CORPORATE CULTURE, FINANCIAL STABILITY AND BANK LITIGATION*

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October 2015

ABSTRACT

Excess (i.e., well above average) litigation against a large bank holding company (BHC) is one indicator of a corporate culture that presents risks to financial stability because excess litigation reflects a failure to maintain a strong system of internal control. We analyze five different measures of bank financial performance during the financial crisis and a unique hand-collected data set on bank legal expense. Our results are consistent with the hypothesis that high legal expense predicts weak future bank performance. If investors had regular legal expense information there would be greater market discipline. Bank regulators should require reporting of legal expense on call reports to help identify institutions with weaknesses in internal control. Existing reporting creates unnecessary information asymmetries since investors are not as informed as they could be about the lack of an ethically sound corporate culture at a BHC, no doubt leading to mispricing of bank securities.

*We thank Allen Berger, Scott Barnhart, Lamont Black, Steve Dennis, Bob DeYoung, Curt Hunter, Ed Kane, Steven Kane, Tom Lindley, Melinda Newman, James Thompson, Larry Wall and other participants at the Financial Stability Conference and Annual Meetings of the Eastern Finance Association and Southern Finance Association for very helpful comments and discussion. Professor McNulty also thanks the College of Business at Florida Atlantic University for Summer Research Grant support. We are solely responsible for any errors or omissions.
EXCESS LITIGATION AGAINST A LARGE BANK HOLDING COMPANY (BHC) IS ONE INDICATOR OF A CORPORATE CULTURE THAT PRESENTS RISKS TO FINANCIAL STABILITY BECAUSE EXCESS LITIGATION REFLECTS A FAILURE TO MAINTAIN A STRONG SYSTEM OF INTERNAL CONTROL. WE ANALYZE FIVE DIFFERENT MEASURES OF BANK FINANCIAL PERFORMANCE DURING THE FINANCIAL CRISIS AND A UNIQUE HAND-COLLECTED DATA SET ON BANK LEGAL EXPENSE. OUR RESULTS ARE CONSISTENT WITH THE HYPOTHESIS THAT HIGH LEGAL EXPENSE PREDICTS WEAK FUTURE BANK PERFORMANCE. IF INVESTORS HAD REGULAR LEGAL EXPENSE INFORMATION THERE WOULD BE GREATER MARKET DISCIPLINE. BANK REGULATORS SHOULD REQUIRE REPORTING OF LEGAL EXPENSE ON CALL REPORTS TO HELP IDENTIFY INSTITUTIONS WITH WEAKNESSES IN INTERNAL CONTROL. EXISTING REPORTING CREATES UNNECESSARY INFORMATION ASYMMETRIES SINCE INVESTORS ARE NOT AS INFORMED AS THEY COULD BE ABOUT THE LACK OF AN ETHICALLY SOUND CORPORATE CULTURE AT A BHC, NO DOUBT LEADING TO MISPricing OF BANK SECURITIES.
1. INTRODUCTION

Fixed-rate deposit insurance creates a put option on the value of a bank’s assets with a strike price equal to the maturity value of bank liabilities (Merton, 1977, 1978). Since bank managers can maximize the value of the option by behaving opportunistically, there is an important role for bank regulation in curbing such behavior. Aggressive and opportunistic behavior by a bank holding company (BHC), which represents an implicit attempt to maximize the value of the put option, is often revealed in litigation against the institution.

In many cases consistently high litigation exposure and expense reflects the classic causes of banking problems – an aggressive corporate culture focusing on short-term earnings, the inadequate training for employees which often results from such a focus, and a failure to have in place, or to adhere to, well established policies and procedures for managing risk. New York Federal Reserve Bank President William Dudley (2014) discusses the connection between corporate culture, bank management, and bank litigation. He comments with respect to improving a bank’s corporate culture, “How will a firm know if it is making real progress? Not having to plead guilty to felony charges or being assessed large fines is a good start.” This statement fits very well with the theme of our ongoing research that one important measure of corporate culture at a bank is the bank’s legal expense relative to peer banks.

The link between litigation and performance is the bank’s system of internal control. “Good” internal control exists when “no one person is in a position to make significant errors or perpetuate significant irregularities without timely detection” (Comptroller of the Currency, 1998,
p. 2).\(^1\) Weak internal controls create operational risk. Robertson (2011) shows that the risky lending, lax securitization and other due diligence failures that contributed to the 2007-09 US financial crisis also reflect operational risk. Chernobai, Jorion and Yu (2011) analyze a database of 2,426 unique operational risk events involving 731 US financial institutions from 1980 to 2005. They note that “most operational losses can be traced to a breakdown in internal control” (p. 1683). They conclude “currently, a large number of banks treat operational losses as independent events. [However] the evidence suggests that many factors internal to the firm contribute to the occurrence of operational risk events of all types. This implies that the common assumption of independence of events within the firm may be seriously flawed” (p. 1719). The finding that operational losses reflect internal factors points to the importance of econometric research exploring the role of corporate culture as a determinant of bank performance.

\(^1\) The OCC notes that a broader definition of internal control includes “the accuracy and reliability of accounting data…operational efficiency…adherence to subscribed managerial policies…a training program designed to aid personnel in meeting their responsibilities, and an internal audit staff to provide additional assurances to management as to the adequacy of its outlined procedures and the extent to which they are being effectively carried out…That broad definition is a clear indication that development and maintenance of a satisfactory system of internal control is a managerial responsibility within a bank” (p. 1, emphasis added). Litigation against banks can be frequently traced to situations in which one person or a few people in the organization are able to perpetuate irregularities without detection for a significant period of time. Hence, a bank without a good system of internal control is more likely to be sued than other banks. These points support the notion that excessive litigation is a reflection of managerial weaknesses. The system of internal control establishes limits on the amount of risk that one employee can commit BHC to accept; thus internal control has an important ethical dimension that is likewise a function of corporate culture.
The literature in business ethics emphasizes that ethical decision making is not an individual matter; it depends on the climate within the organization. Indeed, outside efforts to educate officers and employees about ethical issues will often fail to produce the desired results in the absence of a sound ethical climate within the organization. Put simply, “unethical conduct may be related more to attributes of the business itself than to attributes of the individual employee” (Chen et al, 1997, p. 855). Hence, a code of ethical conduct put in place to please bank regulators will not generate the same results as one that reflects inherent values in the organization. The “tone at the top” is a more important driver; employees know what types of behaviors are encouraged and rewarded and what type of behavior is punished. Corporate governance is a related and crucial influence on the ethical climate. When significant irregularities occur and regulators bring enforcement actions, directors are partly responsible (Nguyen, Hagendorf and Eshraghi, 2015).

There is another important connection between legal expense and culture. In cases where internal controls are weak, management has an incentive to prolong the litigation, deny everything, hide the risk, and push problems into the future. In these situations, *aggressive banking strategies and aggressive litigation strategies accompany one another*, and the full extent of managerial weaknesses is often evident only when the litigation is resolved many years later. (Some of the Wachovia cases described in Appendix A were in the courts for ten years or more.) These BHCs would have legal expense significantly higher than peers. In such instances payments to law firms are higher than if the issues were resolved expeditiously.

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2 Busy Bee v. Wachovia (1996, 2006) involves the alleged destruction of a 108-year-old family business. The case required ten years to litigate; then there was an appeal (see Appendix A). In several other larger Wachovia cases the weaknesses in internal control also went on for close to ten years. An example is provided in footnote 5.
Making bank legal expense data public by requiring it to be reported on bank call reports can reveal an aggressive managerial orientation. Reporting is discussed in more detail immediately below.

In this paper we provide econometric evidence on the relation between bank litigation and corporate culture. Since legal expense is a measure of corporate culture, our hypothesis is that high legal expense is associated with weak future bank performance. We suggest there is a lag between excessive legal expense and deteriorating bank performance. In the short run, aggressive and risky behavior may bolster bank earnings, but the litigation is often an indicator of managerial weakness. Often unsound loans are restructured; it takes time for the loans that are made under weak systems of control to adversely affect performance. Hence, we test whether banks that had high legal expense before the 2007-09 financial crisis performed worse than other banks, both in terms of market returns and loan quality, during the crisis. Because of the complexity of corporate culture and bank litigation, we provide both econometric and case study evidence.

We use a unique hand-collected data set reflecting bank legal expense (our legal expense proxy) to examine the hypothesis that high legal expense predicts weak future bank performance. The proxy includes payments to law firms in all cases; these will clearly be higher when a bank is sued more frequently. The proxy comes from annual BHC 10K reports for the pre-financial-crisis period, 2002-06. This measure reflects differences among banks in total (unobservable)

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3 The proxy does not provide a precise measure of bank legal expense because it is combined with several other items. In addition, many BHCs, including Citigroup, do not report their 10Ks in a format that would allow us to construct the proxy. These institutions are excluded from the sample.
bank legal expense (excluding settlements) and identifies those BHCs with above average expense. We examine the effect of the legal expense proxy on five measures of bank performance in 2007 and 2008 – buy-and-hold returns (BHRs), abnormal BHRs, non-performing loans, loan charge-offs, and loan loss provisions.

Large banks’ legal bills from mortgage-backed securities misrepresentation and fraud, the foreclosure crisis, and the more recent LIBOR manipulation are estimated to total at least $100 billion and could reach $176 billion (Kapner, 2013). While these high profile settlements and judgments against banks weaken current bank financial performance, this is essentially an accounting relationship which is not the subject of this paper. Settlements are a lagging indicator reflecting weaknesses from earlier periods. We are interested in a more important question, is excess legal expense (payments to law firms) a leading indicator of banking problems?

Our findings are that the legal expense proxy for 2002-06 predicts the five bank performance variables for both 2007 and 2008. Consistent with the hypothesis, high pre-crisis legal expense is associated with lower stock returns and lower loan quality during the crisis, and the relationships are economically and statistically significant. The standardized regression coefficients indicate that legal expense is one of the more important variables affecting bank performance.

The difficulties in collecting these data include the wide variety of reporting formats in the annual 10-K reports, and the lack of separate reporting of the required data by many BHCs. We examine reports for over 150 BHCs, of which 102 report information sufficient to construct the proxy. Lack of complete performance data for some institutions reduces the sample to 83 BHCs for each of the five years.

4 Kapner (2013) mentions four US BHCs and three European banking organizations, but does not state which large global banks are reflected in the estimates. We know of no comparable estimate for the recent expenses of litigation for smaller banks. Nocera (2012) provides an overview of the LIBOR manipulation cases.
performance. While Zeiden (2013) and Nguyen, Hagendorff and Eshraghi (2015) find that enforcement actions against US banks, a measure of corporate wrongdoing, are associated with negative stock market reactions, we believe that this is the first research to find a relation between legal expenses and bank performance.

The policy implication of our research is that federal regulators can learn about corporate culture at BHCs by: (1) requiring disclosure of legal expense on publically-available bank call reports and BHC Y9 reports, (2) incorporating the resulting ratios (legal expense/assets and legal expense/revenues) into their Uniform Bank Performance Reports (UBPRs) for both banks and BHCs, and (3) monitoring these data. The item that should be reported and monitored is item BHCK4141 on the Y9 and RIAD4141 on the call report. The definition of both items is “legal fees and expenses”. We suggest a two-step procedure. First identify the banks with consistently high legal expenses relative to peer banks. Second, evaluate the litigation against these banks to determine if there is an ongoing and systematic pattern of that suggests deficiencies in the corporate culture giving rise to weaknesses in internal control.

There is major interest in market discipline in the banking literature. Researchers envision an environment in which managers are discouraged from taking actions, or creating and perpetuating a corporate culture, detrimental to the long-run interests of stakeholders because managerial actions would be transparent. Investors should be less willing to accumulate securities, and more willing to sell securities, issued by banks with high legal risk (a form of operational risk). Market discipline should also operate through the firm’s debt obligations as

5 We do not suggest that all legal expense reflects bad bank behavior since there are some forms of legal expense that are normal, necessary, and potentially value enhancing. We discuss this point in Section 6.2.
investors sell the firm’s bonds for the same reasons and drive up cost of debt. Banks with high legal risk may also be less able to fund themselves in the short-term money market, or do so only at higher cost. Effective market discipline does not require that all investors in bank securities understand and act on legal expense data. It only requires that the marginal investor do so. Regulatory reporting would allow investors and regulators to make peer group comparisons, and better estimate normal levels of legal expense for banks and BHCs in different size groups. Our analysis thus shows investors why they should be interested in bank legal expense data, and how they can use it.

Market discipline requires that managers operate in a transparent environment. In 2002 through 2012, less than 15% of BHCs reported legal expense on their Y9 reports, and in 2011 and 2012 there was no reporting on call reports, so there is a complete lack of transparency in this area. Akhigbe, McNulty and Stevenson (2013) find that greater levels of transparency are associated with higher profit efficiency at publically traded BHCs. Identification of weaknesses in internal control at smaller, non-publicly-traded community banks would also be facilitated by improved reporting.

Bank mergers can weaken internal control because they require the integration of two sets of policies and procedures and two corporate cultures. Such reporting would allow regulators to identify banks that can develop the appropriate corporate culture at the new institution and handle bank mergers without a major increase in operational risk.

The ethical component of corporate culture influences a banking firm’s ability to create long-term value for shareholders. In Barron’s (2011) annual survey of professional money managers on the “Nation’s Most Respected Companies” portfolio managers make extremely critical comments about the management of US commercial banks, especially Citigroup and
Bank of America. The media has reported extensively about a large amount of litigation at both institutions. These institutions ranked 96th and 97th respectively out of 100 in the survey. Nonetheless, we note that if it is corporate culture that is the primary cause of bad behavior, it is unlikely that breaking up large banks exhibiting such behavior, a possibility mentioned by some industry observers, will produce meaningful change unless the breakup changes the culture.

This introduction is followed by Section 2 which summarizes the economics and finance literature on both corporate culture and operational risk. Section 3 develops our hypothesis concerning the relation between corporate culture, operational risk and legal expense. Section 4 describes the data, and Section 5 presents descriptive statistics and empirical tests of the relation between bank performance and legal expense. Section 6 presents the policy implications of our research, while Section 7 concludes. Appendix A presents the three case studies; Appendix B describes federal bank examiners’ responsibilities with respect to bank litigation; Appendix C analyzes current regulatory reporting requirements for bank legal expense.

2. LITERATURE REVIEW

We summarize the economics and finance literature on both corporate culture and operational risk. Other things equal, a bank which is sued much more frequently than peer banks (especially if it is repeatedly sued for the same reasons) can be considered to have a more aggressive corporate culture than other banks. Banks with aggressive corporate cultures often have weaker systems of internal control. This gives rise to weaker than average bank financial performance after a period of time.
2.1. Corporate culture

Coase (1937) views the firm as a nexus of contracts. His contractual theory of the firm is extended in Alchian and Demsetz (1972), Jensen and Meckling (1976), and Fama and Jensen (1983). A brief summary of this literature is provided in Boatright (2002; 2008). Brickley, Smith and Zimmerman (2002) build on Coase by defining organizational architecture (their term for corporate culture) as the nexus of contracts that bind an individual to an organization. They argue that organizational architecture reflects the ethical climate within a firm, and that business ethics and organizational architecture are “inextricably linked” (p. 1822) because both reflect the incentive structure for the individuals that comprise the firm. This ethical climate reflects the way the firm deals with customers, employees and suppliers. The firm assigns decision rights and authority, develops a performance appraisal system and a reward system derived from it, and produces and enforces (or fails to enforce) a code of conduct to encourage or discourage certain types of behavior.6 As noted below, there is an important difference between nominal and effective codes of conduct. Donaldson and Dunfee (2002), Chami and Fullenkamp (2002) and Hausman (2002) provide additional ethics-in-finance studies but do not discuss litigation against a firm.

