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STATEMENT ON

THE FDIC's USE OF
CIVIL RICO ACTIONS

PRESENTED TO

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

BY

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Mr. Chairman and members of the Committee, my name is Dan Persinger. I am the FDIC's Deputy General Counsel for Closed Banks. I appreciate this opportunity to give my views on the FDIC's use of civil RICO actions under Title 18 U.S.C. § 1964(c).

THE RICO STATUTE

The Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-1968 (1982), was enacted as Title IX of the Organized Crime Control Act of 1970, Pub. Law 91-452 (1970). It authorizes a private right of action for "any person injured in his business or property by reason of a violation of Section 1962". 18 U.S.C. § 1964(c). RICO Section 1962 makes it unlawful, with respect to an enterprise affecting interstate or foreign commerce, for a person to (a) invest income derived from a pattern of racketeering activity in acquiring an interest in, or establishing or operating such an enterprise; (b) acquire, through a pattern of racketeering activity, an interest in or control of such an enterprise; (c) conduct or participate in the conduct of the affairs of such an enterprise through a pattern of racketeering activity; or (d) conspire to violate (a), (b) or (c). 18 U.S.C. §§ 1962 (a)-(d).

RICO was designed to combat the efforts of organized criminal activity. In enacting RICO, Congress recognized the need for a broadly-based law which would counter such activities which it determined threatened the stability of the Nation's economic

system, harmed innocent investors and competitors, interfered with free competition, seriously burdened interstate commerce, threatened domestic security and undermined the general welfare of the Nation and its citizens. The Organized Crime Control Act expressly provides that RICO is to be "liberally construed" to effectuate its purposes.

Under RICO, a private citizen can sue for and recover treble damages as a result of injury to his business or property. This private right of action is in addition to the authority given the Attorney General to institute criminal RICO actions and to pursue civil actions seeking not only damages but also (1) divestiture of a person's interest in an enterprise, (2) the imposition of restrictions on a person's future activities or investments, particularly in enterprises of the same type as that involved in the action, or (3) dissolution or reorganization of an enterprise, making due provision for the rights of innocent persons. 18 U.S.C. § 1964 (a) and (b).

A number of controversies have arisen as to the scope of RICO and its applicability to so-called "garden variety" criminal fraud cases. Some commentators and courts have argued that an expansive construction of RICO effectively federalizes a variety of acts formerly deemed criminal only under state laws. Others have argued that such a reading would have RICO supplant existing remedial arrangements, such as those afforded private litigants under the Federal securities laws.

The United States Court of Appeals for the Second Circuit recently narrowed the scope of civil RICO by imposing two limitations on its use: First, in Sedima, S.P.R.L. v. Imrex Co., Inc., 741 F.2d 482 (1984), and the companion case of Bankers Trust Co. v. Rhoades, 741 F.2d 511 (1984), the Second Circuit held that the plaintiff in a civil RICO case was required to plead and prove a "racketeering injury" separate and distinct from any injury caused by the predicate criminal acts set forth in the statute. Second, in Sedima, the Second Circuit also held that the plaintiff must plead and prove that the defendants had been convicted of the alleged predicate criminal offenses. Both of these limitations are now under review by the Supreme Court.

ROLE OF THE FDIC IN FAILED BANKS CASES

The FDIC insures deposits in virtually all commercial banks in the United States. When a bank insured by the FDIC fails and is closed by its chartering authority, the FDIC is appointed as the bank's receiver to liquidate its assets and to pay claims of creditors and shareholders. Whenever an insured bank fails, the FDIC must draw upon its insurance fund to pay the claims of insured depositors or to facilitate the assumption of the failed bank's deposits and other liabilities by another insured bank. In either case, the FDIC has a claim against the failed bank's estate for monies paid out of its insurance fund. As receiver, the FDIC acts in a private capacity not only by standing in the

shoes of the failed bank but by acting on behalf of the bank's creditors and shareholders in seeking to maximize the recovery on its assets for their benefit. The FDIC is today liquidating assets in excess of $6.5 billion (not including $3.5 billion in assets associated with the Continental Illinois assistance transaction) belonging to 281 failed banks, including the approximately 30 which have failed so far this year.

