

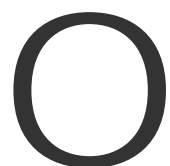


Comptroller of the Currency
Administrator of National Banks

Litigation and Other Legal Matters

Comptroller's Handbook

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Background

Real or threatened litigation can pose significant costs to banking organizations. Whether legal issues give rise to unenforceable contracts, lawsuits, adverse judgments, forgone business opportunities, loss of corporate focus, or diminished reputation in the community, they can disrupt the operations of a bank, possibly reducing the institution's earnings and capital. Therefore, both bank management and examiners must properly assess, and bank management must properly manage, the risks associated with litigation and other legal matters.

This booklet describes litigation risks faced by banks¹ and provides guidance to both bankers and examiners on how to properly monitor, assess, and respond to the risks associated with litigation and other legal matters. Bank management is responsible for developing formal or informal policies to ensure that it remains fully informed of potential litigation and other legal issues and acts to monitor and control these risks. Examiners must also assess the impact of these risks on the institution. During bank examinations, examiners will attempt to identify any pending or threatened litigation involving the bank, assess the liabilities and any impact from those legal matters, and determine whether the bank is effectively identifying, measuring, monitoring, and controlling those risks.

Types of Litigation Exposure

Litigation exposure can result from either bank-initiated or third-party-initiated litigation. Bank-initiated litigation occurs when bank management initiates legal proceedings. Such legal actions enforce contract rights, including loan and lease covenants; recover debts or obligations owed to the bank; foreclose on property in which the bank holds a security or ownership interest; or recover damages caused by insiders or third parties. In some cases, bank-initiated litigation gives rise to countersuits.

Third-party-initiated litigation occurs when an action has been threatened or commenced against the bank. Third-party-initiated litigation may involve allegations of

¹ For the purposes of this document, the terms "national bank" and "bank" describe any national banking association and any federal branch or agency of foreign banks. The terms also describe any bank or trust company in the District of Columbia that operates under OCC supervision.

errors, omissions, violations of law, damages, or personal injury caused by the bank, its management, or staff.

Risks Associated with Litigation and Other Legal Matters

OCC examiners assess banking risk relative to its impact on capital and earnings. From a supervisory perspective, risk is the potential that events, expected or unanticipated, may have an adverse impact on the bank's capital or earnings. The OCC has defined nine categories of risk for bank supervision purposes. These risks are: strategic, reputation, credit, compliance, transaction, interest rate, liquidity, price, and foreign currency translation risk. These categories are not mutually exclusive; any product or service may expose the bank to multiple risks. For analysis and discussion purposes, however, the OCC identifies and assesses the risks separately.

The primary risks associated with litigation are: liquidity, reputation, strategic, credit, and compliance risk. These risks are discussed more fully in the following paragraphs.

Reputation Risk

Reputation risk can expose the institution to financial loss as a result of damage to its reputation. When this happens, it affects the institution's ability to establish new relationships or services, or to continue servicing existing relationships. Widely publicized litigation, regardless of its ultimate outcome, can affect the bank's community standing, limit its business opportunities, and impair its basic franchise value. To avoid negative publicity, particularly for business lines like asset management whose success depends on a sound reputation, some banks have elected to settle threatened litigation to avoid or minimize potential damage to their reputation.

Strategic Risk

Strategic risk can expose the bank to litigation when an institution, in an effort to remain competitive, rapidly and aggressively introduces new products and services without fully performing due diligence reviews or implementing the infrastructure to support the activity. Strategic risk can be mitigated when banks have a corporate culture that includes appropriate planning, due diligence, planned implementation, delivery networks, and risk management systems. When pursuing new activities, management should fully investigate the possibility of legal impediments and determine the impact to earnings and capital.

Liquidity Risk

A damaged or impaired reputation caused by potential or pending litigation may weaken the bank's liquidity position by reducing its access to capital markets, thereby increasing its cost of funding. Additionally, depositor confidence in an institution may be shaken by litigation against the bank, and may lead to unanticipated loss of both deposits and capital.