In this literature, corporate culture is generally defined as a set of shared norms and values by members of the firm. Lazear’s (1995) models the process of growth of this common set of values and beliefs. He views corporate culture as an attempt by the firm to change

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6 Brickley, Smith and Zimmerman (2002) note that many institutions put codes of conduct on company websites. An example for FirstBank is at www.firstbankmi.com. This bank’s code deals with personal interests vs. corporate interests, use of confidential information, record keeping, fair dealing, proper use of company assets, compliance with laws, rules and regulations, and other ethical issues.
preferences and tastes of employees in the direction desired, instead of using the price system: “The establishment of a culture generally requires an initial investment that instills a particular set of values in its workers so that they behave in the desired fashion as a natural consequence of utility maximization” (p. 589). Thus, rather than starting with a given utility function, corporate culture theory postulates that firms attempt to alter the utility function of employees. Akerlof and Kranton (2000, 2005) directly introduce identity, a person’s sense of self, directly into the utility function. They view organizational culture as a way to motivate employees that is different from ordinary monetary compensation.

Cronquist, Low and Nilsson (2007, 2009) study the effect of corporate culture on firm financial policies. They point out that Lemmon, Roberts and Zender (2008) attribute 90% of the explained variation in capital structure across firms to firm-specific effects; standard models, in contrast, account for only six percent. Thus, they argue the notion that corporate culture matters in finance is compelling. Cronquist, Low and Nilsson (2007) contrast conservative corporate cultures, such as Morgan Stanley, with aggressive ones, such as Citigroup. Corporate culture encompasses the extent to which individuals identify with the organization and adopt its goals as their own, thus internalizing the culture. When significant irregularities occur and regulators bring enforcement actions, directors are partly responsible (e.g., Nguyen, Hagendorf and Eshraghi, 2015).

Cronqvist, Low and Nilsson (2007, p. 1) suggest that “firms preserve their cultures by selecting managers who fit into their cultures.” In a set of firm spinoffs over 1980-2005, they compare a broad range of financial policies and the performance of the parent and spinoff operating separately. Similarities between parent and spinoff across investment, financial and operating decisions, as well as profitability, are remarkable, and they are long term. These
similarities are stronger in firms that have grown internally and in older firms, which is consistent with corporate culture theory. They attribute their results to a set of shared norms and beliefs inherited, possibly from the firm’s founder. This study provides further important empirical support for the notion that corporate culture matters in finance. For example, Appendix A notes that the founder of Countrywide had a strong influence on that firm’s aggressive approach to mortgage lending before the financial crisis.

In his Presidential Address to the American Economic Association, Akerlof (2007) discusses norms: “According to Pareto, people typically have opinions as to how they should, or how they should not, behave. They also have views regarding how others should, or should not, behave. Such views are called norms, and they may be individual as well as social. The role of norms can be easily represented in people’s preferences by modifying the utility function to include losses in utility insofar as they, or others, fail to live up to their standards” (Akerlof, 2007, p. 8, emphasis in the original).

Individuals may lose utility if they do not conform to the prevailing norms of the organization (Akerlof and Kranton, 2000, 2005). Corporate culture is thus partially self-selecting; employees who don’t fit will feel adrift and seek employment elsewhere. Lazear (1995) also suggests that employees are selected from a population on the basis of their fit with the firm’s culture. Cronqvist, Low and Nilsson (2007) cite a Wall Street Journal article reporting that “fit” is one of the most important factors corporate recruiters consider. This is also consistent with Van den Steen (2005, 2010) who develops theoretical models in which a strong belief by a corporate manager causes a sorting effect in the labor market that aligns the beliefs of employees with those of the manager. Shared beliefs eliminate the agency problems that arise from differences in objectives, hence they enhance performance. Nevertheless, Van den Steen
(2010) suggests strong performance creates a strong culture, rather than the reverse. Kosfeld and von Siemens (2011) develop a model in which workers differ in their willingness to cooperate voluntarily with other workers, and they self-select into firms composed of individuals who are similarly inclined. “There always exists a separating equilibrium in which workers self-select into firms that differ in … their level of worker cooperation” (p. 23). Since successful firms are characterized by cooperative efforts, *corporate culture affects firm performance*. They provide the example of Southwest Airlines, a successful firm which is a model of employee cooperation, and less successful airlines where employee cooperation is less.

Banking practitioners and bank management textbooks recognize the significance of corporate culture. For example, Hall (2012) estimates based on his bank consulting experience that only 10% of banks have a culture characterized by good internal communication and people from different departments working effectively together to meet organizational goals. He argues that a weak operating culture evidenced by disputes among departments and individuals is one of the most serious risks at banks. His urgings that “the board of directors and senior management must come together to define the values and characteristics the bank intends to operate under” and “values need to be integrated with shared beliefs” echoes this academic literature. Koch and MacDonald (2010, pp. 556-558) discuss the differences between a “values-driven” credit culture and a “current-profit-driven” credit culture. The first is marked by concern for loan quality, bank soundness, stability and consistency. The second is characterized by a focus on short-term earnings, and a high tolerance for risk.

2.1.1. *Measuring corporate culture*
The literature on corporate culture in business ethics and management science developed because of concerns about such issues as product and workplace safety, environmental issues, and cultural fit in mergers and acquisitions and led scholars to attempt to measure corporate culture. Most of the data rely on specially-constructed surveys. For example, Nwachukwu and Vitell (1997) survey 3,000 marketing executives to evaluate the impact of the existence and enforcement of a formal organizational code of ethics on willingness to approve advertising for baby food, athletic shoes, and cigarettes. Weber et al (1996) introduce a detailed survey of senior managers designed to measure cultural fit at a sample of firms involved in both domestic and international mergers and acquisitions (M&As). Their anonymous survey uses important questions to assess both perceptions and results, and includes questions on sensitive subjects (such as the perceived amount of discord in the post-merger firm) to assess the impact of two types of culture, national and corporate, on the success of merger and acquisitions. (Usable data were obtained from the questionnaire for 52 M&As.) Chattergee et al (1992) also employ survey techniques to measure corporate culture. All of these survey approaches to measuring corporate culture rely on perceptions.

*The Wall Street Journal* (Glazer and Rexrode, 2015) reports that, in response to regulators’ concerns about weaknesses in corporate culture, a “cottage industry of consultants and other experts” has developed to design and administer surveys to bank employees, and that banks are collectively spending tens of millions of dollars on such efforts. But such surveys can only capture a small portion of human experience and perception; there may be a tendency for even the most straightforward bank employees to select those aspects of his/her experience that he/she thinks management and regulators want to hear about. Arguably, a series of questionnaires that are clearly designed for the purpose of bank regulation and compliance may
elicit answers that are not reflective of the actual corporate culture within the organization. While such surveys can potentially be useful, *there should be an independent measure of corporate culture*, such as bank legal expense, that is not subject to such reporting and selection bias. Our approach to measuring corporate culture in this research is quite different since we rely exclusively on data on the legal expense proxy from the BHCs 10K report.

A related issue is codes of ethical conduct at BHCs. Brickley, Smith, and Zimmerman (2002) report that many firms post codes on company websites. But Arjoon (2005) suggests that rules designed primarily to protect senior managers will produce cynicism among employees and be counterproductive to the ethical climate. Chen *et al* (1997) note in this context that “unethical conduct may be related more to attributes of the business itself than to attributes of the individual employee” (p. 855). We noted the importance of the “tone at the top” earlier. On the other hand, if BHC compliance officers were required to review publically-available data on their BHCs legal expense/assets and (for those BHCs well above the mean) to explain to their boards of directors why their BHC is being sued so frequently, more meaningful improvements may take place than would occur from such postings.

2.2. *Operational Risk and Internal Control*

The definition of operational risk used by regulators and financial institutions is “the risk of loss from inadequate or failed internal processes, *people* and systems, or from external events” (Robertson, 2011, p. 1, emphasis added). Robertson shows that the due diligence failures that led to the financial crisis are a form of operational risk. Importantly, he sees the entire crisis as “born of operational risk” (p. 4) because people behaved badly and internal controls that should

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7 This definition is the one used by the Basel Committee on Bank Supervision (2006).
have prevented failures in both lending and securitization were not in place. Securitization transmitted operational risk from one institution to another. “An operational risk in the mortgage industry that is probably as old as mortgages themselves – mortgage fraud – exposed operational failures by mortgage originators, mortgage bundlers, credit-rating agencies, asset managers, investors, and ultimately regulatory agencies” (p. 2). These linkages created a domino effect throughout the international financial system when the quality of the subprime loans came into question.

Mian and Sufi (2009, 2010) analyze individual zip code data on mortgage originations and household income for the pre-crisis period. They report:

Zip codes that see the largest increase in home purchase mortgage originations from 2002 to 2005 experienced relative declines in income… In fact, the evidence is even more extreme. From 2002 through 2005 the negative income growth zip codes witnesses a growth in mortgage originations that was almost twice as large as in the positive income growth zip codes! (Mian and Sufi, 2010, p. 2).

They find that “2002 through 2005 is the only period in the past eighteen years in which income growth and mortgage credit growth are negatively correlated” (Mian and Sufi, 2009, p. 1449). The explosion of mortgage credit in low and moderate income areas, and especially in areas where income is actually declining, relative to more affluent and positive income growth areas, highlights the lack of due diligence by some mortgage lenders in the pre-crisis period. (Moosa (2007) points out the close relation between operational risk and credit risk. Persistent failure to have in place or to follow good procedures for evaluating credit is a form of operational risk.)

The weakness in due diligence and internal control described in the Countrywide and National City cases in Appendix A reflect this type of operational risk. In a comprehensive pre-crisis literature summary on operational risk, Moosa (2007) points out that this issue has
attracted much more attention because of “greater dependence on technology, more intensive competition, and globalization” as well as “the emergence of new products and business lines” (p. 167). He emphasizes that defining operational risk is controversial, but regardless of the definition, the major reason operational risk has increased substantially in recent years is rapid technological change. He shows that a major bank is as likely, or perhaps more likely, to fail from operational risk than from credit risk or market risk. Moosa’s analysis confirms that our emphasis on corporate culture is appropriate. He mentions “groupthink” as a cause of operational risk; this is clearly a corporate culture argument. He cites Rao and Dev (2006) who argue that operational risk is much more under the control of management than credit or market risk and “depends strongly on the culture of the business units” (p. 173). For example, the classic operational risk case is the failure of Barings Bank in 1995. In Barings, a single trader created a $1.3 billion loss that brought down a very large institution, partly because appropriate policies were not in place and supervision was inadequate. As noted, a failure to adhere to standard banking procedures and to maintain a strong system of internal control is a common cause of operational risk losses.  

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8 Two recent examples involving large banks further illustrate that the complex relations among internal controls, operational risk and bank litigation are ongoing concerns. Federal regulators and the US Justice Department decided not to indict HSBC for money laundering and illegal transfers involving Iran and terrorist groups because criminal prosecution might cause the bank to lose its US charter and cut the bank off from investors. The loss of a major bank was also considered a potential threat to the global financial system and the fragile US economic recovery. The bank entered into a deferred prosecution agreement with the Justice Department for violations dating back to 2001 (US Department of Justice, 2012; United States of America against HSBC Bank USA, N.A. and HSBC Holdings PLC, 2012; Silver-Greenberg, 2012). Six months later, court documents were released revealing that the
The argument in the present paper that operational risk and weaknesses in internal control reflects the corporate culture and these causes are thus internal to the firm is also consistent with Chernobai, Jorion and Yu (2011). They analyze a database of 2,426 operational risk events involving 731 US financial institutions from 1980 to 2005. They conclude “currently, a large number of banks treat operational losses as independent events.” However, “the evidence suggests that many factors internal to the firm contribute to the occurrence of operational risk events of all types. This implies that the common assumption of independence of events within the firm may be seriously flawed, and that internal measures of operational risk capital are understated” (p. 1,719). They also report, consistent with our argument in this paper, that “most operational losses can be traced to a breakdown in internal control” (p. 1683).

The sample used by Chernobai, Jorion and Yu (2011) involves 925 publically reported operational risk events involving 176 US financial institutions from 1980 to 2005. They report the largest operational risk events in an appendix table. They place these events into the following six categories: “Internal Fraud….External Fraud… Employment Practices and Workplace Safety...Clients, Products and Business Practices….Business Disruption and System Failures…. Execution, Delivery and Process Management” (pp. 1720-21). There are a total of 17 large events that (by our analysis) may be under the control of management. (We exclude a seventh category, events related to the terrorist attacks of September 11, 2001 (entitled “Damage to Physical Assets” in their paper) from the events analyzed here.) Seven of the 17 events involve insurance companies, which are outside the scope of the present study, and one involves a 1982 allegation of fraud during the savings and loan crisis. Hence, there are nine other

140-year-old Zions Bank of Utah had facilitated fraudulent internet money transfers and benefited substantially (Silver-Greenberg, 2013). Hence, these issues go beyond the financial crisis.
operational risk events involving depository financial institutions or subsidiaries of BHCs. Two of these nine operational risk events involve Citigroup, two involve Bank of America, one involves Washington Mutual, and one involves JPMorgan Chase. Washington Mutual experienced serious financial problems and was merged into another institution during the financial crisis. JPMorgan Chase continues to experience significant operational risk problems (e.g., Langley and Fitzpatrick, 2013). Some examples of the nine large operational risk events are large settlements for allegedly aiding and abetting Enron financial fraud (Citigroup), the payment of fraudulent medical claims by Travelers, an insurance subsidiary of Citigroup, and questionable lending practices (Fleet Financial, now part of Bank of America). Most of the major operational risk events identified by Chernobai, Jorion and Yu resulted in litigation. (They do not identify any other individual operational risk events in addition to those discussed here.)

