Testimony Presented to the House Committee on Financial Institutions, Testimony on House Bill 1522 On Behalf of the Texas Department of Banking

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Testimony of Randall S. James, Banking Commissioner
House Bill 1522, Seizure and Forfeiture, Chapter 59, Criminal Statutes

Good afternoon, Chairman West and members of the committee. For the record I am Randall James, the Texas Banking Commissioner.

Approximately one year ago, I took some phone calls from some Texas bankers that told me they were being threatened with closure or being placed in jail if they did not turn some money over to the Bexar County District Attorney. At first I thought there was a mistake – this is not how law enforcement deals with banks. Surely law enforcement understood the bank regulatory framework. I began to find out that I was wrong. My federal bank regulatory counterparts and I began to hear more. I met with some of these bankers to hear their concerns. I later corresponded with the Bexar County District Attorney's office and also met with some of its officers. I then submitted follow-up correspondence to them on my continuing concerns. I met with our Attorney General. Other involved state and federal banking regulators expressed similar concerns about these events. Everyone was raising the same questions. There have been numerous news articles about these events and related activity over the last year, all of which are available to each of you.

I then began to research the law of asset seizure and forfeiture as it exists in Texas today. My review of the current law disclosed something that I would not have known had it not been for the events of February 2000. No matter how innocent a bank or other lienholder might be, if the lien was on assets obtained through criminal activity and the lien was obtained subsequent to the crime, the lien was invalid under statute.

I then sought the legislative history of the current law. We reviewed those portions of the 1989 testimony before the state legislature on a crime package bill that changed Texas law to what we have today. The testimony by the Texas District and County Attorneys Association and issues raised by members of the Legislature clearly indicated an intent to protect innocent lienholders, an intent not borne out by the adopted language. The actions this past year by the Bexar County District Attorney, however, were not inconsistent with, or precluded by, the statutory language.

I then began research into how other states and the federal government have dealt with these same issues. We have reviewed statutes of some 21 other states, and the United States. We found that most statutes from other states that exist today (20 out of 21 researched) are much different from the current law in Texas. The bill before you bears much closer similarity to those in other

states. We have found that current federal seizure and forfeiture statutes are different from Texas statutes as well.

I request that you allow the Department of Banking's Assistant General Counsel, Sarah Shirley, testify when I conclude as to the results of this research in a more complete fashion. Copies of this research are also available to you.

My overriding concerns center on the need for the state to reaffirm:

- The structure that exists for financial institutions in Texas and this country;
- Lien attachment priorities under the Uniform Commercial Code;
- The regulatory supervisory framework that distinguishes banks from most other businesses; and
- The need for law enforcement to work with, and not against, bank regulators.

Senator Robert Duncan requested me to work with him on legislative solutions that would address the problems that I observed from those events of February 2000. I believe the bill proposed before you at this time does that.**How each of the recommended changes in the bill came into being:**

I. Constructive Seizure

This was the first area I sought to address due to the reports I received of how law enforcement took its actions last February.

It might be beneficial to briefly discuss here the fact that an immediate and unexpected "closing" of a bank, even briefly, as well as an immediate withdrawal of funds has a material impact on a financial institution. The actions could jeopardize its liquidity and potentially precipitate a de facto failure. I have documented my concern in this area in my correspondence to the Bexar County District Attorney's office.

Section 5 of this bill, with changes to Article 59.12, requires the bank to place a freeze on those assets sought by law enforcement, and places the potential of monetary damages payable by the bank should it fail to comply.

I would note here that bank regulatory structure does place banks under different restraints from other forms of businesses. As the Texas Bank Commissioner, I have the authority to place a conservator in a banking institution that violates the law. The purpose is to provide stability in a volatile situation until the problems are corrected; the bad actors, if any, are out; and the bank is once again performing correctly under its charter. Conservatorship is a serious action and cannot be taken lightly.

As a comparison, the Texas statutes on the state comptroller's authority to seize corporate assets to effect collection of unpaid franchise taxes contains a specific exception for banks and savings and loan associations. The exception states that the banking or savings and loan commissioner, in that situation, must appoint a conservator to pay the franchise taxes. This statute recognizes the distinctiveness of banks, the bank regulatory framework, and achieves a result without closing the bank and destroying the community.

Let me quickly note that while this statute does not state it, coordination between the state comptroller and the banking commissioner requires communication and a working relationship between the two. This leads me to my next point.

II. Inclusion of primary bank supervisors when potentially large or draconian forfeitures are foreseen by law enforcement:

I had no notice of the pending investigations or actions that were being contemplated by law enforcement. It is extremely important for the banking regulators to know if law enforcement has reached a decision that either bankers in a bank are criminals, or that they view the bank as criminal. It is also important for law enforcement to understand the potential impact of their demands on a bank's liquidity or equity accounts.

Required interaction between law enforcement and banking regulators in such instances would seem to place appropriate regulatory authorities together to seek a proper resolution to a problem.