Credit Risk

Litigation can affect a bank's lending, investment, or dealing activities, primarily as they pertain to the contractual agreement between the bank and its borrower or counterparty. Litigation can also develop from process shortcomings in disbursing and curtailment of advances to a borrower. Credit-related risk historically has been the most common form of risk experienced by banks as a result of litigation.

Lender liability litigation is a significant source of potential loss for banks. Banks must be able to demonstrate rational behavior consistent with past practices and written policies and procedures to avert costly lawsuits and loss. Credit-related litigation risk also can become a significant issue with derivative instruments, because dealer banks must sometimes enforce contract terms against counterparties. The exposure becomes more significant as derivative contract terms lengthen, become more structurally complex, or involve higher-risk counterparties.

Credit risk exposure in most cases is limited to the actual value of the transaction agreed to in the contract. However, in certain cases, the potential liability can exceed this contractual amount. For instance, when borrowers allege that a bank violated the terms and conditions of a credit agreement or the implied spirit of the agreement, they can allege that the bank's actions caused bankruptcy or liquidation.

A bank that receives an adverse decision in a lender liability suit may have a potential liability that far exceeds the basic contractual amount. Liability could include not only the bank's legal costs but also the plaintiff's legal costs, lost interest, and other administrative expenses. The examiner should attempt to quantify a bank's material credit exposure and associated liabilities that may result from legal actions threatened or pending. A comprehensive risk management process is essential to control the risks of litigation.

A very important aspect of minimizing credit-related litigation risk is developing a process for centralized oversight of all communication with the borrower. Management should initiate this process at the first indication that a credit problem may develop.

Communications from all sources within the bank to the customer must be consistent. Also, the legal staff should review all correspondence for possible lender liability issues.

Compliance Risk

Like credit risk, compliance risk may exceed the value of the underlying financial instrument. If noncompliance with applicable statutes and regulations is pervasive, loss of a single legal case can lead to a much larger class action. An adverse judgment in a class action suit could result in actual and punitive damages that may exceed the terms of a contractual agreement. For example, some Regulation Z — Truth in Lending Act violations can result in treble damages. Similarly, litigation arising from a bank's failure to comply with fair lending laws can have a significant monetary impact on the bank. In addition, banks acting in a fiduciary capacity have traditionally been held to very high legal standards. The failure to comply with all applicable laws may expose the bank to litigation for actual damages to the account, compensation for lost opportunities, and punitive damages.

Litigation Risk Management

Litigation risks can, if unrecognized, uncontrolled, or improperly managed, disrupt the operations of a bank, potentially reducing the institution's earnings and capital. To ensure that litigation risks are recognized, controlled and properly managed, banks should establish a controlled litigation environment throughout the organization. In order to establish such an environment, banks should:

- Establish and maintain an internal management information system that informs the board and management of existing or pending litigation in a timely and accurate manner.
- Assess realistically the potential losses posed by existing or pending litigation.
- Incorporate a review system that tracks and evaluates litigation exposure for every product and service.
- Implement systems and controls to ensure continual and full compliance with current laws, regulations and other legal requirements.

By maintaining a controlled litigation environment, a bank does not seek to know how all litigation will be resolved. Rather, it evaluates and prepares for potential litigation losses.

When earnings or capital could be negatively affected, management should take steps to mitigate, prepare for, and limit the effects of that potential reduction in capital or earnings on the overall operations of the bank.

Measures that management can take to reduce risk exposures and the likelihood of litigation include:

- Implementing training programs and internal control processes to identify, limit, and manage litigation exposure.
- Seeking legal advice and assistance to reduce the risk of potential claims becoming actively litigated claims.

Measures that management can take to mitigate the impact of litigation include:

- Increasing capital or specific reserves to cover potential judgments or settlements.
- Maintaining adequate and cost-effective insurance coverage.