Cummings, Lewis and Wei (2006) also study a large number of financial institution operational risk events and their causes. They note that “mergers and acquisitions create operational risk arising from the integration of previously separate information systems” (p. 2606). Particularly important in this context is our case study of Wachovia, which was formed through a large number of mergers over many years and was a major operational risk failure. Researchers could integrate legal expense data (if it were available) into studies of bank mergers. In addition, information on legal expense and litigation patterns could be used by regulators to identify adverse trends at individual banks after mergers have taken place, to help identify which banks can best handle the process, and which experience significant increases in operational risk. This information could be used as an input into decisions to approve or deny future mergers.
3. HYPOTHESIS DEVELOPMENT AND THE REGRESSION MODEL

3.1 Hypothesis Development

The ethical climate in a bank (ECLIMATE) depends on the incentive system within the organization (INCENTIVES), the character of the managers (CHARACTER), the quality of corporate governance (GOVERNANCE), the nominal code of conduct (NOMCODE), the effective code of conduct (i.e., how managers actually behave, EFFCODE) and the difference between the two (CODEDIFF).\(^9\)

ECLIMATE = f (INCENTIVES, CHARACTER, GOVERNANCE, NOMCODE, EFFCODE, CODEDIFF)

Excessive legal expense (LEGAL EXPENSE) reflects the ethical climate. Banks that are sued more frequently than others often have weaknesses in systems of internal control which allow one person or a group of people to perpetuate irregularities.\(^10\) In some cases the entire institution is focused on maximizing lending volume; quality becomes a secondary consideration. Legal expense also reflects other bank characteristics. For example, banks involved in mergers may have higher legal expense than other banks. The regulatory environment is different for national

\(^9\)CODEDIFF is discussed in Arjoon (2005). He suggests that rules designed primarily to protect senior managers will produce cynicism among employees and be counterproductive to the ethical climate.

\(^10\)For example, lender liability lawsuits arise in situations in which a loan officer is able to put an unsuitable loan on the bank’s books (reflecting a lack of internal control), or fails to take the proper steps to document the loan and/or perfect the bank’s security interest in the collateral. Other lender liability lawsuits arise when a loan officer calls a loan or thwarts a borrower’s attempt to use a line of credit that the bank is contractually obligated to honor. Budnitz (2006) and McNulty (2008) discuss numerous cases.
banks than for state chartered banks, and it also differs among the states. The regulatory environment may affect LEGAL EXPENSE directly or through its influence on the code of conduct. Banks with strong systems of internal control and well-developed policies and procedures should have less legal expense. Banks that deal with issues ethically as they arise (possibly through timely settlements) rather than pushing problems into the future through unnecessary litigation will also have less legal expense. Thus,

\[ \text{LEGAL EXPENSE} = g (\text{ECLIMATE}, \text{MERGER}, \text{OTHER}). \]

Litigation can be used to push problems into the future and reduce criticism of senior management. *In the short run, it may be cheaper to prolong litigation on a large operational risk problem than to resolve it in a timely manner.* To consider a not-completely-hypothetical example, if a bank has a major deposit fraud or money laundering case with anticipated settlement costs of $150 million to $200 million, and the annual costs of litigation are, say $1 million per year, it is much cheaper to litigate in the short run.\(^\text{11}\) In addition, new senior managers are often in place when the full litigation costs are realized as the case is resolved. *This approach – focusing only on the effect of litigation on current earnings rather than on the long term value of the firm – can become part of the corporate culture.*

We now integrate the above reasoning to summarize the logic behind our hypothesis. Our literature review suggests that institutions have a corporate culture (e.g., Lazear, 1995; Akerlof and Kranton, 2000, 2005), that corporate culture affects a firm’s approach to finance (Cronqvist, Low and Nilsson, 2007; Lemmon, Roberts and Zender, 2008), and that corporate culture has an ethical component (e.g., Brickley, Smith and Zimmerman, 2002). Chernobai, Jorion and Yu (2011) find that operational risk is internal to the firm. *While they do not*
introduce corporate culture into their analysis, it is very reasonable to assume that operational risk is internal because different firms have different corporate cultures.\textsuperscript{12} In this context, we note that some banks have boards of directors, CEOs, and senior management teams that are more risk averse than other banks, and that in all organizations senior managers set the direction for other managers. Specifically, we suggest that banks with aggressive corporate cultures are more likely to have weak systems of internal control and other deficiencies that eventually result in above average operational risk and higher legal expense. Some examples are the due diligence failures that preceded the financial crisis (e.g., Robertson, 2011). Aggressive corporate cultures are a matter of concern in banking because the deposit insurance put option creates an incentive for increased risk taking (e.g., Merton, 1977, 1978). Most of the major operational risk events identified by Chernobai, Jorion and Yu (2011) resulted in litigation. Since excessive litigation is a reflection of managerial weakness, if legal expense is high, bank financial performance should deteriorate \textit{after a period of time}.

For the purpose of developing the model and hypothesis, Table 1 formally presents our reasoning. The table describes two hypothetical corporate cultures, and the relation between corporate culture, operational risk and legal expense. The conservative corporate culture is characterized by strong internal controls, an emphasis on credit quality, and low operational risk. This culture results in low legal expense and stronger financial performance over time. The aggressive corporate culture is characterized by weaker internal controls, higher levels of operational risk and weaker financial performance after a period of time. There are possibly as

\textsuperscript{12}Speaking of operational risk events, Chernobai, Jorion and Yu report that “most events can be characterized as consequences of a weak internal control environment” (p. 1685) and that “these sample statistics show that many firms with operational risk events are repeat offenders” (p. 1693).
many corporate cultures in banking as there are banks; *the table describes tendencies, not absolute differences*. We posit a lag between excessive legal expense and bank performance. In the short run, aggressive and risky behavior may bolster bank earnings. Complex bank litigation often goes on for many years. The full extent of managerial weaknesses (such as deficiencies in the system of internal control) are often evident only when the litigation is resolved, which may be many years later, often when new managers are in place. Eventually, managerial weaknesses are reflected in deteriorating bank performance (PERFORM).

Hence, based on the above reasoning, we posit the following relation as the basis of our empirical analysis:

\[ \text{PERFORM}_t = h(\text{LEGAL EXPENSE}_{t-1}, \text{CONTROLS}_{t-1}) \]  

(3)

PERFORM\(_t\) is bank financial performance in period \(t\), which we measure by both credit quality and stock returns. LEGALEXP\(_{t-1}\) is our legal expense proxy (lagged)\(^\text{13}\) and CONTROLS\(_{t-1}\) represents a vector of lagged control variables to be described below. We state equation (3) as a one-period lagged relation for convenience of exposition. It is the nature of the banking business that the lag is *long and variable*, and hence virtually impossible to identify *a priori*. In our empirical analysis we do not impose any lag structure on the data. In order to take maximum advantage of the limited available data on the legal expense proxy, we do not average the data; instead we include the data for each BHC separately for each year. To be consistent, we follow this procedure for the other independent variables as well. *The hypothesis we test in our regression analysis is that a higher legal expense proxy in any year from 2002 to 2006 is*  

\(^{13}\)We state the hypothesis in terms of “excessive” legal expense. The regression procedure considers which banks have higher expense than other banks. Of course, all banks have some normal legal expense associated with drafting loan documents, pursuing collections, defending some lawsuits, and other activities.
associated with weaker financial performance in 2007 and 2008. We measure financial performance (PERFORM) by both credit quality (loan losses) and stock returns. We expect a negative relation between LEGALEXP02-06 and stock returns for 2007-08, we expect a positive relation between LEGALEXP02-06 and the three loan loss measures for 2007-08.

3.2 Regression Equations

Based on the above reasoning, we estimate two regression equations:

LOAN LOSSES08 = f (LEGALEXP02-06, ASSETS02-06, FINHOLDCO02-06, HHI02-06*LOCATION02-06, MARKET/BOOK02-06, MERGER02-06, ROE02-06).

(4)

RETURNS07-08 = g (LEGALEXP02-06, NON-PERFORMING LOANS/ASSET02-06, ASSETS02-06, MARKET/BOOK02-06, ROE02-06, HHI02-06*LOCATION02-06, FINHOLDCO02-06, MERGER02-06).

(5)

The dependent variables are:

- LOAN LOSSES08 = three measures of credit quality for 2008 relative to end-of period assets for the same year: LOAN CHARGE-OFFS/ASSETS08, LOAN LOSS PROVISIONS/ASSETS08, and NON-PERFORMING LOANS/ASSETS08. We also run the regressions using the same loan quality data for 2007.
• $\text{RETURNS07-08} = \text{abnormal-buy-and-hold returns (ABHR07-08, the difference between bank buy-and-hold returns and market-buy-and-hold returns), and buy-and-hold returns (BHR07-08). Both are measured from January 1, 2007 to December 31, 2008.}$

The explanatory variables are:

• $\text{LEGALEXP02-06} = \text{our legal expense proxy/ assets;}$

• $\text{ASSETS02-06} = \text{the natural logarithm of total assets for 2002 through 2006; }$

• $\text{FINHOLDC02-06} = \text{an indicator variable equal to one for a BHC that is a financial holding company, and zero otherwise; }$

• $\text{HHI02-06} = \text{the sum of the squared market shares, a measure of local market concentration; }$

• $\text{LOCATION02-06} = \text{an indicator variable equal to one for banks that are located in the Midwest and Northeast regions of the US, and zero otherwise; }$

• $\text{MARKET/BOOK02-06} = \text{the market value of total BHC assets divided by their book value for 2002 through 2006; }$

• $\text{MERGER02-06} = \text{an indicator variable equal to 1 for BHCs that were involved in mergers and acquisitions in the 2002 - 2006 period, and zero otherwise; }$

• $\text{NON-PERFORMING LOANS/ASSETS02-06} = \text{non-performing loans/assets for 2002 through 2006; }$

• $\text{ROE02-06} = \text{the ratio of net income to the book value of equity for 2002 through 2006.}$

$\text{ASSETS02-06 and MARKET/BOOK02-06 are the Fama-French (1993) factors commonly used to analyze stock returns. The non-performing loan variables are not the same.}$

$\text{NON-PERFORMING LOANS/ASSETS02-06 is an explanatory variable in equation (5) while}$
NON PERFORMING LOANS/ASSETS07-08 is one of the three dependent variables in equation (4).

3.3 Rationale for control variables and other econometric issues

The reasons for including the control variables in equations (4) and (5) are as follows: ASSETS02-06 is included because banks of different sizes often have different lending strategies; these may produce a different loan loss experience and different stock returns. ASSETS02-06 is also a Fama-French factor. We include the Fama-French (1993) variables, ASSETS02-06 and MARKET/BOOK02-06 in equation (4) to be consistent with equation (5). BHCs that formed a financial holding company (FINHOLDCO02-06) after passage of the Gramm-Leach Bliley Act in 1999 may also have a more aggressive business strategy.

HHI02-06*LOCATION02-06, an interaction term, is included because, as discussed below, the HHI is one of the most important variables affecting bank financial performance in many studies. LOCATION02-06 is included because banks in the slower-growing Northeast and Midwest regions may have different lending strategies due to the nature of their market areas. The megabanks in the Northeast were also heavily involved in securitizing subprime mortgage loans; investors in many of these securities experienced large losses in 2007 and 2008. We use an interaction term for these two variables because they both measure the characteristics of the market that the bank competes in. MERGER02-06 is included because banks involved in a merger or acquisition may have a different loan loss experience than other banks. More importantly, they would have higher legal and accounting expenses as a result of the merger. Data on accounting expense is included in our legal expense proxy, so we need to control for the
higher proxy that would be reported by a BHC involved in one or more mergers. (As described below, the proxy is the item generally entitled “professional expense” in the 10K reports.) ROE02-06 is included because banks may be highly profitable in one period because of an aggressive lending strategy that may produce losses or lower profits in later periods. These control variables are similar to those used to analyze bank performance and risk in other studies (e.g., Berger and DeYoung (1997); Berger and Mester (1997); Akhigbe and Martin, 2008; Peni and Vahamaa, 2012).

We include ASSETS02-06, HHI02-06*LOCATION02-06, MARKET/BOOK02-06, and ROE02-06 in Equation (5) for the same reasons these variables were included in equation (4). We include NON-PERFORMING LOANS02-06 in equation (5) because loan losses should have a negative impact on stock returns.

Ordinary least squares (OLS) is the appropriate regression procedure for these data since we are predicting out of sample.\textsuperscript{14} As noted, the hypothesis we are testing is that high legal expense in any year from 2002 through 2006 is associated with weaker financial performance in 2007 and 2008.

There may appear to be simultaneous equation bias in these relations. For example, we posit that nonperforming loans depends on legal expense because legal expense is one measure of the corporate culture and system of internal control. However, legal expense depends on nonperforming loans because the expenses of collection often involve legal fees. However, the model is a lagged relationship, as described above, which substantially reduces this problem.

\textsuperscript{14} We have a panel of independent variables. Nonetheless, we cannot take advantage of panel techniques because we are predicting out of sample.
The lags are long and variable and can be up to six years (2002 to 2008). As noted, the model is not based on an accounting relationship.

4. DATA

We draw our data from four sources:

Legal expense. We examine annual 10K reports for over 150 BHCs for 2002-06, the period prior to the financial crisis. We are able to hand collect usable data on the legal expense proxy for 102 institutions. Only 83 of these institutions have stock return data available from CRSP\textsuperscript{15}. The proxy includes payments to law firms in all cases; these will definitely be higher when a bank is sued more frequently.

As shown in Table 2, we identify two accounting models used to report non-interest expense in BHC 10K reports. Accounting Model 1, described in Ryan (2007), has six categories

\textsuperscript{15} We begin with a list of the top 150 BHCs for 2006 from the American Banker. We add as many smaller BHCs with annual 10K reports as we can find, and we also search for 10K reports for earlier years. There are many additional, generally small, BHCs in the industry, but these institutions do not have stock return data on CRSP, and/or they do not publish a 10K report showing the legal expense proxy. These two factors limit our sample to 83 institutions.

One could speculate that the sample may have a reporting bias if BHCs that have high legal expense systematically choose Accounting Model 1 where legal expense is combined with a large number of other items. The best evidence we have on this point is that the three BHCs with high legal expense discussed in the case studies in the appendix all use Accounting Model 2, with its more detailed reporting. Hence reporting bias does not appear to be a serious problem. Because of the lack of more detailed reporting by some institutions, it is impossible to test this hypothesis; there are no data. Nonetheless, if this were an accurate description of actual BHC reporting patterns (i.e., if separate legal expense data were suppressed at some institutions, perhaps to hide operational risk from investors and regulators), it would support the argument made here for considering legal expense transparency.
under total non-interest expense: personnel; occupancy; technology and communications; deposit insurance; advertising; and other. “Other” expense includes an extremely large number of items in addition to legal expense. Ryan reports that this format meets all accounting and disclosure requirements. Citigroup is one example of a BHC producing a 10K report using Accounting Model 1. Peer analysis of “other expense” from this accounting model would be meaningless. For institutions following this model, legal expense cannot be analyzed, even approximately.

We exclude all BHCs following Accounting Model 1 from our analysis. There are 102 institutions following Accounting Model 1. Of these institutions, 83 have stock returns data available from CRSP.

Accounting Model 2 has more detail; the banks we include in our sample all follow Accounting Model 2 in their 10K reports. The BHCs we include in the regressions and in the rankings are the 83 institutions that have data available from CRSP to compute stock returns and also report a separate item under non-interest expense generally entitled “professional fees.” This is the legal expense proxy. Table 3 provides more detail on how the 83 BHCs using Accounting Model 2 report legal expense. This table shows that there is a high degree of reporting consistency among the 83 BHCs; most use the same or very similar terminology. Considering the point that many BHCs also use the same accounting firms, these data can be used for both the regression analysis and the case study rankings with assurance that the same or very similar items are being reported across the sample. It is clear from the descriptions in Table 3 that the data include payments to law firms in all cases. This expense measures the first step in the litigation process, and these payments to attorneys would be an ongoing expense until the matter is resolved. Settlements are generally reported as other operating expense in the 10K reports and hence are not included in the proxy.
Financial Crisis Buy and Hold Returns. We use simple buy-and-hold returns (BHR07-08) and abnormal returns (ABHR07-08, as defined above) as additional measures of bank performance during the 2007-09 financial crisis. We measure stock returns for the two-year period ending December 31, 2008.


