule, or regulation, . . ., the agency may issue and serve upon the depository institution or such party a notice of charges in respect thereof.

Id.; *see also* 12 U.S.C. § 1818(c) (1992). This section provides in pertinent part:

> (1) Whenever the appropriate Federal banking agency shall determine that the violation or threatened violation or the unsafe or unsound practice or practices, specified in the notice of charges served upon the depository institution or any institution-affiliated party, . . ., is likely to cause insolvency or significant dissipation of assets or earnings . . . or otherwise prejudice the interests of its depositors . . . the agency may issue a temporary order requiring the depository institution or such party to cease and desist from any such violation or practice . . . .

Id.

[9] *Id.*

> *cial loss to, or a significant adverse effect on*, the insured depository institution.[10]

All the violations alleged against the respondents in the notice of charges were pre-FIRREA.[11] Therefore, the initial question is whether FIRREA is retroactive for the purpose of exercising a banking agency's jurisdiction. If FIRREA is not retroactive, only one of two arguments is legally plausible. First, the failure of Congress to expressly list attorneys as individuals over whom the bank regulators could exercise their cease-and-desist powers, when such an express reference is made in FIRREA, could only mean that Congress did not intend to provide banking agencies with the power to exercise jurisdiction over attorneys.

Second, if Congress had intended to give regulators the authority under the pre-FIRREA legislation to exercise jurisdiction over attorneys, the FIRREA concept of an institution-affiliated party merely clarified under what circumstances the bank regulators could pursue an enforcement action against attorneys. Since FIRREA was clearly enacted to broaden the powers of the regulators, it is not credible to argue that OTS's pre-FIRREA powers over attorneys were more expansive than their post-FIRREA powers.

Therefore, section 1813(u) must, by definition, describe the outer-limits of the agency's pre-FIRREA powers regarding attorneys. This analysis is the same even if FIRREA was retroactive. Regardless of which scenario applies, it does not appear that OTS had the authority to sanction the respondents because it lacked jurisdiction over them.

The express language of section 1813(u) provides that the ability of the regulator to exercise jurisdiction over an "independent contractor" is premised, not just on the individual's status, but his conduct as well. For example, if an attorney for a bank knowingly and recklessly participates in a violation of law or regulation, but the violation does not cause or is not likely to cause more than a

[10] 12 U.S.C. § 1813(u) (1992) (emphasis added).

[11] *See* 12 U.S.C. § 1818(b)(1) (1992). The statute provides that a notice of charges shall contain:

> a statement of the facts constituting the alleged violation or violations or the unsafe or unsound practice or practices, and shall fix a time and place at which a hearing will be held to determine whether an order to cease and desist therefrom should issue against the depository institution or the institution-affiliated party.

Id.; *see also* Notice of Charges, *In re* Fishbein, OTS AP No. 92-19 (Mar. 1, 1992). A notice of charges is the civil equivalent of a criminal indictment.

minimal financial loss to the institution, he is not an institution-affiliated party and thus, not subject to sanction by the regulatory agencies.[12]

Juxtapose this to a member of a board of directors that engages in similar activities without causing loss or the likelihood of loss to the institution. The director is still subject to any number of sanctions, including: those arising under the regulators' cease-and-desist powers;[13] a removal or prohibition from the industry or both;[14] and civil money penalties.[15]

The notice of charges as it related to jurisdiction stated, *inter alia*, that:

> As described more fully below Respondents, and each of them, *participated in the conduct of the affairs* of Lincoln and [American Continental Corporation ("ACC")] and were institution-affiliated parties, in that they and each of them:
>
> a. Provided advice to Lincoln and ACC, represented and acted as agent of Lincoln before the FHLBB, and participated in defining the course of conduct by Lincoln and ACC in conducting their business and in responding to the FHLBB's regulation and examination of Lincoln's operations as a federally-insured depository institution;
> b. Represented and acted as agent for Lincoln and ACC before the FHLBB and, in connection therewith, omitted material facts from and made misrepresentations in submissions to the FHLBB that are the subject of this Notice of Charges;
> c. Acted as securities counsel to ACC, were intimately familiar with its affairs and operations and those of its subsidiaries and affiliates, including Lincoln, and prepared and/or reviewed security disclosure documents that were filed with the FHLBB and other federal regulatory agencies.
> d. Acted as Lincoln's counsel and agent in providing information and otherwise responding to FHLBB in connection with the examination of Lincoln in the 1986-1989 pe-

[12] *See* 12 U.S.C. § 1813(u)(4) (1992) (defining "institution-affiliated party").

[13] 12 U.S.C. § 1818(b)-(c) (1992) (statute provides for cease-and-desist proceedings and temporary orders).