Evaluating Litigation Risk

To evaluate a bank's litigation risk, examiners must know whether any significant litigation is threatened or pending against the institution. Before each safety and soundness examination, they obtain a list of any such litigation from the bank. (Between examinations, bank management has a responsibility to keep examiners apprised of significant changes in the status of this litigation.) These materials, and the examiners' evaluation of relevant internal control systems, are the principal basis for evaluation of litigation activities. In evaluating litigation, examiners also consider the likely outcome and duration of the litigation, and whether management has effectively managed the litigation process.

Examiners should consider whether individual suits concerning the same or similar issues evidence a pattern or practice at the bank that needs management's attention. If examiners find unanticipated risks or what appears to be a recurring pattern of litigation, they should discuss the matter with management and the board of directors. If necessary, examiners should request action plans to eliminate or mitigate the potential impact and exposure to the bank. To the extent necessary, examiners should consult with OCC district counsel when assessing litigation activities.

When assessing bank-initiated litigation, examiners should rely on bank management, internal bank records, and material provided by internal or external legal counsel.

Examiners should not attempt to make complex legal judgments based on such information. Depending on the significance of the events or conditions, the examiner should interview bank personnel who, according to the bank, are knowledgeable about the matters in litigation. If the information provided does not adequately address the examiner's concerns, the examiner should, upon consulting with the supervisory office and OCC counsel, request that management obtain a letter from the bank's attorneys that corroborates and evaluates the information. Requests should be limited to issues or matters in litigation that are significant or potentially significant to the bank's earnings or capital.

If third-party-initiated litigation is significant, the examiner should interview personnel who, according to the bank, are knowledgeable about the matters in litigation to properly identify and assess the litigation's associated risks. In addition, the examiner should determine whether any insurance coverage exists that would reduce the potential loss or legal costs. The examiner also should ask management whether it knows of any threatened litigation. Further, the examiner should request information on claims, contingent liabilities, and other legal matters that have a reasonable likelihood of impairing assets or incurring liabilities. Contingent liabilities should include unsettled and outstanding claims or assessments and the anticipated cost of defending such claims. As a general rule, management should be encouraged to seek legal advice or guidance whenever litigation is highly likely. The bank should obtain such advice before the suit is filed.

Occasionally bank management itself does not know the background, current status, or other particulars of threatened or pending litigation, or management's knowledge is not sufficient to properly assess the identified risks. Thus, the examiner may need to obtain information from bank counsel to properly assess the risks associated with certain third-party-initiated litigation. After consulting with the supervisory office and OCC counsel, examiners should make all requests for information from legal counsel through bank management. Requests may include corroboration or confirmation of third-party-initiated litigation, the facts giving rise to the litigation, and the legal issues and exposure presented by the case.

The bank is likely to be charged for the time required to research and respond to any inquiry of this nature. Accordingly, the examiner should weigh the cost of gathering the requested information against the litigation's overall risk to the bank. The OCC should not place an undue burden on the bank if the risk exposure is likely to be nominal.

The examiner should not assume that the bank's counsel (internal or external) will keep the OCC informed of developments after the initial response. If examiners believe that litigation may evolve, they should ensure that management contacts counsel regularly and reports significant information through management to the examiners before the

examination ends. The examiner also may consider following up later in the supervisory cycle (depending on the nature and significance of pending or threatened litigation).

National banks occasionally are involved in private litigation on an issue of importance to the entire industry. Given sufficient notice, the OCC may be able to play a role in the litigation. Accordingly, examiners should determine, based on information received from the bank and bank's counsel, whether a lawsuit raises significant legal or policy issues within the scope of the OCC's supervisory responsibility, such as the proper interpretation of federal banking laws. Bankers and examiners should bring such litigation to the attention of the OCC's legal counsel.