Mergers and Acquisitions. We use Lexis/Nexis to identify those BHCs that were involved in a merger or acquisition during the sample period 2002-06.

5. DESCRIPTIVE STATISTICS AND REGRESSION RESULTS

Table 4 shows the descriptive statistics for the sample. Abnormal buy-and-hold returns for 2007-08 (ABHR07-08) average -5.11% and range from -82.66% to +79.99%. Simple Unadjusted BHRs (BHR07-08) average -43.57% and range from -96.12% to +39.99%. The other data are for 2002 to 2006. Our legal expense proxy/total assets (LEGALEXP02-06) averages 0.13% and ranges from zero (rounded) to 0.77%.

Since the median (0.11%) is fairly

Legal and professional expense of 0.77% is clearly high relative to the mean of 0.13%. By way of comparison, return on assets (ROA) for all US banks during the period 2002 through 2006 ranged from 1.28% to 1.38% (Federal Deposit Insurance Corporation, 2007). To illustrate that the difference between 0.13% and 0.77% is an economically significant difference, assume that a bank had a legal expense proxy 0.50% (or even 0.25%) higher than necessary. This would clearly cause a significant reduction in that bank’s ROA. However, in our analysis, the main link is not an accounting relationship. As illustrated in Table 1, the hypothesized link is behavioral (high litigation expense reflects managerial weaknesses) and the hypothesized relation is lagged.
close to the mean, the data have some of characteristics of a normal distribution.\(^\text{17}\) The ratio NON-PERFORMING LOANS/ASSETS\(_{02-06}\) averages 0.59% and ranges from zero to 5.71%. Total ASSETS of the BHCs average $56.2 billion. The BHCs range in size from $269 million to almost $1.5 trillion. MARKET/BOOK\(_{02-06}\) averages 266% and ranges from 108% to 1,030%. Return on equity averages 18.62% and ranges from -43.78% to +47.66%. 55.88% of the BHCs are located in the Northeast and Midwest Census regions. 38.23% of the BHCs are part of a financial holding company and 83.09% were involved in a merger or acquisition during the sample period.

We show the results of estimating equation (4) in Table 5. These results show that the legal expense proxy for 2002-06 predicts all three measures of loan quality for 2008 with statistical significance at the one percent level in one equation (non-performing loans) and the five percent level in the other two. We also run the same regression equations using all three 2007 credit quality measures and obtain similar results. (These results are not shown here to conserve space.) There are no variables that are measured contemporaneously with the dependent variable in these regression equations. Thus, the point that our legal expense proxy

\(^{17}\)As shown in Table 4, the standard deviation of legal expense/assets is also 0.0011. The difference between the mean (0.0013) and the median (0.0011 is 0.0002. Thus, the median is 0.18 (.0002/.0011) standard deviations from the mean. The data are distributed as follows: 25\(^{\text{th}}\) percentile: 0.0007; median: 0.0011; 75\(^{\text{th}}\) percentile: 0.0016; 90\(^{\text{th}}\) percentile: 0.0023. The maximum is 0.0077, indicating that there are a few outliers in the data. Table 6 indicates that one of the case study banks (National City) ranks fourth out of the 83 institutions in the sample for 2006 with a ratio of 0.0020. Thus, in 2006 NCC ranks between the 75\(^{\text{th}}\) and 90\(^{\text{th}}\) percentile for the entire distribution. (There are 408 individual bank-year observations. There would be 415 (83 times 5) individual bank-year observations if every BHC reported in every year.)
predicts all three measures of loan quality both one and two years ahead demonstrates empirically the relation between bank legal expense and future bank performance.

The control variable, ASSETS02-06, is positive and significant at the one percent level in all three equations, indicating that larger banks had higher loan losses in 2007 and 2008. ROE is positive and significant in the first two equations. This result reflects a risk-return tradeoff – on average banks that were more profitable in the pre-crisis period (reflecting greater risk in some cases) experienced higher loan losses during the crisis. These two results taken together almost certainly reflect more aggressive lending strategies by some banks (especially larger banks) in the pre-crisis period. The HHI02-06*LOCATION02-06 interaction term is positive and significant in the first two equations. Thus, banks headquartered in the Northeast and Midwest had higher loan losses than those in the South and West census regions. Some of these banks are the larger banks headquartered in the Northeast that were heavily involved in securitizing mortgage loans; some of these mortgage-backed securities later created very large losses for the institutions involved. MARKET/BOOK02-06 is positive and significant in the first two equations, but at a lower level of significance than the abovementioned variables.

Standardized regression coefficients are shown in the second column of Table 5. Standardized coefficients measure the effect on the dependent variable of a one standard deviation change in each explanatory variable. By ranking the variables in terms of the absolute value of the standardized regression coefficients, we compare the economic significance of each of the explanatory variables. (We use the absolute value because the direction of the effect is not relevant in analyzing economic significance; positive and negative coefficients of the same size indicate the same level of economic significance.) ASSETS02-06 has the largest standardized coefficient in all three regressions. LEGALEXP02-06 ranks fifth out of eight variables in both
the NON-PERFORMING LOANS/ASSETS08 equation and the LOAN CHARGE-OFFS/ASSETS08 equation, and third out of eight variables in the LOAN-LOSS PROVISIONS/ASSETS08 equation. Several of the coefficients that are ranked higher than LEGALEXP02-06 in the first two equations, ASSETS02-06, MARKET/BOOK02-06, ROE02-06 and HHI02-06*LOCATION02-06 are not generally under the direct control of management. In contrast, legal expense ranks as a very important variable affecting credit quality that management can influence. (As noted, legal expense partly reflects the efforts management has made to establish a good system of internal control, ensure adherence to well-established policies and procedures, and establish the proper culture within the organization.) Importantly, the effect of the legal expense variable is more than half the effect of ROE02-06 in all three regressions. In the third regression it has an effect that is 79% of the effect of ROE (0.1127 for LITEXP02-06 vs. 0.1431 for ROE02-06). Clearly, legal expense has economic significance in predicting bank credit quality. We return to the issue of economic significance below.

The results of estimating equation (5) are shown in Table 6. Legal expense predicts two additional measures of bank performance with high statistical significance. In the first regression, which uses buy-and-hold returns for 2007-08 as the dependent variable, LEGALEXP02-06 is significant at the one percent level. In the second regression, which uses abnormal buy-and-hold returns for 2007-08 as the dependent variable, LEGALEXP02-06 is significant at the five percent level. It has the expected negative sign in both equations – higher legal expense in the pre-crisis period is associated with lower stock returns. ASSETS02-06 is negative and significant at the one percent level in both equations. Thus, as in the previous set of results, smaller banks perform better — these banks have higher stock returns during the 2007-
08 financial crisis period\textsuperscript{18}. ROE02-06 is positive and significant at the one percent level. This indicates that BHCs with a higher ROE in 2002-06 also had higher returns during the crisis by both measures. BHCs that formed a financial holding company also had higher returns by both measures with significance at the one percent level. Banks with higher levels of non-performing loans in 2002-06 actually had higher stock returns in 2007-08. In interpreting this result, we note that non-performing loans in 2002-06 were modest, with a mean value of 0.59\% of assets and a median of 0.42\% (Table 4). Therefore, the sign of this coefficient should not be overemphasized.

In the rankings of the standardized coefficients in Table 6, LEGALEXP02-06 ranks fourth out of eight variables. It ranks higher than NON-PERFORMING LOANS02-06, MARKET/BOOK02-06, the HHI02-06*LOCATION02-06 interaction term, and MERGER02-06. Its effect in the first equation is over 40\% of the effect of ROE (0.1328 for LITEXP02-06 vs. 0.2912 for ROE). Its effect in the second regression is also about 40\% of the effect of ROE (0.1915 for LITEXP02-06 vs. 0.4968 for ROE.) Again, legal expense is economically significant. These results are especially noteworthy because LEGALEXP02-06 contains expenses other than legal expense.

A large number of both theoretical and empirical studies have found local market concentration (usually measured by the HHI) to be a very important determinant of bank performance (e.g., Berger and Hannan, 1989; Hannan, 1991; DeYoung and Hassan 1998; Akhigbe and McNulty, 2003; Hannan and Prager, 2004). The point that the standardized regression coefficient of our legal expense proxy is actually higher than that of

\textsuperscript{18}Throughout the text we refer to the 2007-09 financial crisis. The end of the recession that is associated with the crisis is considered to be March 2009. We measure stock returns through December 2008.
HHI06*LOCATION02-06 in a number of the regressions further demonstrates the importance of legal expense in the analysis of bank performance.

Considering the five regressions, LEGALEXP02-06 is significant at the one percent level in three of the five equations and at the five percent level in the other two. The level of economic significance is generally at least 40% of that of return on equity; it is 79% of the effect of ROE in one regression. It also compares favorably to the HHI interaction term. It is important to note that even after controlling for factors reflecting more aggressive strategies (e.g., non-performing loans in the second equation), the legal expense proxy predicts stock returns with high statistical significance. The case study results described in Appendix A provide additional evidence supporting the hypothesis that legal expense (and litigation patterns) predicts future bank financial performance.

6. POLICY IMPLICATIONS AND IMPLEMENTATION

6.1. Policy Implications for Operational Risk and Market Discipline

Moosa (2007) notes “it would be rather difficult to argue against the proposition that diversity is indeed a distinguishing characteristic of operational risk” (p. 172). Excessive litigation against a bank is one indicator of one type of operational risk because it reflects weaknesses in the system of internal control. This could manifest itself in inadequate policies and procedures, a lack of proper training for employees, overlapping or unclear lines of authority, an aggressive lending strategy, opportunistic treatment of borrowers, or other weaknesses. One indicator of weaknesses in internal control is legal expense significantly above
peer institutions. Because banks are not required to report legal expense separately on call reports or BHC Y9 reports and are not confronted with unfavorable peer group comparisons, managers can mislead investors, regulators, and themselves about the extent of this risk in the short run. Indeed, bank managers can use protracted litigation to hide a corporate culture characterized by weak internal controls.

We suggest that excessive operational risk can be mitigated by market discipline. There is significant interest in market discipline in banking among both academics and bank regulators. In such an environment, managers are discouraged from taking actions, or creating and perpetuating a corporate culture, detrimental to the long-run interests of stakeholders because the results of managerial actions are transparent. Some investors who are made aware of such actions and/or cultures would be unwilling to accumulate additional shares of the company’s stock and may sell some or all of the shares they own. Market discipline should also work through the firm’s debt obligations as investors sell the firm’s bonds for the same reasons and drive up the interest rate on the bonds. Banks with significant operational risk problems may also be less able to fund themselves in the short-term money market, or be able to do so only at higher cost. The resulting decline in securities prices and the possible higher cost of short-term funding would induce managers and directors to take action to correct the operational risk issues that gave rise to the high legal expense. *Effective market discipline does not require that all investors in bank securities understand and act on legal expense data; it only requires that the marginal investor do so.*

To facilitate market discipline with respect to weak systems of internal control, regulators should consider requiring reporting of bank legal expense (item 4141) on both bank call reports and BHC Y9 reports. The ratio of legal expense to assets and to revenue could then be
incorporated into the Uniform Bank Performance Reports (UBPRs) for both banks and BHCs. The UBPR shows what percentile the institution is in for several hundred financial ratios relative to peer institutions. Since these four reports (the two financial reports and the two corresponding UBPRs) are publically available to investors, such reporting and disclosure would facilitate greater market discipline in banking. Institutions consistently in the top percentiles for both ratios would be easily identified; securities analysts and investors could begin to carefully research the causes of the excessive litigation, if necessary by examining individual cases to see if there is a pattern that reflects weaknesses in internal control. This operational-risk-related market discipline would improve the functioning of bank securities markets, enhancing overall economic welfare. It would also improve the bank regulatory process by providing incentives for managers to improve their systems of internal control without direct pressure from regulators.

In Appendix C we show that during 2002-12 less than 15% of BHCs reported legal expense on their Y9 reports, and in recent years there has been no reporting on call reports. This is an important omission because much of bank regulation is at the individual bank level. The three case study banks did not report legal expense in any year from 2002 through 2007, despite their very high legal exposure documented in this paper (Appendix A). The lack of a reporting requirement creates unnecessary information asymmetries since investors are not well informed about bank operational risk, no doubt leading to mispricing of bank securities.

The data should also prove useful for bank regulators. Regulators have confidential databases that contain many items not available to the public; it is difficult to know if a measure of legal expense is available from these sources and is used by regulators. The best evidence that such a measure is not used is that no recent early warning model of bank financial distress published by economists in the bank regulatory community in the past ten years that we could
identify contains legal expense as a predictor (see, e.g., Guenther and Moore, 2003; Jagtiani, Kolari, Lemieux and Shin, 2003; and Whalen (2010). Our research indicates that the ratio of the legal expense proxy to total assets predicts bank financial problems. If the data were reported, it could and should be incorporated into early warning models of bank financial distress. In addition, if weak systems of internal control are identified by bank examiners through the analysis of legal expense, this should affect the “Management” component of the bank’s ratings in the CAMELS rating system.19

As discussed in Appendix B, bank regulators already have important responsibilities with respect to legal risk. Federal bank examiners are required to determine if there is a pattern of excessive litigation that puts the bank at risk (Office of the Comptroller of the Currency, 2000). These responsibilities would be easier to fulfill if the UBPR contained legal expense ratios. It is doubtful that examiners have a good measure of how much legal expense is normal for a given peer group of banks because the data are not reported. Bank compliance officers and directors could also find legal expense data helpful in fulfilling their responsibilities. In summary, the data could be an important tool for investors, regulators, bank compliance officers and bank directors, since they all have responsibilities with respect to operational risk.

19 CAMELS represents the rating system for individual banks used in the bank examination process; it is an acronym for capital adequacy, asset quality, management quality, earnings, liquidity and sensitivity to market risk. Koch and MacDonald (2010) provide details.
6.2. Value enhancing vs. value destroying litigation.

Not all bank litigation reflects operational risk. There are a large number of cases that take place every year in which a financial institution is involved in litigation but has done nothing wrong. In *Regions Bank vs. Guardian Financial Services* (2011) a bank put a first mortgage of approximately $3 million on a property for which another financial institution had an existing and valid first mortgage that had not been paid off. Naturally, the institution with the valid first mortgage needed to defend its claim in court. Additional examples involve disputes over collateral such as automobile titles or other assets, collecting on delinquent loans, Uniform Commercial Code interpretations, deposit and money transfer transactions, and investment suitability issues involving the bank’s trust department. Put simply, a BHC can handle a deposit, loan, investment, or investment banking transaction in an entirely appropriate manner and still be sued.