[14] *See* 12 U.S.C. § 1818(e) (1992). This section provides that the appropriate Federal banking agency may "serve upon such party a written notice of the agency's intention to remove such party from office or to prohibit any further participation by such party, in any manner, in the conduct of the affairs of any insured depository institution." *Id.*

[15] *See* 12 U.S.C. § 1818(i) (1992). This provision provides that any insured depository institution or any institution-affiliated party violating the statute will suffer civil penalties. *Id.*

> riod. Kaye, Scholer and each of the individual Respondents violated and facilitated Lincoln's violations of applicable banking statutes and regulations, as more fully described below.[16]

It appears from the notice of charges that OTS took the position that FIRREA was not retroactive because it predicated its jurisdiction on the respondents having "participated in the conduct of the affairs" of the thrift and not the general contractor language of section 1813(u). Since OTS could not possibly take the position that its pre-FIRREA jurisdiction did not extend to lawyers, it becomes necessary for the agency to prove that the respondents, assuming they knowingly or recklessly participated in a violation of law, breach of fiduciary duty or unsafe or unsound practice, caused or were likely to have caused, more than a minimal financial loss to, or significant adverse effect on the thrift. This does not appear to have been done.

Certainly no such allegations were made in the jurisdictional section of the notice of charges. Therefore, facially at least, the pleading failed to establish jurisdiction. However, OTS also alleged:

> 182. As a consequence of Respondents' reckless breach of its fiduciary duty of competence and due care, Lincoln made direct investments that resulted in substantial losses.
> 183. As a consequence of the Respondents' failure to inform the Board of Directors of Lincoln of its fiduciary duties to the depositors and to the federal insurance fund in light of the material facts of which Respondents were aware, the Board of Directors was deprived of the opportunity to take appropriate action with full knowledge of its fiduciary duties concerning the transactions described in this Notice of Charges.
> 184. As a consequence of the Respondents' knowing misrepresentations and omissions of material facts in communications to the FHLBB, the FHLBB was deprived of the opportunity to exercise its official regulatory judgment and discretion with full knowledge of all material facts concerning the transactions and other matters described in this Notice.
> 185. As a consequence, Lincoln, ABC, and the federal insurance fund have suffered actual losses from the transactions described in this Notice of at least $275 million.[17]

[16] *See* Notice of Charges, *supra* note 11, at 5-6 (emphasis added).
[17] *See id.* at 79.

Even if the "injury" portion of the pleading was incorporated into the jurisdiction section of the notice of charges, the allegations on their face still failed to establish the requisite causation necessary for jurisdiction over the respondents. The gravamen of the allegations against the respondents dealt with their alleged intentional failure to disclose certain material information to the thrift's board of directors and the Federal Home Loan Bank Board, OTS's predecessor.

The allegations made in paragraph 182, assumed that if the respondents had made the proper disclosures, Lincoln would not have made the direct investments. Given Charles Keating's record, this is a rather dubious premise. In addition, the allegation assumed that it was the act of failing to disclose that caused the losses associated with the investments. More than likely, the actual cause of the losses was a downturn in the economy or a change in the tax law.

The allegations in paragraph 183 also made a number of risky assumptions. First, it assumed that the board members breached their fiduciary duty to the institution and its shareholders by not knowing what their fiduciary duties were. Second, it assumed that if they did not know and were told by the respondents of their fiduciary duty, they would have done something with the information. This is unlikely in this instance because the board members never cared enough to learn of their fiduciary duties in the first instance. Lastly, it assumes that if they did not know and that the respondents informed them of their duties, and the board took some unnamed action, that those actions would have prevented the loss.

There is also no shortage of assumptions in paragraph 184. The allegations in paragraph 184 assumed that if the FHLBB had been fully informed by the respondents of the thrift's transactions, its interpretation of the law governing the transactions would have been the same as OTS's. The agency's argument is in essence, that since OTS would have taken some currently unknown steps to protect the institution, the FHLBB would have taken the unknown action. The allegation further assumed that those currently unknown actions, would have prevented the losses.

Therefore, it is quite a stretch to argue that the respondents caused or were likely to have caused more than a minimal financial loss to, or a significant adverse effect on, the insured deposi-

tory institution. Thus, it is also a stretch to argue that the respondents are institution-affiliated parties over whom OTS could have exercised jurisdiction.

II. Regardless of Whether OTS Had Jurisdiction Over Respondents, the Asset Freeze Was a Mistake

Assuming that OTS had jurisdiction over the respondents, the question becomes whether the asset freeze should have been imposed. As discussed above, the asset freeze was ill-advised because it shifted the focus away from the respondents' alleged violations and caused public debate to revolve around the OTS's conduct. If the debate had focused on the respondents' conduct, the banking industry would have been better served because the dialogue would have been about the substantive legal issues relating to attorneys and the duty they owe to the banks they represent.