Evaluating Other Legal Matters

National banks should obtain legal advice on matters unrelated to pending or threatened litigation. For example, counsel should review new products, services, systems, or processes that are developed or purchased by a bank to ensure their full compliance. Such reviews should take place whether the innovations are purchased or developed and before they are introduced. Similarly, counsel may be engaged to review loan or investment documents used by a bank to ensure compliance with existing legal requirements, or to evaluate the legality of particular transactions. In some cases, the views and opinions of a bank's internal or external counsel may help the examiner to evaluate a bank's activities, or to assess the risk exposure presented by a particular activity, practice, or transaction.

When evaluating the risk exposure of a bank's products, services, or transactions, or when testing their legality, the examiner should ask management to provide any records prepared by the bank that address legal or compliance issues. Depending upon the type of product, service, or transaction being evaluated, and the level of risk exposure to the bank, the examiner may find it necessary to request access to legal opinions and legal reviews. Whether such opinions and reviews are the work of internal or external counsel, they may be protected by the attorney-client privilege, or the attorney work-product privilege. Thus, examiners should request these privileged materials only when the bank's capital and earnings are exposed to material risk, or when the bank's exposure is otherwise considered significant.

Access to Privileged Materials

When evaluating matters in litigation or other legal matters, an examiner should be aware that certain documents prepared by, or in the possession of, bank counsel may indeed be privileged and the examiner therefore should take certain precautions to safeguard these privileges. Bank management or counsel, while desirous of being fully cooperative, may be

concerned that disclosure of certain materials to an examiner could result in a waiver of an applicable privilege (i.e., attorney-client privilege or attorney work-product privilege).

The OCC is of the view that a bank that discloses privileged information to an examiner during an examination does not waive its privileges. Nevertheless, the agency recognizes that the OCC's and bank's common interest in encouraging forthright and open communications is best maintained by taking appropriate steps during an examination to safeguard a bank's privileged materials.

As a general matter, examiners should, when possible, obtain needed information from sources that are not privileged. In those few instances when access to privileged materials or information is considered necessary, the examiner, in consultation with the OCC legal counsel, should evaluate how to obtain the needed information. Safeguards that should be considered by the examiner and counsel include:

- Requesting privileged documents only when the risk exposure to the bank's earnings or capital is material.
- Limiting the form and scope of a request for privileged documents.
- Exchanging written communications with the bank setting forth the precise identity of the materials being provided, confirming the OCC's and bank's expectations that the privileged materials are being provided pursuant to the agency's examination authority (i.e., 12 USC 481), and confirming that the confidentiality of the materials will be maintained to the extent required or permitted by law.

Review of Audit and Insurance Coverage

Internal/External Audit Activities

When evaluating the risks of litigation and other legal matters, examiners should review the scope, frequency, and coverage of internal and external audit activities. The audit scope and coverage should be sufficient to determine that exposure represented by pending litigation is appropriate and understood across the various risk areas. An evaluation of risks in any area of the bank subject to litigation should determine how often the bank audits that area. When assessing an operation's risk, auditors should consider:

- The nature of the operation and related assets and liabilities.

- Whether the operation's policies and internal control standards are adequate.
- Whether operating procedures and internal controls are effective.
- Whether errors or irregularities associated with the operation could be material.

Insurance Coverage

When evaluating the risks of litigation and other legal matters, examiners should review insurance coverage. They should assess the reasonableness of deductibles and determine whether comprehensive coverage is maintained. If the institution self-insures against risk, they should evaluate the bank's capacity to self-insure, taking into consideration the bank's overall risk profile, the complexity of its operations, and its methods of assessing and controlling risk. Insurance coverage should never be relied upon to compensate for poor operational controls or the absence of proper management attention.

General Procedures

These procedures are intended to determine the adequacy of the bank's policies, procedures, and internal controls as they relate to litigation and other legal matters. The extent of testing and procedures performed should be based on the examiner's assessment of risk. To assess risk, examiners should consider work performed by other regulatory agencies, internal and external auditors, and other internal compliance review units; the bank's formal policies and procedures; and the effectiveness of its internal controls and management information systems.

Objective: Determine how much risk the bank's litigation and other legal matters pose to the institution's financial condition. Identify weaknesses and corrective action necessary to minimize these risks.