Attorneys’ fees may not involve litigation. In the process of financial innovation a bank often needs to involve attorneys to be sure the rights and claims of all parties to a transaction are protected. Koch and MacDonald (2000, p. 21) present a comprehensive list of major financial innovation from 1961 to 1998 by both bank and non-bank financial institutions, most of this would have required significant input from attorneys. (The list contains 32 items; some examples are money market mutual funds, derivative mortgage-backed securities, interest rate swaps, credit derivatives, and internet banking.) BHCs also involve attorneys in drafting loan documents, providing advice, expertise, and assistance with documentation with regard to mergers and acquisitions and investment banking transactions, and numerous other services. As noted throughout, much of this would be *normal legal expense*. The concern of this paper is
legal expense that is above normal, i.e. well in excess of that of peer institutions. (The regression procedure used in Section 5 automatically identifies legal expense that is above the mean.) While some legal expense is value enhancing, the empirical results of this paper suggest that a significant portion of bank litigation reflects value-destroying bank operational risk.

We must emphasize that high legal expense alone should not subject a bank to criticism, and should not necessarily cause investors to sell bank securities. Consistently high legal expense provides a signal that securities analysts and bank examiners needs to look further by examining litigation patterns. What is the bank being sued for, is there a pattern of similar litigation, and do the bank's alleged actions involve operational risk? BHCs themselves provide a guide in their 10K reports which should summarize major litigation against the firm.

6.3. Alternatives for legal expense reporting.

There are at least two choices for reporting. Regulators could simply require banks to fill in the blank space on the current call report for item 4141 (“legal expenses and fees”) or they can break legal expense into components. (Of course, making the proposal more complex reduces the probability that it will be implemented.) One simple breakdown would be to divide legal expense into two categories: (a) expense associated with litigation and (b) other legal expense. This would require changing the call report and adding additional instructions. Law firms would have to bill the bank separately for the two items, and bank accountants would have to learn to differentiate between the two categories. Simply amending the call report and requiring

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20 The case studies in Appendix A provide examples of the types of bank litigation that reflect operational risk and deserve such scrutiny.
reporting of one item may be sufficient until regulatory agencies, investors, and bankers themselves gain experience in using the data. Initially, only those BHCs consistently in, say the 90th percentile or above in the ratio of legal expense/assets and legal expense/revenues may be scrutinized. Early warning models would need to be developed and verified. These procedures would take time, and participants should learn about the data in the process. It is possible that the results of increased operational risk would not be evident until the banking industry enters another period of sustained high loan losses such as it experienced in 2007-09, and in the 1980’s and early 1990s. Nonetheless, if even a few bad individual actors exit the banking industry, and if bank compliance officers are able to work within the bank to improve its procedures after excess litigation occurs, the banking industry will be well served by the improved reporting, and its purpose will be accomplished.

7. CONCLUSIONS

Corporate culture theory postulates that the labor market is characterized by a process whereby workers self-select firms composed of individuals who think as they do, and that firms endeavor to develop a common set of values in their employees (e.g., Lazear (1995); Van den Steen, 2005, 2010). Applying this notion to banking suggests that people who are inclined to take greater risk in financial transactions, and/or who are less careful and precise than others, may be employed by firms containing other individuals with similar characteristics. These firms may well have weaker systems of internal control than they should. Since federal regulators have an incentive to identify such BHCs, they need to better understand corporate
culture. Bank legal expense is one measure of corporate culture because banks are sued more frequently when there are weaknesses in their systems of internal control.

Legal risk is a form of operational risk, a major form of bank risk (e.g., Basel Committee on Bank Supervision, 2006; Koch and MacDonald, 2010; Robertson, 2011). A comprehensive literature survey emphasizes that banks are more likely to fail from operational risk than from credit or market risk, and that such risk has increased dramatically in recent years because of rapid technological change (Moosa, 2007). Consistently high legal expense at a bank could reflect a weak system of internal control manifested in opportunistic bank behavior, the absence of certain values within the corporate culture, an aggressive approach to the banking business, and/or a lack of proper training for employees. Nonetheless, there are only a few studies in the finance literature exploring bank legal risk, such as Zeiden (2013) and Nguyen, Hagendorf and Eshraghi (2015).

We develop a unique hand-collected data set from annual 10K reports for bank holding companies (BHCs) for the pre-financial-crisis period, 2002 through 2006, to construct a legal expense proxy. This measure includes payments to attorneys for all BHCs and excludes settlements. It thus reflects differences among banks in total (unobservable) bank legal expense. We test the hypothesis that this legal expense proxy predicts future (2007-08) bank performance. We find that it predicts three different measures of credit quality and two different measures of bank stock returns with a high degree of both statistical and economic significance. Consistent with our hypothesis, credit quality is lower in both 2007 and 2008, and stock returns are also lower, for banks with high legal expense. Three of the coefficients are significant at the one percent level, and the remaining two coefficients are significant at the five percent level. The standardized regression coefficient for legal expense ranks as high as third out of eight
independent variables, and no lower than fifth. These results indicate that the legal expense proxy has an effect that is equivalent to other variables that have a major effect on bank performance, such as local market concentration. This finding is consistent with our argument that high legal expense is an indicator of managerial weaknesses. We believe that our research is the first to find that legal expense predicts future bank performance.

Further evidence relevant to our hypothesis is provided in case studies of three noteworthy bank failures during the financial crisis (Countrywide, National City and Wachovia), as reported in Appendix A. All three BHCs show extensive litigation and very high legal expense relative to peer banks before the crisis. All three banks rank high relative to peer banks in the ratio of legal expense to total assets. In the first case, Countrywide experienced a rapid increase in legal expense between 2004 and 2006. In the second case, National City ranks fourth out of 83 banks in 2006 and is either in the top tenth percentile, or close to it, in the ratio of the legal expense proxy to total assets from 2002 through 2006. In the third case, Wachovia experienced a large amount of highly unusual banking litigation related to weak internal controls before it failed; it generally ranks in the top one third of large banks, and is generally in the top half, with respect to the same ratio.

Operational risk was originally considered exogenous to the banking firm, but more recent literature, including this paper, suggests that it is internal. Different banks have different corporate cultures, and bank litigation (both the legal expense data and litigation patterns) reflects the corporate culture and the system of internal control. The notion that the causes of operational risk are internal to the firm is consistent with Chernobai, Jorion and Yu (2011) who analyze a database of 2,426 operational risk events involving 731 US financial institutions from 1980 to 2005. They conclude “currently, a large number of banks treat operational losses as
independent events.” However, “the evidence suggests that many factors internal to the firm contribute to the occurrence of operational risk events of all types. This implies that the common assumption of independence of events within the firm may be seriously flawed…” (p. 1,719). They also report that “most operational losses can be traced to a breakdown in internal control” (p. 1683). We note further that if corporate culture is a primary cause of bad behavior, it is unlikely that breaking up large banks exhibiting such behavior, a possibility mentioned by some industry observers, will produce a change unless the breakup changes the culture.

Currently, a measure of total legal expense is not available to the investing public. We find that less than 15% of BHCs report legal expense on regulatory reports, and the three case study banks did not report in any year from 2002 through 2007, despite their very high legal exposure documented in this paper. In recent years there is no reporting of legal expense on call reports. This creates unnecessary information asymmetries as investors are not as informed as they could be about bank operational risk. This no doubt leads to mispricing of bank securities. To allow financial markets to discipline banks with weak systems of internal control, regulators should consider requiring reporting of bank legal expense on both bank call reports and BHC Y9 reports. The ratios of total legal expense to assets and total legal expense to revenue could then be incorporated into the Uniform Bank Performance Reports (UBPRs) for both banks and BHCs. Since the financial reports and the UBPRs are publically available to investors, such reporting and disclosure would allow investors to identify banks with potential weaknesses in internal control. It would also allow regulators to identify banks that can handle bank mergers without a major increase in operational risk. This corporate-culture-related market discipline would improve the functioning of bank securities markets and the bank regulatory process, and enhance overall economic welfare.
APPENDIX A

CASE STUDIES OF COUNTRYWIDE/BANK OF AMERICA, NATIONAL CITY, AND WACHOVIA

a. Overview

These three case studies consider three major BHCs that were merged into other institutions during the crisis because of serious financial problems (Countrywide, National City and Wachovia). All three rank above the median in the ratio of the legal expense proxy to total assets in 2006; National City ranks fourth out of 83 BHCs in 2006, and among the top ten percent in three of the five years, 2002-2006. All three experienced a very unfavorable pattern of litigation against the bank in the pre-crisis period. In the first case, Countrywide engaged in high-risk mortgage lending before the crisis. It experienced a 36% increase in legal expense (measured by the proxy) between 2004 and 2005 and a 70% increase between 2005 and 2006, while total assets and total revenues rose only modestly. These are the largest increases of any major financial institution for which data are available. In the second case, National City, another very aggressive mortgage lender, ranks in the top tenth percentile among the sample BHCs in four of the five years 2002-06 in the ratio of the legal expense proxy to total assets. In the third case, Wachovia had weak internal controls that allowed Mexican cartels to launder drug money and telemarketers to steal hundreds of millions of dollars from customers’ accounts, and
many other operational risk weaknesses also revealed in litigation. These may appear to be extreme examples, but the activities at issue did boost earnings in the short run. Thus, legal expense and litigation patterns help predict three noteworthy and severe problem bank situations associated with the financial crisis.

b. *Countrywide (CFC) and Bank of America (BOA).*

Countrywide is well known for its high-risk mortgage lending practices in the pre-crisis period. The firm allegedly used extremely deceptive sales practices to make hundreds of billions of dollars of mortgage loans that borrowers could not afford. An intense sales culture drove the company (Morgenson, 2007; Michaelson, 2009) as CFC employees allegedly encouraged borrowers to purchase homes that they could not afford, and its commission structure rewarded these salespeople (Morgenson, 2007). Commission rates were much higher for subprime loans than for prime loans. The firm attempted to place borrowers in higher risk categories than appropriate; FHA loans were discouraged, even when most suitable for the borrower, because of lower commissions. Company profit margins on some high-risk loans (e.g., loans with prepayment penalties to high-risk borrowers) reached 15% in some cases, compared to 3 to 5% on other loans. Prepayment penalty loans were encouraged because investors paid more for loans with prepayment penalties, since returns were locked in (Morgenson, 2007).

The Countrywide loans were packaged into mortgage-backed securities (MBSs) and sold to investors through securities dealers. CFC’s MBS have been associated with foreclosures,

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21 According to complaints filed by the US Department of Justice in the cases, some of these activities began as early as 2001, and possibly earlier (see Appendix A). Wachovia settled the telemarketing case for $178 million in 2008 (Duffy, 2008).
major losses for the investors, and a flood of litigation. Befitting its culture, CFC treated foreclosure as a profit center. Countrywide resisted efforts to arrange renegotiated loans for troubled borrowers (Schwartz, 2007), fought responsible lending legislation, and often significantly exaggerated amounts owed in foreclosure. Courts throughout the country have considered evidence that Countrywide’s attorneys routinely forged documents to justify higher recoveries and filed the false documents in court. Judges repeatedly sanctioned CFC in foreclosure cases.

By June 2008, CFC was the subject of investigations by the Securities and Exchange Commission, the FBI, and the Federal Trade Commission and was being sued by many state attorneys general and community groups for extremely loose underwriting practices, improper and hidden fees, inflating amounts owed and failing to keep accurate records of balances, attempting to obtain money and property from debtors under false pretenses, filing inaccurate pleadings in bankruptcy court and other abuses of the bankruptcy system. In one case Countrywide boarded up a home without a judgment or a court order when the homeowner was actually current on the loan (Efrati, 2007, Morgenson, 2008a, 2008c, 2008d). The company also allegedly lost or destroyed more than half a million dollars in checks paid by homeowners in bankruptcy over a two-year period. There were 300 bankruptcy cases in western Pennsylvania alone where such issues were raised (Morgenson, 2008c). There was clearly a weakness in internal control.

Angelo Mozilo, the firm’s owner for many years and the alleged architect of its business strategy, was also the subject of investigations by both the Securities and Exchange Commission and the U.S. Justice Department. The Wall Street Journal announced in May 2009, “SEC Ready to Charge Mozilo with Fraud” (Scannell and Emshwiller, 2009, p. A1). In June 2008, the State
of Illinois filed suit against Countrywide and Angelo Mozilo personally for fraud. The suit included many of the above allegations, including the point that people were locked into loans that they could not afford and could not get out of. The complaint argued that several loans took only 30 minutes to underwrite. The Illinois case specifically alleges that the incentive structure of the company was structured to reward employees and brokers to make the riskiest loans.

The raw data for the legal expense proxy (not shown in the tables) reveals that CFC’s legal expense was on a sharp upward trend as early as 2004. It increased by 36% between 2004 and 2005 and then increased by 70% between 2005 and 2006, while total assets and total revenues rose only modestly. These are the largest increases of any major financial institution for which data are available. Table 7 shows Countrywide’s ranks for 2002 through 2006 in the ratio of the legal expense proxy/total assets relative to all institutions in the sample. Countrywide increased from a rank of 54 in 2005 to 32 in 2006 as a result of the 70% increase in the legal expense proxy.

Countrywide was taken over by Bank of America (BOA) in January 2008 after experiencing large losses and a sharply falling stock price; BOA inherited a flood of litigation from this acquisition. Soon afterward, BOA paid $8.4 billion to settle numerous lawsuits filed by several state attorneys general, and many other lawsuits remain. Since 2008, BOA has spent billions of additional dollars to resolve further legal issues created by the Countrywide acquisition (e.g., Morgenson, 2011). One portfolio manager at the time commented in relation to BOA’s then CEO Lewis: “This is a horrible deal. Ken Lewis wants to be number one in this business and Countrywide gives him the opportunity to be the dominant player. But Bank of America has all the pieces in place already. They don’t need this.” Another investment manager was equally critical: “It’s a lot to ask Bank of America shareholders to stomach” (Morgenson,
2008b, p. C6). *The Wall Street Journal* (Efrati and Simon, 2008, p. A8) also called attention to “a flood of legal troubles” faced by Bank of America as a result of the acquisition from “a barrage of borrower suits and investigations by federal and state agencies for alleged lending and loan servicing abuses as well as shareholder suits stemming from its financial decline.” The *Journal* mentions at least a dozen class action lawsuits filed by borrowers for deceptive lending practices. Three years later the *Journal* suggested that this may have been the worst merger in American history (Ovide, 2011) because BOA’s enormous legal problems from the CFC acquisition have continued and seriously eroded BOA’s performance. As of January 2014 BOA had spent “nearly $50 billion” in legal costs associated with the Countrywide acquisition (Raice, 2014).

c. *National City Corporation.* Like CFC, National City Corporation (NCC) of Cleveland, Ohio, once one of the ten largest banks in the country, engaged in high risk mortgage lending. NCC experienced record losses from bad mortgage loans; the resulting publicity created heavy withdrawals of uninsured deposits as early as September 2008, a month before the bank was sold. Senior bank officers worried about an “immediate liquidity crisis” (Murray, 2009). NCC, a 163-year-old institution at the time, was acquired by PNC Bank in October 2008.