Established and accepted standards of conduct would place the attorneys on notice as to what are expected of them and help foster public confidence in the bank regulatory agencies. As it turned out, no generally accepted standards were created or even debated. Instead, such standards were imposed by the OTS in the final order to cease-and-desist.[18] In addition, the agency fostered hostility and suspicion among many members of the private bar. OTS should have been working to cultivate their cooperation to help solve the savings and loan crisis and making sure the country did not find itself in a similar situation again.

To help remedy this problem, all asset freezes should be brought only with court approval and only if there is evidence of dissipation or a threat of dissipation of a respondent's assets. An agency's asset freeze power is remedial and not punitive. Therefore, its primary purpose is to maintain the status quo pending the outcome of an administrative hearing. If there is no dissipation or threat of dissipation, the status quo is maintained and an asset freeze is unnecessary.

A. *An Asset Freeze By Fiat*

The Kaye, Scholer asset freeze was brought pursuant to section

[18] *See* Final Order, *supra* note 4.

1818(c)(1).[19] The temporary cease-and-desist powers of this section refer to section 1818(b)(6), which provides, in relevant part:

> The authority to issue an order under this subsection and subsection (c) of this section which requires an insured depository institution or any institution-affiliated party to take affirmative action to correct any conditions resulting from any violation or practice with respect to which such order is issued includes the authority to require such depository institution or such party to . . .
>
> (F) take such other action as the banking agency determines to be appropriate.[20]

The OTS view that the "catch all" language of section 1818(b)(6)(F) included their ability to freeze assets is not novel and has been upheld by numerous courts.[21] The Kaye, Scholer asset freeze was unique because of its breadth and the potential detrimental effect it would have on the viability of one of the most famous and successful law firms in the country. The Kaye, Scholer asset freeze did not just apply to the those individuals at the firm accused of violating laws, rules, and regulations, but to all their partners and partners' family members as well. The order stated:

> IT IS HEREBY ORDERED that Respondent Kaye Scholer:
>
> a. Shall cease-and-desist from, directly or indirectly, causing the sale, transfer or encumbrance of funds or other assets of any nature whatsoever *in which any Respondent or any member of the partnership has a legal or beneficial interest, whether directly or through any other person or entity*, except as provided in this Order. The foregoing shall not apply to assets used to pay (a) interest and payments of principal as due on indebtedness existing on the date of service of this Order or indebtedness drawn down after the

[19] *See* Temporary Order to Cease and Desist for Affirmative Relief From Kaye, Scholer, Fierman, Hays & Handler, OTS AP No. 92-20 at 11 (Mar. 11, 1992).

[20] *See* 12 U.S.C. § 1818(b)(6) (1992) (providing for affirmative action to correct conditions resulting from violations or practices).

[21] *See* Parker v. Ryan, 959 F.2d 579, 581 (5th Cir. 1992) (OTS has authority to issue temporary cease and desist orders and take affirmative action to prevent dissipation of assets); Spiegel v. Ryan, 946 F.2d 1435, 1437 (9th Cir. 1991) (same), *cert. denied*, 112 S. Ct. 1584 (1992); di Stefano v. United States, 787 F. Supp. 292, 294 (D.R.I. 1992) (OTS order and temporary order authorized by federal statute); Paul v. Office of Thrift Supervision of Dep't of Treasury, 763 F. Supp. 568, 571 (S.D. Fla. 1990) (agency may issue temporary order requiring depository institution to cease and desist from any violation or practice), *aff'd*, 948 F.2d 1297 (11th Cir. 1991).

> date of this order under the Term Loan Agreement and Revolving Credit Agreement, both dated August 1, 1991; (b) ordinary and reasonable operating expenses; or (c) for capital expenditures necessary to its business that have a value either singly or through related transactions of less than Fifty Thousand Dollars ($50,000.00).[22]

When the Kaye Scholer asset freeze was imposed by OTS, the legal community, predictably, was outraged. Some of the outrage was justified, while some was not. Concerns over the lack of due process, were the most compelling. However, all of the criticism, except for the most irrational, was avoidable.

B. *Court Ordered Asset Freezes*

There is an alternative to moving for an asset freeze by fiat pursuant to section 1818(b) and (c). The Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990 (the "1990 Crime Bill") was enacted by Congress in November 1990.[23] Section 2521 of the 1990 Crime Bill provided for a court sanctioned freeze and stated in relevant part:

> (A) In any action brought by an appropriate Federal banking agency . . . pursuant to this section, or in actions brought in aid of, or to enforce an order in, any administrative or other civil action for money damages, restitution, or civil money penalties brought by such agency, the court may, upon application of the agency, issue a restraining order that—
> (i) prohibits any person subject to the proceeding from withdrawing, transferring, removing, dissipating, or disposing of any funds, assets or other property; and
> (ii) appoints a temporary receiver to administer the restraining order.
> (B) Standard—A permanent or temporary injunction or restraining order shall be granted without bond upon a *prima facie* showing that money damages, restitution, or civil money penalties, as sought by such agency, is appropriate.[24]