The FDIC's policy is to pursue all those responsible for causing a failed bank to suffer loss, whether that loss was the major contributing cause of the bank's failure or not. This policy serves the dual purpose of maximizing the recoveries available to the FDIC as receiver for the benefit of the bank's creditors and shareholders, and insuring that the FDIC will be able to recover as much of its insurance money as possible. In many cases the FDIC will have used its insurance fund to arrange for the full payment of the bank's depositors and general creditors by having their claims assumed by another insured bank. Where this alternative is used, the FDIC winds up as the failed bank's only general creditor. Since the bank's assets are usually insufficient to pay the FDIC's claim in full, any amounts it recovers from other sources will reduce that shortfall and directly benefit the FDIC's insurance fund.

After a bank fails, the FDIC will conduct an investigation and, depending on the results, may file a claim against the bank's

directors and officers for negligence or misconduct in overseeing its operations. The FDIC may also file a claim with the bank's blanket bond insurance carrier to recover monies lost by reason of dishonest acts committed by its employees. In some cases the FDIC will proceed against the bank's outside accounting firm for losses attributable to its negligence in auditing the bank.

The persons responsible for allowing a failed bank to suffer losses are usually its officers or employees, or those who stand in a close relationship such as its outside directors and accountants. These are the people to whom FDIC has traditionally looked for compensation. There are, however, a small but increasing number of failed banks which have suffered losses due to fraudulent schemes perpetrated by outsiders. Sometimes these losses have themselves been sufficient to cause the failure of the bank. Regardless of the extent of the losses, however, they are almost invariably indicative of efforts on the part of bank management to deal with the bank's financial problems - such as low earnings or excessive loan losses - by making a quick profit in a short time through a series of questionable transactions. Bank management does not have to be an active participant in such fraudulent schemes, or even be aware of their real nature. It is enough that those in charge are so concerned with the precarious condition of the institution that they neglect to take simple precautionary measures and wind up being victimized.

As banking becomes more competitive, banks are coming under increasing pressure to enter unfamiliar areas of business or to engage in more hazardous practices. They thus become targets for those who see them as easy prey to a variety of fraudulent schemes. When those schemes cause serious financial harm, the bank may fail. Even when the harm is not so extensive, the precarious financial condition of the bank, coupled with the losses caused by management's misguided efforts to save it, will often lead to the same result. Once that happens, the FDIC steps in to salvage what it can. It is in this context that civil RICO cases promise to be extremely valuable.

Over the past few years, the FDIC has encountered tangible evidence of the harm that can result when certain individuals are willing to translate the following maxims of "common wisdom" for their own illegal ends: "The best way to rob a bank is to own it" and "Borrow a thousand dollars and the bank owns you; borrow a million and you own the bank". The experience of the recent past has shown that individuals are willing to engage in organized criminal activity involving banks which goes far beyond what has been viewed by the courts as "garden-variety fraud", "run-of-the-mill business disputes" or "ordinary commercial litigation". Rather, such illegal activity has been well organized and carried out on a sustained basis, resulting in serious harm to the target institution. When such a case arises, the FDIC has a substantial economic and legal interest in utilizing the benefits of the civil RICO statute to (1) deter similar activity,

(2) recoup financial loss to the FDIC's insurance fund as well as to the bank's creditors and shareholders, and (3) establish important legal precedents to help proscribe future illegal activity.

The first civil RICO action filed by FDIC to recover treble damages for losses suffered by a failed bank involved an alleged scheme which, in its complexity, went far beyond the mere commission of two predicate criminal offenses and involved much more than "garden-variety" fraud. Ironically enough, the scheme did not involve a new and unfamiliar activity but rather one which has been around (and criticized by the bank regulators) for a long time.

THE INDIAN SPRINGS STATE BANK CASE

On April 3, 1985 the FDIC filed a 66 page, nine count civil RICO complaint in the U.S. District Court in Kansas City, Kansas. That complaint detailed an alleged scheme whereby the defendants conspired to and did acquire and conduct their own enterprise, the affairs of several limited partnerships, and a money brokerage business in such a manner as to fraudulently secure loans from the failed bank in excess of its lending limits, create an artificial market for the bank's certificates of deposit, create a captive market for the properties controlled by the defendants so as to sell such properties at inflated prices, and to otherwise act in such a manner that each defendant could unlawfully enrich

himself. The defendants' activities in organizing the limited partnerships, soliciting the failed bank to provide financing for the purchase of partnership interests, use of "straw borrowers", and the solicitation of persons to invest in the various partnerships, are alleged to have constituted common law fraud, violation of federal and state securities laws, violation of wire and mail fraud statutes, and violation of the RICO statute.