NCC had made a major commitment to expanding its mortgage lending. Aspiring to be a “mortgage superpower” (Mezger, 2008b), NCC purchased of a major subprime lender, First Franklin, from Bank of America eight years earlier. First Franklin specialized in mortgages for borrowers with poor credit who could borrow only at high rates of interest. NCC aggressively bought loans from mortgage brokers nationwide; many such brokers would have little interest in loan quality. NCC decided it was more profitable not to re-sell mortgage loans. In his 2001
annual report letter to shareholders, the NCC CEO stated that subprime loans “have greater lifetime value when held on the balance sheet” (Calvey, 2008).

Between 1999 and 2003, NCC’s mortgage lending volume rose from $4 billion to $30 billion, and profits from mortgage lending increased from $50 million to $1 billion per year. In May 2006, the CEO claimed in an interview, reported in Mezger (2008b), that his strategic plan was “wildly successful” because the bank was writing $130 billion in loans a year, and had become the sixth-largest mortgage lender in the country, just behind Washington Mutual and Countrywide. (Of course, all three of these institutions disappeared during the crisis.)

During the decade of the 2000’s, the Cleveland area was experiencing a major foreclosure crisis that was the subject of public hearings as early as 2002. The percentage of borrowers behind on their mortgage payments in Ohio was in 2000 and 5% in 2001, equal to the national average. By 2004 Ohio’s delinquency rate was 35% above the national average. Ohio’s foreclosure rate was slightly above the national average in 2000, then double the US average in 2002, and triple the average in 2004 (Mezger, 2008a).

Cuyahoga County’s Treasurer James Rokakis testified before Congress in March 2007 that mortgage defaults on loans made to financially strapped homeowners at high interest rates had pushed neighborhoods in Cleveland past the “tipping point” of urban blight. The number of mortgage foreclosures in the county had risen from 3,500 in 1995 to 7,500 in 2000 to 13,000 in 2006 (Turner, 2007). That the largest bank in the metropolitan area engaged in high risk subprime lending most likely contributed in a major way. Unregulated mortgage brokers no doubt contributed to the situation (Turner, 2007); these are the brokers NCC solicited for loans.

The City of Cleveland passed the first responsible lending bill in the country in 2002. The bill requires borrowers to get federally approved counseling before signing mortgage
documents for certain high-interest loans. NCC fought the bill immediately by refusing to make loans in the city, and other lenders followed. An internal First Franklin memo states: “The predatory lending law in Cleveland has caused us to temporarily suspend lending in the city of Cleveland only” (Ryan, 2002). When Toledo and other Ohio cities considered similar legislation, National City threatened to stop making loans in these areas as well (McLaughlin, 2003).

When serious problems in the subprime market developed in 2007, National City was one of the first banks to report major losses. It had held many of these loans rather than selling them, and many were loans in which the borrower had no equity. In August 2007, when the crisis intensified sharply, National City suddenly had $11 billion of mortgage loans it could not sell (Mezger, 2008b). It suddenly stopped lending. The Wall Street Journal reported in early September 2007 that both Lehman Brothers and NCC were scaling back their mortgage lending business, cutting jobs and taking third-quarter losses (Wall Street Journal 2007; Kingsbury, 2007).

National City’s First Franklin was a factor in the demise of Merrill Lynch. After paying $1.3 billion for First Franklin in 2006, Merrill declared the subsidiary worthless one year later and closed it completely. Merrill brought the issue to the attention of the Securities and Exchange Commission, charging that National City had misled it on “alleged losses” associated with certain loans (Mezger, 2008c). The SEC opened an informal investigation.

Mezger (2008b) reports that piggy-back loans, which include a loan for the down payment, were a major product for NCC. For example, if the first mortgage is for 80%, a second mortgage is made for 20%. With FNMA and FHLMC conforming loans, borrowers are prohibited from borrowing their down payment, but there were no such restrictions for subprime loans at that time.
NCC consistently ranks in the top tenth percentile, or close to it, in the ratio of the legal expense proxy/total assets for each year from 2002 to 2006 (Table 7). In addition, its legal expense is consistently increasing relative to its peers. By 2006 it ranks fourth out of 83 institutions. If these data had been collected and analyzed, NCCs potential problems in the pre-crisis period would have been much more apparent to investors.

d. Wachovia. One overview of Wachovia litigation is provided in the 126 page complaint in the class action lawsuit (Horace-Manesse v. Wells Fargo, 2010; Perlman v. Wells Fargo, 2010). Here Wachovia was accused of facilitating a money-laundering scheme and a Ponzi scheme that allegedly bilked thousands of Haitian-Americans out of millions of dollars. The issues include failure to maintain a required Anti-Money Laundering Program, and failure to file required Suspicious Activity Reports and Large Cash Transactions Reports. The complaint calls attention to a US Department of Justice criminal case against the same bank on the same issues (USA v. Wachovia, 2010) and numerous other examples of weak internal controls that were revealed in other court cases going back to at least 2001.

The bank was also accused of allowing two telemarketing firms to obtain the account information of elderly victims and then draw from the accounts using “remote access checks” (Faloney v. Wachovia (2007); USA v. Payments Processing Center (2006); Duhigg, 2008; Duffy, 2008). The bank’s involvement with the telemarketers allegedly lasted for several years beginning in 2003, shortly after the merger with First Union. Emails indicate that even after bank officers learned of the crimes, they continued to solicit the business. The bank’s association with the telemarketing firms continued even after both regulators and other banks alerted the executives to the problem. One company paid Wachovia over $1.5 million in fees in 11 months. One Wachovia executive who knew of the fraud commented about the
telemarketers, “we are making a ton of money from them” (Duhigg, 2008). Despite repeated
denials, Wachovia paid $178 million to 900,000 customers to settle the allegations after the US
Department of Justice investigation (Duffy, 2008). In another breakdown of internal controls,
Wachovia allegedly allowed Mexican drug cartels to launder large amounts of drug money
(Mollenkamp and Perez, 2010). This case was also settled, again after a Justice Department
investigation.

Wachovia (now part of Wells Fargo) also spent $148 million to settle a case with the US
Department of Justice and the Securities and Exchange Commission involving bid rigging in the
municipal securities market during the six-year period ending in 2004 (Wyatt, 2011). Five small
businesses were severely damaged or destroyed by Wachovia or its predecessors during bank
mergers (McNulty, 2008). These firms include a 118-year old Scranton, Pennsylvania shoe
business (Busy Bee v. Wachovia, 2006) and a broker of electronic equipment (Wachovia v. Gulf
Components, Counterclaim, 2003). The jury in Busy Bee, a case that took ten years to litigate,
awarded a $17.3 million verdict against Wachovia for constructive fraud, breach of contract,
breach of fiduciary duty, and negligent misrepresentation. Other important examples of weak
internal control that were revealed in litigation include allowing an unauthorized individual to
deposit a $680,000 check and subsequently obtain access to the funds (Rancy v. Wachovia,
2008).23 There are many other Wachovia cases involving allegations of allowing unauthorized
individuals to cash fraudulent checks (e.g., Palm Beach Business Services v. Wachovia, 2006).

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23 In this case, the plaintiff’s attorney was able to clearly demonstrate perjury in the deposition of the bank customer
services representative who facilitated the $680,000 transaction. The case was ultimately settled in favor of the
plaintiff after approximately three years of litigation.
Wachovia’s 2008 demise, and its subsequent merger with Wells Fargo, are associated with Wachovia’s acquisition of Golden West in 2006. A few years earlier, Golden West had pioneered the “pick a payment” mortgage, giving a borrower the option to skip a payment or make a payment that did not cover interest. These loans, many of them subprime, were highly vulnerable when house prices declined sharply. Wachovia’s CEO commented “I have to go to California to close this deal. This will either cement my reputation or get me fired” (Lowenstein, 2010, p. 70). Many firms approach mergers and other major corporate decisions with thorough and careful due diligence. This comment suggests that this may not have been the corporate culture at this institution. For 2006 Wachovia ranks in the top third of the sample banks in the ratio of the legal expense proxy to total assets, a substantial increase over previous years. If reporting had been quarterly, the increase would have been apparent sometime in 2005. This point, considered together with an analysis of the type of litigation that Wachovia was consistently engaged in might have prompted a closer look at Wachovia’s operational risk in the pre-crisis period.
APPENDIX B

USE OF THE DATA BY BANK EXAMINERS AND SUPERVISORS

a. Examiner’s Responsibilities With Respect to Bank Litigation

Bank examiners already have responsibilities in this area but they are operating without the proper tools – peer group comparisons. *The Comptroller’s Handbook: Litigation and Other Legal Matters* (Comptroller of the Currency (OCC), 2000) provides guidance to national bank examiners concerning the evaluation of a bank’s litigation experience and expense:

Real and 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 management and examiners must properly assess, and bank management must properly manage, the risks associated with litigation and other legal matters....

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. (p. 1)

The OCC takes note of lender liability lawsuits as a “significant source of potential loss for banks” (p. 3), emphasizes that behavior toward a borrower must be “rational” and “consistent with past practices and written policies and procedures” (p. 3) and calls for a “comprehensive risk management process” (p. 4). Rapid and aggressive expansion is considered a cause of problems. Guidance to examiners includes the following:

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 (p. 6; emphasis added).

Boards of directors also have significant responsibility. For example, examiners should “determine whether the board has established appropriate guidelines for managing the risks of
litigation and other legal matters” (p. 14). Examiners should also determine whether the board has discussed litigation that is pending and significant.

\[b. \textit{Recommended two-step procedure.}\]

We suggest a \textit{two-step procedure}. First, identify the banks with \textit{consistently high legal expense relative to peer banks} using the UBPR or a similar but more detailed internal report, perhaps with better peer group definitions. Some legal expense, such as the cost of preparing loan documents and defending the bank against unfounded lawsuits, are normal, and some mistakes by bank personnel that lead to litigation may be inevitable, possibly even in the best managed banks. Second, for the banks with \textit{consistently high} legal expense, evaluate the litigation against that bank to determine if there is an ongoing and systematic \textit{pattern of similar litigation} that suggests weakness in internal control.

A large amount of seemingly unrelated litigation on issues that might be related to internal control, or even one very large case, should also prompt attention. Attention should also be directed at how quickly cases are resolved. The case studies in Appendix A illustrate the way this second step is relevant in more detail. The Wachovia litigation is particularly revealing because of the large number of \textit{different areas} in the bank that were involved in significant litigation suggesting weak internal control before the bank failed.
APPENDIX C
ANALYSIS OF EXISTING REPORTING REQUIREMENTS FOR BANK LEGAL EXPENSE

*How Many Institutions Report?* The BHC Y9 financial report requires BHCs to report their major income and expense items to federal regulators each quarter, and the call report imposes similar requirements for individual banks. There are four separate components of legal and related expenses detailed in the Instructions for preparation of the Y9 Bank Holding Company quarterly financial report:

(4) Legal fees and other direct costs incurred in connection with foreclosures and subsequent noninterest expenses related to holdings of real estate owned….
(12) Charges resulting from litigation or other claims.
(14) Retainer fees, legal fees, and other fees and expenses paid to attorneys who are not officers or employees of the holding company or its consolidated subsidiaries.
(22) Civil money penalties and fines.

(Board of Governors of the Federal Reserve System, 2014).

There are similar components in the instructions for the call report. The Y9 report contains a space for legal expense as item BHCK4141; the call report contains a similar space at RIAD4141. The definition of both items is “legal fees and expenses”. *The discussion here applies entirely to item 14*, which includes attorneys’ fees, the item which our legal expense proxy represents. We are not suggesting reporting of data on settlement expense. Actual reporting of settlements is discussed below.

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24 Reporting of data on settlements may require a bank to disclose its settlement strategy in advance, which could jeopardize its settlement strategy and would be completely inappropriate. Accounting rules state that settlements are not to be reported as an expense unless the amounts can be estimated.
Table 8 reports the number and percentage of US BHCs and banks that reported in space BHCK4141 and RIAD4141 for each year from 2001 through 2012. The reporting percentages are less than 15% for the BHC Y9 report. For the call report, the percentages were under 37% until 2008. The highest reporting percentage for the call report was 56.11% in 2010. In 2011 and 2012 there was no reporting of legal expense on the call report.

To analyze the data in Table 8, we consider 2006, the last year of our study. The instructions for preparing these reports, issued in September 2006 and effective in December 2006, state as follows:

7.d Other noninterest expense.
Report all operating expense of the bank for the calendar year to date not required to be reported elsewhere in Schedule RI... Include as other noninterest expense: ... (5) Retainer fees, legal fees, and other fees and expenses paid to attorneys who are not bank officers or employees and to outside law firms. [Report the amount of legal fees and expenses in Schedule RI-E, item 2f if this amount exceeds 1 percent of the sum of the bank’s total interest income from Schedule RI, item h and its total noninterest income from Schedule RI, item 5.m.] (Federal Financial Institutions Examination Council, 2006, p. RI-20a).

Thus, in 2006 legal expense was required to be reported separately on the call report if it exceeded one percent of total interest and non-interest income. Similar requirements applied to BHCs. If legal expense is less than this threshold it is not reported separately; it is included in other noninterest expense.

Consider a hypothetical bank or BHC that has exactly $100 million in assets and has expense ratios exactly equal to the industry average in 2006. Total interest income averaged 5.68% of bank assets in 2006 and total non-interest income averaged 2.25% (FDIC, 2014). Hence total interest and non-interest income averaged 7.93% of assets in 2006. For this hypothetical bank or BHC with $100 million in assets and industry-average ratios, legal expense should have been reported for 2006 if it exceeded one percent of 7.93%, or 0.0793% of assets. For a $100 million BHC this would be $79,300. For a larger BHC it would be $79,300 per
hundred million dollars of assets. (The exact threshold for the bank and BHC would depend on that institution’s income to assets ratios which, of course, could be higher or lower than the industry average.) As shown in Table 8, only 4.05% of BHCs reported legal expense on their Y9 reports in 2006. While the data are not available (because of the lack of reporting that is under consideration here) it would be hard to defend the proposition that over 95% of BHCs had total legal expense below this threshold. Clearly, in a given year, many BHCs would be expected to spend more than $79,300 per $100 million in assets in legal expense. The percentage reporting was still only 14.62% in 2012. The most logical conclusion is that investors are not seeing data that are required to be reported.

The requirement in effect in 2006 was based in part on total interest income as a percent of assets. This percentage can vary from year to year depending on interest rates. There is no economic rationale for having a greater percentage of institutions reporting legal expense when interest rates are high than when interest rates are low.

The 2014 instructions for the Y9 report require BHCs to report legal expense separately if it exceeds 3% of “other noninterest expense.”25 The exact wording is as follows:

*Line item 7(d) Other noninterest expense.*

Report all operating expenses of the holding company for the calendar year not required to be reported elsewhere in Section HI. Disclose in Schedule HI, Memorandum items 7(a) through 7(n), each component of other noninterest expense, and the dollar amount of such component, that is greater than $25,000 and exceeds 3 percent of the other noninterest expense reported in this item. (Board of Governors of the Federal Reserve System, 2014, p. HI-17).