I have staff today that works with numerous law enforcement officials, much of which involves efforts to stem illegal drug activities and money laundering activities. The federal agencies my staff works with includes the FBI, U. S. Customs, the IRS, the DEA, ATF, and the INS. At the state level, we work routinely with city police and sheriff's departments, the DPS, and the financial crimes and specialized prosecutions division within the Texas Attorney General's office. The Legislature recognizes the benefit of law enforcement working with other regulatory agencies for the common good.

Through the limited contact that I have had with law enforcement over the last year on this issue, I have concluded that the working belief of law enforcement is that a "banker" and a "bank" are one and the same. The banking regulators do not work on this basis.

In those instances where we find or suspect an individual or group of individuals in a bank of culpability or complicity in a criminal action, we investigate, and not infrequently we bring in law enforcement. And if we deem it appropriate, we exercise our statutory authority to remove those individuals from the institution. The process allows for the individuals or banks to defend themselves against us before the court, should they so choose, but removal can be immediate. We recognize that a bank is distinct from those individuals and their actions. The bank is deeply involved in a community's activities and economic well being. To impact that public and community confidence negatively without consideration of the extensive ripple effect it would have in the community, without consideration of possibly causing either a run on the bank and/or its failure, and without being prepared to handle that impact, is irresponsible. The bank has no authority to conduct illegal activity. Bank regulators seek to remove the culpable individuals, not automatically indict or close the bank.

The current situation leaves bank regulators with possible criminals remaining in the banks and no proof, and no way to protect the banks and their customers from similar actions again. Bonding and regulatory issues now exist for bank regulators; that is, if the allegations of criminal activity are really true. And I see no solution under current law.

This portion of the bill, with amendments to Article 59.13 and Article 59.14 addresses these problems. The bill provides that all shared or noticed information is confidential, should that be a concern to law enforcement. The bill does not require law enforcement to provide information to bank regulators, but it does require law enforcement to provide advance notification if their action is material enough so as to cause a possible regulatory concern.

This brings me to third integral piece of this bill.

III. Removal of the "timing" requirement in lien attachment for innocent lienholders

As the Texas Banking Commissioner, I must provide the Legislature an assessment as to the safety and soundness condition of the Texas banking system. That assessment would include, among many other analyses, an evaluation, with some relative degree of assurance, of the reasonable capacity of banks to respond to the legitimate banking needs of their communities. For example, if neither banks nor bank regulators can rely on Article 9 of the Texas Uniform Commercial Code and its "comprehensive scheme for liens on personal property," then credit will become less available. I have no way to measure this effect. Because loans are the primary asset of most banks, I rely on that legal, constructive framework. If neither the bank nor the regulators can rely on a bank's lien positions, the system won't work. The current statute in Texas severely restrains that adequate assessment.

The current "timing" requirement that a security interest be acquired and perfected prior to or during the commission of the felony offense means that a lienholder cannot acquire and perfect its interest after the offense is committed. The lender can lose that interest no matter how innocent it might be. This timing requirement undermines the certainty that the Uniform Commercial Code establishes for commercial transactions and threatens reasonable commercial expectations. Our review of federal and many other states' statutes reveals that Texas imposes a substantially greater burden upon, and provides less protection for, a truly innocent lienholder than do other jurisdictions.

The current statute does not provide for a lienholder to even present a possible defense of being "innocent" of the charge that it "knew or should have known" if its lien was taken on assets purchased with criminal proceeds after that crime has been committed. The impossibility of success places lenders in substantial jeopardy. Even if a lender could clearly evidence that they do not meet the "knew or should have known" standard they are not protected. (For law enforcement to "exercise discretion" in its review is fine, but the law needs to be changed for those instances of valid disagreement. In other words, the issue should be before a court.)

Reasonable certainty is required to sustain commercial transactions, and financial institutions should not be precluded from defending their lien position on bank collateral, or to be able to at least present an "innocent lienholder" defense. The "knew or should have known" standard exists frequently in state law. As a non-lawyer, this seems to place a two-fold burden on the financial institution: First, if the banker "**KNEW**", and still took a lien on assets resulting from a crime, then I concur with law enforcement, the bank takes the loss (but it would be covered by fidelity insurance). As a bank regulator, I want any such individual that facilitates such a transaction out of the institution. Again, bank regulators have statutory removal authority for such situations, and can act immediately if the need arises. This protects the bank and its customers from future

problems. However, if law enforcement takes the position that the banker "**SHOULD HAVE KNOWN**" and the courts agree, then this situation becomes a question of adequate due diligence on the part of the bank officer before they allowed the financial institution to enter the transaction. Bank regulators then need to address the weakness in the institution to prevent the problem from recurring.

Should law enforcement believe a bank fails the test of either "knew or should have known" of criminal activity to the point that its lien should be forfeited, then this bill says law enforcement presents that position to the court that is handling resolution of the matter, and the bank defends itself. The burden of proof is on the bank, not law enforcement, so there should not be additional burden on law enforcement.

Section 2 of the Bill, with proposed changes to Article 59.02 addresses this issue. The focus of the bill, and the focus of all of us, should be on the concept of "know or should have known"; timing should not be relevant.

I would be happy to answer any questions you might have.