In that complaint we alleged the following facts: The defendants set up a series of limited partnership deals for real estate speculation in Kansas, Missouri and Hawaii. Bank loans were then sought to provide financing for the limited partnership interests in the approximate amount of $3 million. Individuals, some of them only "straw borrowers", were solicited to participate. The proceeds from these loans were deposited directly into bank accounts controlled by the defendants, where the money disappeared. Some of the borrowers were given a cash fee to execute blank loan documents later submitted to the bank. Other borrowers overstated assets, understated liabilities and exaggerated their net worth. Even though the bank sought to collect on the loans, it was unable to do so. Normally the bank would not even have been able to consider making such loans because of its relatively small size. The defendants, however, overcame this problem by offering "courtesy deposits" through a moneybroker. The bank was told that institutional investors would be directed to purchase its certificates of deposit if the bank could issue such certificates

above the prevailing rate of interest. That interest rate differential was rebated to the bank which did not have to pay the usual fee to the moneybroker for causing the funds to be deposited. The moneybroker was also a beneficiary of the limited partnerships and received other compensation for his participation in the scheme.

In effect, the FDIC alleged a scheme where the bank was offered a series of deals whereby it could make a substantial profit on millions of dollars of loans. In the end, the deal was too good to be true. The loans were never repaid and the bank failed.

The FDIC charged that as a result of the pattern of racketeering and other violations of law, the Indian Springs State Bank suffered a $3 million loss as well as the loss of its banking business because of its resulting insolvency and failure. The FDIC alleged that its insurance fund suffered a loss as a result of the bank's insolvency and sought damages for that loss. In addition, the FDIC as receiver alleged that the bank suffered losses as a result of the specific predicate acts committed.

FUTURE USE OF RICO

We believe that the Indian Springs case illustrates the value of civil RICO to the FDIC where it is attempting to deter criminal

conduct aimed at banks which are already in a precarious financial condition. It is also useful as a means of compensating the FDIC for losses to its insurance fund incurred in carrying out its statutory responsibility to protect the insured depositors in a bank failure.

Banks are an essential element in the Nation's economic system. Organized criminal activity which affects banks can have a profound effect on the stability of the banking system and can hurt innocent depositors, creditors and investors. It is exactly this type of activity with which Congress was concerned in 1970. (See Senate Report No. 617, 91st Cong., 1st Sess., 81-82 (1969).) It remains a legitimate concern today. The vast majority of FDIC-insured commercial banks simply do not have the financial resources or the expertise to protect themselves from organized criminal activity and fraud. Ninety-seven percent of these banks have assets of less than $500 million, eighty-four percent have assets of less than $100 million and sixty-six percent have assets of less than $50 million.

The FDIC would not favor changes in the present law that could significantly curtail its usefulness as a basis for dealing with organized criminal conduct aimed at federally-insured banks. Since the FDIC would only be filing RICO actions in cases of failed banks, the requirement of a separate racketeering injury would

seem to have little impact on FDIC-related lawsuits. In such cases the banks have not only sustained a loss from the criminal activity but the loss has contributed to the bank's failure as well. Of equal importance is the fact that we do not view the FDIC's prospective use of civil RICO actions as a threat to the conduct of legitimate business activities. The type of organized conduct which would take advantage of a bank's precarious financial condition, or its lack of diligent management, to steal money from it can hardly be considered "legitimate" in any sense of the word.

We do, however, suggest one minor change to RICO which would permit it to be used more effectively in cases of bank fraud. On October 12, 1984, Congress amended the Federal criminal statutes to make it a crime "to defraud a federally chartered or insured financial institution". The penalty is a fine of not more than $10,000 or imprisonment of not more than five years, or both. 18 U.S.C. § 1344. While the Attorney General may bring a civil action to enjoin a violation of the bank fraud statute, just as in the case of mail or wire fraud, there is no provision in RICO denominating bank fraud a "predicate act", as there is in the case of mail or wire fraud. We believe bank fraud should be so denominated, thus allowing a private right of action for treble damages where such fraud amounts to a pattern of racketeering.

Given the concern shown by Congress over the effect of bank fraud on the Nation's federally chartered and federally insured institutions, an amendment to RICO is a sensible extension of the intent to make bank fraud a federal crime.

Mr. Chairman and members of the Committee, I thank you for your kind attention and I would be pleased to answer any questions.