1. Review previous litigation-related examination findings. Review and determine the adequacy of management's response to those findings.
2. Obtain from bank management a list of significant pending litigation. What is "significant" should be determined after consulting with the examiner-in-charge (EIC). Consider:
 - Nature of the litigation.
 - Background of parties involved (individuals, corporations, advocacy groups, etc.).
 - Progress of the case to date.
 - Management's response or intended response.
 - The likelihood of an unfavorable outcome.
 - The cost to pursue the litigation and an estimate of the amount or range of potential loss.
3. Obtain from the examiner assigned internal and external audits a list of any significant litigation noted in the latest review performed by the internal/external auditors.

4. Obtain from management a list of any threatened litigation or claims for damages that have been or may be asserted and whose outcome would likely be unfavorable to the bank. Consider:
 - The nature of the matter.
 - The relationship of involved parties.
 - How management intends to respond if litigation is commenced or a formal claim for damages is asserted.
 - The potential exposure if the claim is asserted and the estimated cost of defending the claim.

5. Obtain and review the list of attorneys and legal firms to whom the bank has referred litigation and related matters. Consider:
 - Potential conflicts of interest between attorneys and legal firms and the bank, i.e., insider or lending relationships.
 - Billing amounts.

6. Review all examination findings and identify any litigation risks. Consider especially areas where litigation is prevalent. Examples of these areas include:
 - Asset management
 - Fair lending
 - Insider activity

Quantity of Risk

Conclusion: The quantity of risk is (low, moderate, high).

Objective: Determine whether threatened or pending litigation, claims, or contingent liabilities against the bank exist and quantify their potential effect on capital, earnings, and financial soundness.

1. Evaluate management's list of litigation, unasserted claims for damages and assessments, and analysis of potential litigation risks for their impact on the financial condition of the bank. Consider whether:
 - The bank maintains adequate insurance coverage for errors and omissions, liability, personal injury, and related risks.
 - A contingency reserve would be appropriate.
 - A common or recurring pattern or practice, or concentration of legal actions, points to a systemic problem in an area of the bank.
2. After consulting with the supervisory office and OCC counsel, consider asking management to obtain a briefing paper or synopsis from the bank's legal counsel that summarizes the material facts, legal issues, and likelihood of success of significant or potentially significant pending or threatened litigation. If the document is not provided or does not contain sufficient information to properly assess the risks, contact the appropriate OCC district counsel for assistance.
3. Review bills supporting major charges to general ledger expense accounts for legal services to test the completeness of the bank's list.

Quality of Risk Management

Conclusion: The quality of risk management is (strong, satisfactory, weak).

Policy

Objective: Determine whether the board has established appropriate guidelines for managing the risks of litigation and other legal matters by assessing whether management has policies or procedures in place to actively monitor and manage potential litigation and minimize related risks/exposures.

1. Review the bank's policies on litigation and other legal matters. Determine whether they:
 - Establish procedures for reviewing the risks of threatened litigation.
 - Establish procedures to review the bank's products and services for legal compliance.
 - Sufficiently address risk.
2. Determine whether the policies are comprehensive, clear, and communicated properly to appropriate personnel.

Processes

Objective: Determine whether management and the board have established adequate and effective processes and systems to identify and manage litigation risk.

1. Review the processes for monitoring litigation to determine whether they need to be changed. Consider whether:
 - The board discusses significant pending litigation.
 - Management communicates in a timely manner with legal counsel on significant pending litigation.
2. Determine whether the bank's processes for obtaining legal review of the bank's new products, services, and systems should be changed. Consider whether these processes:
 - Ensure full compliance with applicable laws, rules and regulations.
 - Consider legal risks associated with product liability.