It is important to note that the standard of a prima facie showing is significantly less than the general injunctive relief standard

[22] *See* Temporary Order to Cease and Desist for Affirmative Relief From Kaye, Scholer, Fierman, Hays & Handler, OTS AP No. 92-90 at 11 (Mar. 11, 1992) (emphasis added).
[23] 12 U.S.C. § 1818(i) (1992).
[24] *See* 12 U.S.C. § 1818(i)(4) (1992) (providing for prejudgment attachment) (emphasis added).

of a showing of a likelihood of success on the merits and irreparable harm. Therefore, any concern that the regulators had concerning their ability to obtain a freeze was misplaced. In any event, if the agency is incapable of satisfying the prima facie standard, the regulator should review whether or not to bring the enforcement action altogether.

During my tenure at OTS, I successfully litigated one of the first asset freeze cases brought pursuant to section 1818(i)(4). The circumstances surrounding that freeze, when compared to those involving Kaye, Scholer, demonstrate why court-ordered freezes, when coupled with evidence of dissipation, best serve the public good. In my case, the focus remained on the respondent's conduct and concerns over due process were assuaged. Once a disinterested party has made a determination that there is a prima facie showing of a violation, the regulator is shielded from accusations of being vindicative and arbitrary.

In *In re Hartmann*,[25] a former member of the board of directors of a failed New Jersey savings and loan association (the "New Jersey thrift"), obtained approximately $59,000,000 in illegal loans from the New Jersey thrift.[26] Mr. Hartmann did this by having his wife use a variation of her maiden name in connection with the loans, or having his son represent to the New Jersey thrift that he, and not his father, was the principal in the commercial entities seeking loans. After OTS began its investigation, Mr. Hartmann transferred millions of dollars of assets to his family members in an attempt to place them beyond the reach of the agency. OTS moved in the District Court for the District of New Jersey for an asset freeze.[27] A prima facie case was established, evidence of dissipation was presented,[28] and an asset freeze was

25 OTS AP No. 91-27 (June 12, 1991).

26 *See* 12 C.F.R. § 563.43 (1993). Although this regulation has since been amended, at the time of this case loans to insiders for a commercial purpose were limited to $100,000 in the aggregate.

27 *See* 12 U.S.C. § 1818(i)(4) (1992). The statute provides, in pertinent part:

> In any action brought by an appropriate Federal banking agency . . . to enforce an order in, any administrative or civil action for money damages, restitution, or civil money penalties brought by such agency, the court may, . . . issue a restraining order that—
>
> (i) prohibits any person subject to the proceeding from withdrawing, transferring, removing, dissipating, or disposing of any funds, assets or other property . . . .

Id.

28 Although dissipation is not an express requirement of section 1818(i)(4), I am not sure that without such evidence, the New Jersey District Court would have granted the freeze.

granted.

Clearly this is preferable to the Kaye, Scholer approach, where OTS never alleged that the firm or its partners were dissipating or planning to dissipate their assets. Without a threat of dissipation, the imposition of the asset freeze became a totally gratuitous act and provided fuel for those who wanted to argue that the agency acted arbitrarily and with malice.

C. *Congress Has Manifested Its Intent to Require Court Ordered Asset Freezes*

Finally, notwithstanding the fact that there are post-FIRREA cases upholding the regulator's ability to impose a freeze by fiat,[29] the argument should be made that since the 1990 Crime Bill was enacted after FIRREA, Congress manifested its intent to require the bank regulators to obtain an asset freeze only after a prima facie showing pursuant to section 1818(i)(4). In the event a temporary cease-and-desist order is issued, a respondent has ten days to move "for an injunction setting aside, limiting, or suspending the enforcement, operation, or effectiveness of such order . . . ."[30] It is at this juncture that the respondent would argue that the agency was required to make their application for an asset freeze on a prima facie showing in a court of competent jurisdiction pursuant to section 1818(i)(4). While available to the defense bar, to date, I am not aware of this argument having ever been made before a court of competent jurisdiction.

CONCLUSION

Our elected officials tell us that the savings and loan crisis is coming to a close. While OTS should continue to investigate and prosecute banking violations, the asset freeze should be used sparingly. Asset freezes should be sought only where there is a threat of dissipation of assets and only after the agency has made a prima facie showing before a court of competent jurisdiction. Through such diligent effort, public support for OTS and prosecution of banking violations, will grow.

[29] *See supra* note 8 (discussing 12 U.S.C. § 1818(b)-(c)).
[30] 12 U.S.C. § 1818(c)(2) (1992).