This set of requirements was also effective in 2013 and 2012, the last year for which we report data in Table 8. Total “other non-interest expense” was 1.27% of total assets in 2012

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25 The point that the 3 percent threshold applies to each of approximately 25 items indicates that it is clearly not a materiality threshold applied to bank litigation expense.
Again, consider a hypothetical BHC that has exactly $100 million in assets with expense ratios exactly equal to the industry average. This BHC should report legal expense separately if such expense exceeds 3% of 1.27% of assets or .0381% of assets (.03 x .0127 = .000381). This is an extremely low threshold – $38,100 per $100 million in assets. To be below it, our hypothetical $100 million BHC would have to have total legal expense less than $38,100 (.000381 x $100 million). A typical (i.e. about average) BHC with a larger asset size would have a dollar threshold that is proportionately higher but remains at approximately $38,100 per $100 million in assets. (Again, the actual requirement is based on the individual institution’s ratios.) Nonetheless, as noted, only 14.62% of BHCs reported legal expense on the Y9 report in 2012. Again, investors are not seeing data that should be reported. If legal expense data reflect operational risk, investors should have the opportunity to be informed about such risk by having the data publically reported.

We hypothesize that high legal expense is an indicator of managerial weakness, and our empirical results are consistent with this hypothesis. We find that high legal expense predicts bank financial problems several years in advance. Peer group comparisons using several years of data are necessary for a securities analyst or investor to determine if operational risk for the institution substantially exceeds industry norms. In an industry in which the percent of institutions that report is very small, reliable peer group comparisons are impossible to perform. The Uniform Bank Performance Report (UBPR) which compares several hundred financial

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26 There is a difference in the FDIC interactive website between “additional noninterest expense” (1.33% in 2012) which includes amortization and related items, and “other noninterest expense” (1.27%) which excludes these items. Consistent with the reporting instructions we use the lower figure here.
ratios for each bank with its peer group does not include legal expense. Similarly, economists developing early warning models of bank financial distress (even those working inside regulatory agencies) are apparently unable to include legal expense in their models, despite its clear predictive ability, because of a lack of consistent data for most institutions.

The three case study BHCs did report an item on their 10K reports sufficient for us to construct their legal expense proxy. These BHCs had very high legal exposure in 2002 through 2006, as discussed in Appendix A. The high values for the proxy almost certainly reflect the high legal expense resulting from this exposure. Nonetheless, these three BHCs did not report legal expense on the call report or Y9 in any year from 2002 through 2007. This is further evidence that a measure of bank legal expense (excluding consulting, accounting and auditing expense) is not available to the investing public. The lack of publically available data creates unnecessary information asymmetries since investors are not as informed as they could be about bank operational risk. This no doubt leads to mispricing of bank securities. These points further support our suggestion that regulators should consider eliminating thresholds and requiring that all institutions report legal expense (item 4141) on both bank call reports and on the Y9 report. Item 4141 should be reported and publically disclosed for all banks and BHCs.

27 These reports are available to the public at FDIC.gov and are discussed in detail in Koch and MacDonald (2011), Chapter 3.

28 In theory, institutions should compute their total legal expense to determine if they are above the threshold. In practice, thresholds may be a way for some banks to avoid reporting. In effect, thresholds appear to make legal expense reporting voluntary.

29 Much bank regulation is at the bank level where the call report is used. Legal expense data on the call report could be very helpful to bank examiners, as well as to regulatory economists developing early warning models of bank financial problems. Facilitating market discipline would require disclosure at the BHC level as well.
Legal Settlements. Settlements are reported separately in the 10K reports and hence are not included in the proxy. An example is Bank of America’s (BAC) 2014 10Q report, which contains some of the same information as the annual 10K. This is well outside the sample period, but it illustrates reporting practices at one large BHC. The report states “noninterest expense increased...$5.3 billion to $40.8 billion for the...six months ended June 30, 2014 compared to the same period in 2013, primarily driven by higher other general operating expense. These increases in other general operating expense reflected increases in litigation expense, primarily related to previously disclosed legacy mortgage-related matters, of ...$7.3 billion to $10.0 billion for the six months ended June 30, 2014 compared to the same period in 2013...” (emphasis added). Hence, for BAC, settlements are included in other general operating expense (see Table 2). This is the second largest item in total noninterest expense, and is almost as large as personnel expense ($14.6 billion for other general noninterest expense vs. $18.1 billion for personnel expense. As noted, the litigation expense item is stated as a broad range ($7.3 billion to $10 billion) rather than as a precise figure, even though a precise figure would have to be available for accountants to compile a total for other general operating expense.

Accounting rules state that settlements are not to be reported as an expense unless the amounts can be estimated. If there is a potentially large settlement, but the amount cannot be estimated, BHCs are not to report it as an expense in the current period.\(^30\) However, in the case

\(^30\) For example, Bank of America’s 2013 10K report states: “In accordance with SFAS No. 5, “Accounting for Contingencies, the Corporation establishes reserves for litigation and regulatory matters when those matters present loss contingencies that are both predictable and estimable. When loss contingencies are not both probable and estimable, the Corporation does not establish reserves.” (p. 128). Establishing a reserve requires reporting a charge for anticipated losses as an expense.
of BAC the amounts are expensed and included in other general operating expense. Our proposal would not affect the reporting of legal settlement expense.
Table 1

Hypothesized effect of corporate culture on firm performance

<table>
<thead>
<tr>
<th>Type of corporate culture</th>
<th>Indicators of the corporate culture</th>
<th>Legal expense (a measure of the ethical component of corporate culture)</th>
<th>Loan quality (lagged)</th>
<th>Market returns (lagged)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conservative</td>
<td>• Strong internal controls</td>
<td>Lower</td>
<td>Higher</td>
<td>Higher</td>
</tr>
<tr>
<td></td>
<td>• Comprehensive policies and procedures</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Lower operational risk</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Values driven credit culture</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Lower risk tolerance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aggressive</td>
<td>• Weaker internal controls</td>
<td>Higher</td>
<td>Lower</td>
<td>Lower</td>
</tr>
<tr>
<td></td>
<td>• Less comprehensive policies and procedures</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Higher operational risk</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Current profit driven credit culture</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Higher risk tolerance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Other managerial weaknesses</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

31 These relations are the basis for the hypothesis which is tested using regression analysis; as such they represent tendencies, rather than absolute categories.

32 Cronqvist, Low and Nillson (2007) distinguish between conservative and aggressive corporate cultures in banking.

33 This term reflects adherence to a set of values and customs that place the stability and longevity of the organization above monetary benefits to individuals. (As noted, many BHCs post codes of conduct on company websites and expect employees to adhere to them.) Litigation expense is one measure of the ethical climate in a banking organization, not necessarily the only measure.

34 This category includes both the existence of policies and procedures in all areas of operations as well as adherence to these policies and procedures.

35 Chernobai, Jorion and Yu (2011) find that most operational risk cases involve repeat offenders. We suggest that this finding is consistent with our hypothesis and must reflect differences in the corporate culture among the banks in their sample.

36 We adopt the terminology used by Koch and MacDonald (2010) and discussed in Section 2.
Table 2

The two accounting models used to report non-interest expense in BHC 10K reports

<table>
<thead>
<tr>
<th>Accounting Model 1</th>
<th>Accounting Model 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personnel</td>
<td>Personnel</td>
</tr>
<tr>
<td>Occupancy</td>
<td>Occupancy</td>
</tr>
<tr>
<td>Technology and Communications</td>
<td>Equipment</td>
</tr>
<tr>
<td>Deposit Insurance</td>
<td>Marketing</td>
</tr>
<tr>
<td>Advertising</td>
<td>Professional Fees*</td>
</tr>
<tr>
<td>Other</td>
<td>Amortization of Intangibles</td>
</tr>
<tr>
<td>Total Non-interest Expense</td>
<td>Data Processing</td>
</tr>
<tr>
<td></td>
<td>Telecommunications</td>
</tr>
<tr>
<td></td>
<td>Other General Operating**</td>
</tr>
<tr>
<td></td>
<td>Merger and Restructuring Charges</td>
</tr>
<tr>
<td></td>
<td>Total Non-interest Expense</td>
</tr>
</tbody>
</table>

Sources: Model 1 from Ryan (2007); model 2 from Bank of America, 2006 Annual 10K Report.

*Payments to law firms are included here, along with accounting, auditing and consulting expense (see Table 1).
**Settlements are included here, along with other items.
Table 3

How legal expense is reported in the sample BHC 10K reports

<table>
<thead>
<tr>
<th>Exact description of expense item in annual BHC 10K report</th>
<th>Number of BHCs using this description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Professional fees</td>
<td>23</td>
</tr>
<tr>
<td>Professional services</td>
<td>21</td>
</tr>
<tr>
<td>Legal and professional fees or legal and other professional fees</td>
<td>7</td>
</tr>
<tr>
<td>Legal fees</td>
<td>2</td>
</tr>
<tr>
<td>Professional and examination fees</td>
<td>3</td>
</tr>
<tr>
<td>Professional and regulatory fees</td>
<td>1</td>
</tr>
<tr>
<td>Professional and consulting fees</td>
<td>2</td>
</tr>
<tr>
<td>Professional fees and services or professional fees and outside services</td>
<td>2</td>
</tr>
<tr>
<td>Outside services or outside professional services</td>
<td>4</td>
</tr>
<tr>
<td>Attorney commissions and court costs</td>
<td>1</td>
</tr>
<tr>
<td>Legal, consulting, accounting, and auditing expenses</td>
<td>1</td>
</tr>
<tr>
<td>Legal and consulting fees</td>
<td>1</td>
</tr>
<tr>
<td>Legal, accounting and consulting</td>
<td>1</td>
</tr>
<tr>
<td>Legal and accounting</td>
<td>1</td>
</tr>
<tr>
<td>Legal costs and other professional fees</td>
<td>1</td>
</tr>
<tr>
<td>Legal, audit, accounting, and supervisory examination fees</td>
<td>1</td>
</tr>
<tr>
<td>Legal, audit, and professional fees</td>
<td>1</td>
</tr>
<tr>
<td>Legal and professional services</td>
<td>2</td>
</tr>
<tr>
<td>Legal and other professional services</td>
<td>1</td>
</tr>
<tr>
<td>Legal expenses</td>
<td>1</td>
</tr>
<tr>
<td>Litigation and operational losses</td>
<td>1</td>
</tr>
<tr>
<td>Professional and examination fees</td>
<td>1</td>
</tr>
<tr>
<td>Professional services: legal and accounting</td>
<td>1</td>
</tr>
<tr>
<td>Professional services and litigation settlement</td>
<td>1</td>
</tr>
<tr>
<td>Professional service fees</td>
<td>1</td>
</tr>
<tr>
<td>Services and fees</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>83</strong></td>
</tr>
</tbody>
</table>
Table 4
Summary statistics for variables used in the regressions

Our sample consists of 408 bank-year data points for 83 bank holding companies (BHCs) for the period 2002-06 for the independent variables (data is missing for some BHCs for some years) and comparable observations on the dependent variables for the same BHCs for 2007-08. This table presents summary statistics for both sets of variables. The dependent variables are:

- ABHR07-08 = abnormal buy-and-hold returns (the difference between the bank buy-and-hold return and the market buy-and-hold return) for 2007-08;
- BHR07-08 = bank buy-and-hold returns for 2007-2008;
- LOAN CHARGEOFFS/ASSETS07 = loan charge-offs as a percent of total assets for 2007;
- LOAN CHARGEOFFS/ASSETS08 = loan charge-offs as a percent of total assets for 2008;
- LOAN LOSS PROVISIONS/ASSETS07 = loan loss provisions as a percent of total assets for 2007;
- LOAN LOSS PROVISIONS/ASSETS08 = loan loss provisions as a percent of total assets for 2008.
- NON-PERFORMING LOANS/ASSETS07 = non-performing loans as a percent of total assets for 2007;
- NON-PERFORMING LOANS/ASSETS08 = non-performing loans as a percent of total assets for 2008.

The independent variables are:

- ASSETS02-06 = the book value of total assets for 2002-06 ($billions);
- FINHOLDCO02-06 = an indicator variable equal to one for a BHC that is a financial holding company in 2002-06, and zero otherwise;
- HHI02-06 = the Hirschman-Herfindahl index for 2002-06;
- LEGALEXP02-06 = our legal expense proxy as a percent of total assets for 2002-06;
- LOCATION02-06 = an indicator variable equal to one for banks that are located in the Midwest and Northeast regions of the US, and zero otherwise;
- LOAN LOSS PROVISIONS/ASSETS02-06 = loan loss provisions as a percent of total assets for 2002-06;
- MARKET/BOOK02-06 = the ratio of the market value of equity to its book value for 2002-06;
- MERGER02-06 = an indicator variable equal to one for BHCs that were involved in mergers and acquisitions in the sample period, and zero otherwise;
- NON-PERFORMING LOANS/ASSETS02-06 = non-performing loans as a percent of total assets for 2002-06;
- ROE02-06 = return on equity, the ratio of net-income to equity, for 2002-06.
<table>
<thead>
<tr>
<th>Variables</th>
<th>Mean</th>
<th>Median</th>
<th>Standard Deviation</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>DEPENDENT VARIABLES:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ABHR07-08</td>
<td>-0.0511</td>
<td>-0.0744</td>
<td>0.3188</td>
<td>-0.8266</td>
<td>0.7999</td>
</tr>
<tr>
<td>BHR07-08</td>
<td>-0.4367</td>
<td>-0.4744</td>
<td>0.3240</td>
<td>-0.9612</td>
<td>0.3999</td>
</tr>
<tr>
<td>LOAN CHARGE-OFFS/ASSETS 07</td>
<td>0.0039</td>
<td>0.0023</td>
<td>0.0080</td>
<td>0.0000</td>
<td>0.1883</td>
</tr>
<tr>
<td>LOAN CHARGE-OFFS/ASSETS 08</td>
<td>0.0097</td>
<td>0.0052</td>
<td>0.0143</td>
<td>0.0000</td>
<td>0.2054</td>
</tr>
<tr>
<td>LOAN LOSS PROVISIONS/ASSETS07</td>
<td>0.0046</td>
<td>0.0025</td>
<td>0.0089</td>
<td>0.0000</td>
<td>0.1530</td>
</tr>
<tr>
<td>LOAN LOSS PROVISIONS/ASSETS08</td>
<td>0.0136</td>
<td>0.0079</td>
<td>0.0175</td>
<td>0.0000</td>
<td>0.2389</td>
</tr>
<tr>
<td>NON-PERFORMING LOANS/ASSETS07</td>
<td>0.0047</td>
<td>0.0028</td>
<td>0.0092</td>
<td>0.0000</td>
<td>0.2313</td>
</tr>
<tr>
<td>NON-PERFORMING LOANS/ASSETS08</td>
<td>0.0105</td>
<td>0.0061</td>
<td>0.0152</td>
<td>0.0000</td>
<td>0.2444</td>
</tr>
<tr>
<td><strong>INDEPENDENT VARIABLES:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ASSETS02-06</td>
<td>56.24</td>
<td>4.81</td>
<td>181.75</td>
<td>0.269</td>
<td>1.46368</td>
</tr>
<tr>
<td>FINHOLDC002-06</td>
<td>0.3823</td>
<td>0.0000</td>
<td>0.4866</td>
<td>0.0000</td>
<td>1.0000</td>
</tr>
<tr>
<td>HHI02-06</td>
<td>0.2072</td>
<td>0.1791</td>
<td>0.1207</td>
<td>0.0641</td>
<td>0.7147</td>
</tr>
<tr>
<td>LEGALEXP02-06</td>
<td>0.0013</td>
<td>0.0011</td>
<td>0.0011</td>
<td>0.0000</td>
<td>0.0077</td>
</tr>
<tr>
<td>LOAN CHARGE-OFFS/ASSETS 02-06</td>
<td>0.0047</td>
<td>0.0031</td>
<td>0.0059</td>
<td>0.0000</td>
<td>0.0549</td>
</tr>
<tr>
<td>LOAN LOSS PROVISIONS/ASSETS02-06</td>
<td>0.0037</td>
<td>0.0026</td>
<td>0.0053</td>
<td>0.0000</td>
<td>0.0659</td>
</tr>
<tr>
<td>LOCATION02-06</td>
<td>0.5588</td>
<td>1.0000</td>
<td>0.4971</td>
<td>0.0000</td>
<td>1.0000</td>
</tr>
<tr>
<td>MARKET/BOOK 02-06</td>
<td>2.6580</td>
<td>2.4154</td>
<td>1.0967</td>
<td>1.0760</td>
<td>10.2963</td>
</tr>
<tr>
<td>MERGER02-06</td>
<td>0.8309</td>
<td>1.0000</td>
<td>0.3753</td>
<td>0.0000</td>
<td>1.0000</td>
</tr>
<tr>
<td>NON-PERFORMING LOANS/ASSETS 02-06</td>
<td>0.0059</td>
<td>0.0042</td>
<td>0.0069</td>
<td>0.0000</td>
<td>0.0571</td>
</tr>
<tr>
<td>ROE02-06</td>
<td>0.1860</td>
<td>0.1907</td>
<td>0.0839</td>
<td>-0.4378</td>
<td>0.4766</td>
</tr>
</tbody>
</table>
Table 5