3. Determine whether management engages the bank's general counsel or outside legal counsel to review documents (e.g., contracts, agreements, disclosure statements, etc.) that the bank uses to ensure that all bank activities comply with current legal requirements.
4. Determine whether the bank uses independent counsel when a member of bank management is involved in litigation in an official capacity and whether highly specialized counsel is used when significant litigation is threatened.
5. Determine whether management is alert to new legislation and regulatory rules to ensure that the bank's compliance practices are current.
6. Determine whether the bank maintains regular contact with its regulatory agency to obtain updates on current legal interpretations. Consider management's use of forums such as seminars or outreach programs, as well as its use of publications.

Personnel

Objective: Determine whether the board, management, and affected personnel adequately understand the concepts of risk applicable to litigation and other legal matters and whether they can adequately manage such risk.

1. Determine whether training programs are in place to ensure that employees are thoroughly trained and understand their responsibilities regarding the legal requirements of the bank's products and services.
2. Evaluate how well the bank's staff members understand conflicts of interest as well as whether they have the technical skills to avoid such conflict. To test staff members' understanding, for example, determine whether the bank conducts educational programs to foster staff members' awareness of the importance of avoiding not only conflicts but also the appearance of such conflicts.

Controls

Objective: Determine whether management has established appropriate control systems for litigation and other legal matters and whether these controls and overall insurance protection are sufficient.

1. Review copies of recent reports prepared by internal or external auditors regarding litigation and other legal matters. Consider:

- The significance of disclosed litigation problems.
 - The audit scope of internal controls and adequacy of MIS regarding litigation-related issues.
 - Whether audit reviews verify management's analysis of litigation risk.
 - Recommendations for resolving problems or weaknesses in the process for assessing litigation-related risk.
 - Management's responses and whether corrective actions have been initiated or completed.
 - Any follow-up activities.
2. Determine whether or not pending litigation initiated by the bank or initiated by third parties indicates weakness in controls.
 3. Determine whether the bank's legal counsel has reviewed significant new products, services, systems, and processes for the purpose of ensuring compliance with current regulations and legal requirements. Such reviews should take place whether the innovations are purchased or developed and before they are introduced. If such reviews have not taken place, determine whether management and the board:
 - Evaluate risks adequately.
 - Make informed decisions with regard to potential legal exposure.
 4. Determine whether legal counsel periodically reviews all of the bank's products, services, systems, and processes to ensure continuing and full compliance with current regulations and legal requirements. If not, determine whether management has evaluated risks and made informed decisions regarding potential legal exposure.
 5. Determine the appropriateness of overall insurance protection. Consider:
 - The type of coverage the bank has.
 - The amount of coverage relative to the historical level of third-party litigation and the significance of pending or threatened litigation.
 - The reasonableness of the deductibles.
 - Whether the bank self-insures. If so, evaluate the bank's capacity to self-insure, taking into consideration the bank's overall risk profile and the complexity of its operations.

Conclusions

Objective: Determine overall conclusions and communicate findings.

1. Provide the EIC with a brief conclusion. Discuss with the EIC information that has (or may have) a significant impact on the evaluation of the bank's soundness.
2. For any risk identified while performing the foregoing procedures, determine its impact on aggregate risk and the direction of risk. Consider:
 - Reputation risk.
 - Strategic risk.
 - Credit risk.
 - Liquidity risk.
 - Compliance risk.
3. Discuss findings with management including conclusions regarding applicable risks. Consider:
 - Unwarranted or significant individual litigation risks identified.
 - Whether the review of information systems, processes, and audit coverage revealed significant control deficiencies or systemic litigation risks.
 - Recommending ways to reduce or minimize unwarranted risks and correct deficiencies.
 - Whether to obtain management's commitment and firm time frames for corrective action.
4. After a full discussion with the EIC, prepare written comments on events, transactions, or issues that may have a material effect on the soundness of the bank. Prepare a memorandum of your conclusions and supporting findings and suggest ways the OCC can follow up.
5. Update the work program and ongoing supervisory record with information that will facilitate future supervisory activities.
6. Organize and reference working papers in accordance with OCC guidance.

Laws

Access to Privileged Materials

12 USC 481