**Regression results relating legal expense to non-performing loans, loan charge-offs, and loan-loss provisions**

This table shows the effect of legal expense and other explanatory variables for 2002-06 on non-performing loans, loan charge-offs, and loan loss provisions in 2008. Non-performing loans is the dependent variable in model 1, charge-offs is the dependent variable in model 2, and loan loss provisions is the dependent variable in model 3. The independent variables are computed for 2002-06. They are: LEGALEXP02-06 = our legal expense proxy as a percent of total assets; ASSETS02-06 = the natural log of total assets; MARKET/BOOK02-06 = the ratio of the market value of equity to the book value of equity; ROE02-06 = the ratio of net-income to equity; HHI02-06*LOCATION02-06 = an interaction variable between the HHI (Hirschman-Herfindahl index) and an indicator variable equal to one for banks headquartered in the Midwest and Northeast regions of the US, and zero elsewhere; FINHOLDCO02-06 = an indicator variable equal to one for a BHC that is a financial holding company, and zero otherwise; MERGER02-06 = an indicator variable equal to one for BHCs involved in mergers and acquisitions during any year from 2002 through 2006, and zero otherwise.

The standardized coefficients measure the impact of a one standard deviation change in the explanatory variable on the dependent variable. The symbols *, **, and *** indicate statistical significance for the regression coefficients at the 10 percent, 5 percent, and 1 percent levels, respectively.

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>NON-PERFORMING LOANS/ASSETS08</td>
<td>LOAN CHARGE-OFFS/ASSETS08</td>
<td>LOAN LOSS PROVISIONS/ASSETS08</td>
</tr>
<tr>
<td>Parameter Estimate</td>
<td>1.3568***</td>
<td>1.1233**</td>
<td>1.4372***</td>
</tr>
<tr>
<td>Standardized Coefficient (Rank)</td>
<td>0.1329 (5)</td>
<td>0.1161 (5)</td>
<td>0.1127 (3)</td>
</tr>
<tr>
<td>Parameter Estimate</td>
<td>0.0008***</td>
<td>0.0008***</td>
<td>0.0015***</td>
</tr>
<tr>
<td>Standardized Coefficient (Rank)</td>
<td>0.4429 (1)</td>
<td>0.4350 (1)</td>
<td>0.6429 (1)</td>
</tr>
<tr>
<td>Parameter Estimate</td>
<td>-0.0012**</td>
<td>-0.0011*</td>
<td>-0.006</td>
</tr>
<tr>
<td>Standardized Coefficient (Rank)</td>
<td>-0.2029 (4)</td>
<td>-0.1896 (4)</td>
<td>-0.0788 (6)</td>
</tr>
<tr>
<td>Parameter Estimate</td>
<td>0.0185**</td>
<td>0.0174**</td>
<td>0.0150</td>
</tr>
<tr>
<td>Standardized Coefficient (Rank)</td>
<td>0.2213 (3)</td>
<td>0.2191 (3)</td>
<td>0.1431 (2)</td>
</tr>
<tr>
<td>Parameter Estimate</td>
<td>0.0208***</td>
<td>0.0211***</td>
<td>0.0117***</td>
</tr>
<tr>
<td>Standardized Coefficient (Rank)</td>
<td>0.2247 (2)</td>
<td>0.2401 (2)</td>
<td>0.1009 (5)</td>
</tr>
<tr>
<td>Parameter Estimate</td>
<td>0.0002</td>
<td>0.0002</td>
<td>0.0009</td>
</tr>
<tr>
<td>Standardized Coefficient (Rank)</td>
<td>0.0073 (7)</td>
<td>0.0064 (6)</td>
<td>0.0248 (7)</td>
</tr>
<tr>
<td>Parameter Estimate</td>
<td>0.0003</td>
<td>0.0146 (6)</td>
<td>0.0007</td>
</tr>
<tr>
<td>Standardized Coefficient (Rank)</td>
<td>0.0146 (6)</td>
<td>-0.0014 (7)</td>
<td>0.0248 (7)</td>
</tr>
</tbody>
</table>

| N | 408 | 408 | 408 |
| Adjusted R² | 0.5560 | 0.5335 | 0.5930 |
| F-Value | 64.87*** | 59.31*** | 75.31*** |
Table 6

Regression results relating legal expense to buy-and-hold returns and abnormal buy-and-hold returns

This table shows the effect of legal expense and other explanatory variables for 2002-06 on buy-and-hold returns, and abnormal buy-and-hold returns, for January 1, 2007 to December 31, 2008. The buy-and-hold return is the dependent variable in model 1, and the abnormal buy-and-hold return is the dependent variable in model 2. The independent variables are computed for 2002-2006. They are: LITEXP02-06 = our legal expense proxy as a percent of total assets; ASSETS02-06 = the natural log of total assets; MARKET/BOOK02-06 = the ratio of the market value of equity to the book value of equity; ROE02-06 = the ratio of net-income to equity; HHI*LOCATION02-06 = an interaction variable between the HHI (Hirschman-Herfindahl index) and an indicator variable for banks located in the Midwest and Northeast regions of the US and zero elsewhere; FINHOLDCO02-06 = an indicator variable equal to 1 for a BHC that is a financial holding company, and zero otherwise; MERGER02-06 = an indicator variable equal to one for BHCs involved in mergers and acquisitions during any year from 2002 through 2006, and zero otherwise.

The standardized coefficients measure the impact of a one standard deviation change in the explanatory variable on the dependent variable. The symbols *, **, and *** indicate significance at the 10 percent, 5 percent, and 1 percent levels, respectively.

<table>
<thead>
<tr>
<th></th>
<th>Model 1</th>
<th>Model 2</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Buy-and-hold returns (BHR07-08)</td>
<td>Abnormal buy-and hold returns (ABHR07-08)</td>
</tr>
<tr>
<td>Parameter Estimate</td>
<td>Standardized Coefficient (Rank)</td>
<td>Parameter Estimate</td>
</tr>
<tr>
<td>LEGALEXP02-06</td>
<td>-41.5535***</td>
<td>-0.1328 (4)</td>
</tr>
<tr>
<td>NON-PERFORMING LOANS/ASSETS02-06</td>
<td>5.5773**</td>
<td>0.0967 (5)</td>
</tr>
<tr>
<td>ASSETS02-06</td>
<td>-0.0650***</td>
<td>-1.1082 (1)</td>
</tr>
<tr>
<td>MARKET/BOOK02-06</td>
<td>-0.0067</td>
<td>-0.0362 (8)</td>
</tr>
<tr>
<td>ROE02-06</td>
<td>0.7483***</td>
<td>0.2912 (2)</td>
</tr>
<tr>
<td>HHI*LOCATION02-06</td>
<td>-0.168</td>
<td>-0.0591 (6)</td>
</tr>
<tr>
<td>FINHOLDCO00-06</td>
<td>0.1509***</td>
<td>0.1719 (3)</td>
</tr>
<tr>
<td>MERGER02-06</td>
<td>0.0332</td>
<td>0.0584 (7)</td>
</tr>
<tr>
<td>N</td>
<td>408</td>
<td>408</td>
</tr>
<tr>
<td>Adjusted R²</td>
<td>0.6327</td>
<td>0.0654</td>
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<tr>
<td>F-Value</td>
<td>77.85***</td>
<td>4.12***</td>
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</tbody>
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Table 7

Rankings of the three BHCs covered in the case studies relative to all 83 sample BHCs

This table is compiled from annual 10K reports for the three BHCs analyzed in the case studies, and comparable data for the entire sample of 83 BHCs. The rankings are based on the ratio of the legal expense proxy to total assets in decimal form. BHCs are ranked from highest to lowest for each year based on this ratio. Reporting formats differ among BHCs; the proxy most often consists of an item labeled professional fees or professional services on the BHC’s income statement.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>National City</td>
<td>.002023</td>
<td>4</td>
<td>6</td>
<td>9</td>
<td>7</td>
<td>12</td>
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<tr>
<td>Countrywide Financial</td>
<td>.000995</td>
<td>32</td>
<td>54</td>
<td>58</td>
<td>45</td>
<td>42</td>
</tr>
<tr>
<td>Wachovia</td>
<td>.001232</td>
<td>35</td>
<td>33</td>
<td>43</td>
<td>43</td>
<td>27</td>
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</tbody>
</table>
Table 8

Actual Legal Expense Reporting by BHCs and Banks, 2001 - 2012

Panel A. Reporting on the BHC Y9 Report

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of BHCs reporting</th>
<th>Number of BHCs not Reporting</th>
<th>Total</th>
<th>Percent reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>2002</td>
<td>524</td>
<td>5,233</td>
<td>5,757</td>
<td>9.10</td>
</tr>
<tr>
<td>2003</td>
<td>645</td>
<td>5,145</td>
<td>5,790</td>
<td>11.14</td>
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<tr>
<td>2004</td>
<td>696</td>
<td>5,058</td>
<td>5,754</td>
<td>12.10</td>
</tr>
<tr>
<td>2005</td>
<td>655</td>
<td>5,090</td>
<td>5,745</td>
<td>11.40</td>
</tr>
<tr>
<td>2006</td>
<td>231</td>
<td>5,478</td>
<td>5,709</td>
<td>4.05</td>
</tr>
<tr>
<td>2007</td>
<td>253</td>
<td>5,417</td>
<td>5,670</td>
<td>4.46</td>
</tr>
<tr>
<td>2008</td>
<td>601</td>
<td>4,936</td>
<td>5,537</td>
<td>10.85</td>
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<tr>
<td>2009</td>
<td>685</td>
<td>4,749</td>
<td>5,434</td>
<td>12.61</td>
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<tr>
<td>2010</td>
<td>707</td>
<td>4,559</td>
<td>5,266</td>
<td>13.43</td>
</tr>
<tr>
<td>2011</td>
<td>715</td>
<td>4,432</td>
<td>5,147</td>
<td>13.89</td>
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<tr>
<td>2012</td>
<td>801</td>
<td>4,677</td>
<td>5,478</td>
<td>14.62</td>
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</table>

Panel B. Reporting on the bank call report

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of banks reporting</th>
<th>Number of banks not reporting</th>
<th>Total</th>
<th>Percent reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>3,217</td>
<td>5,781</td>
<td>8,998</td>
<td>35.75</td>
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<tr>
<td>2002</td>
<td>3,184</td>
<td>5,567</td>
<td>8,751</td>
<td>36.38</td>
</tr>
<tr>
<td>2003</td>
<td>3,137</td>
<td>5,472</td>
<td>8,609</td>
<td>36.44</td>
</tr>
<tr>
<td>2004</td>
<td>3,091</td>
<td>5,341</td>
<td>8,432</td>
<td>36.66</td>
</tr>
<tr>
<td>2005</td>
<td>3,008</td>
<td>5,294</td>
<td>8,302</td>
<td>36.23</td>
</tr>
<tr>
<td>2006</td>
<td>2,857</td>
<td>5,381</td>
<td>8,238</td>
<td>34.68</td>
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<tr>
<td>2007</td>
<td>2,802</td>
<td>5,295</td>
<td>8,097</td>
<td>34.61</td>
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<td>2008</td>
<td>3,967</td>
<td>3,906</td>
<td>7,873</td>
<td>50.39</td>
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<tr>
<td>2009</td>
<td>4,072</td>
<td>3,541</td>
<td>7,613</td>
<td>53.49</td>
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<tr>
<td>2010</td>
<td>4,087</td>
<td>3,197</td>
<td>7,284</td>
<td>56.11</td>
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<tr>
<td>2011</td>
<td>0</td>
<td>0</td>
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<td>---</td>
</tr>
<tr>
<td>2012</td>
<td>0</td>
<td>0</td>
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Legal expense reporting on the Y9 Report began in 2002.

All legal expense reporting on the call report ceased after 2010.
Panel C. Reporting by three case study banks, 2001 – 2007

<table>
<thead>
<tr>
<th>Year</th>
<th>Countrywide Y9</th>
<th>National City Y9</th>
<th>Wachovia Y9</th>
<th>Countrywide call report</th>
<th>National City call report</th>
<th>Wachovia call report</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>2002</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
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<tr>
<td>2003</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
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<tr>
<td>2004</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
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<tr>
<td>2005</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
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<tr>
<td>2006</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
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<tr>
<td>2007</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

NOTE: All three institutions experienced serious financial problems and were merged into other financial institutions in 2008, as described in Appendix A.
CASES CITED


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Palm Beach Business Services v. Wachovia, 2006 (Palm Beach County, Florida) Case No. 502006CA008561XXXXMB-AJ.


Rancy/Estate of Malbranche v. Wachovia, 2008, (Polk County, Florida); Case No. 53-2008-CA-009106.


Wachovia Bank, NA, f/k/a First Union National Bank, NA v. Gulf Components, Inc. Gulf Financial, First Passives, Inc. and Augustus E. Raney, Jr., Counterclaim, 2003; Broward County, Florida, Case No. 03-10469 CACE (03).
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