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Financial Services Report

Bank Failure
For Directors and Officers, There Is No Makeup Exam

This is Part III of our three-part series regarding the financial and regulatory crisis and its consequences for the banking industry, banking institutions and their directors and officers. As we write Part III, which focuses on potential director culpability following a bank's demise, we look back to 2009, which ended with 140 bank failures. There have been 111 failures to date in 2010. This year easily could end with double that number considering more than 700 institutions remain on the FDIC's "troubled bank" list.

With the high number of institutional failures—many occurring very quickly—the FDIC is only in the initial stages of its efforts to sue directors and officers of failed banks in its role as receiver of the estate of the closed institution.[1] When a bank is closed, at the direction of its chartering authority, the FDIC becomes the party-in-interest to recover damages caused by the institution's management for actions and inactions amounting to fraud, breach of fiduciary duty, violation of law, gross negligence and, in some cases, simple negligence. Since 1985, the FDIC has sued management in approximately three bank closures out of ten. What the agency will do in 2010 and beyond remains to be seen. Already visible signs appear ominous.[2] It should be noted that the statute of limitations applicable to the FDIC for bringing tort claims is the longer of three years or the applicable state law statute of limitations.[3]

Since 1985, the FDIC has sued management in approximately three bank closures out of ten.

During the last banking crisis, the FDIC was quick to sue many beleaguered executives and boards of directors alleging the charges noted above. Recoveries were substantial, and in some cases the agency was able to recover from the bank's directors and officers liability (D&O) policy up to the limits of the coverage. In certain cases, amounts beyond such coverage were obtained from individual defendants themselves.

As failure for an institution becomes more certain, the FDIC typically begins to intensify its focus on the institution's management and takes preliminary steps to ensure that the bank's failure does not mean the directors are off the hook. Just the opposite is their intent.

In This Issue

[1] There are many other possible claimants and claims when a bank fails, which are beyond the scope of this article.

[2] As this article goes to print, the FDIC has filed its first lawsuit against directors and officers in connection with the failure of IndyMac Bank, F.S.B., which was filed in the U.S. District Court for the Central District of California on July 10, 2010. The complaint alleges that the institution's homebuilding division management acted in a manner that was negligent and violated fiduciary duties and the institution's policies and procedures.

[3] 12 U.S.C. § 1821(d)(14)(A).

During 2009, as bank failures cascaded across the country, the following stood out as having the most failures: Georgia (29), Illinois (21), California (17) and Florida (14). This was not surprising because these states all had recent, explosive growth of *de novo* banks and high levels of commercial real estate (CRE) development. After the bank fails, the FDIC typically sends out a notice letter of impending regulatory scrutiny and a possible full investigation of the institution before the bank's D&O policy expires. This notice is sent to the bank's D&O carrier, but it is also sent to the directors and management who may have culpability. Some observers believe that a notice letter from the FDIC was sent to the D&O carrier in every 2009 Georgia bank failure.[4]

In order to get its recent director liability program up to speed, the FDIC has been hiring so-called "fee counsel," private law firms that will do the brunt of the pre-filing investigation work and file and prosecute the claims for the FDIC. On the other side, attorneys for the failed institution will be precluded from representing the institution's directors and officers post-failure because the FDIC will assert that it, as receiver, is the bank's successor-in-interest (and thereby the attorney's client), and the FDIC will not allow such attorneys to take actions inconsistent with the FDIC's position. Directors and officers, therefore, will be left without the lawyers who advised them during the institution's crisis and failure. By statute, the primary federal regulator of the institution must investigate and determine the causes of each bank's failure. The reports that follow such failures (available on the FDIC's website) are road maps for the fee counsel to follow in ascertaining who was at fault and why.

Directors and officers in the FDIC crosshairs are not without defenses and means to defend themselves. As explained more fully below, the FDIC never must prove more than gross negligence, which normally requires a pattern of acts or especially egregious failures to adhere to well-understood, required practices. It is not necessarily the same test as the FDIC must meet to remove a director or officer from banking—the so-called "heedless indifference to known risks" standard—but it is close (see the discussion in Part II of this series, which discusses removal from banking).

The FDIC recently went public with its intent to sue management of BankUnited in Florida, which failed on May 21, 2009. The allegations on file and discussed below provide insight into potential FDIC allegations during this crisis and reflect some typical banking practices thought to be problematic.

In its November 5, 2009 letter (the "Letter")[5] to various members of management, the FDIC stated that its demand was based on damages "arising out of losses suffered due to wrongful acts committed in connection with the origination and administration of unsafe and unsound residential real estate loans." The Letter cited in particular the individuals' alleged wrongful acts in connection with "pursing an overly aggressive growth strategy focused primarily on the controversial Payment Option ARM product." The Letter asserted that, by the end of 2007, Option ARM mortgages represented 70 percent of the bank's residential loan portfolio and 60 percent of its total loan portfolio, and by 2008 represented 575 percent of the bank's capital.

The Letter further asserted that individuals failed "to implement adequate credit administration and risk management controls and failed to heed warnings and/or recommendations of bank supervisory authorities and bank consultants." In addition, the Letter stated that the "inherent risk" of Option ARM loans was "coupled with deficiencies in the Bank's underwriting, appraisal process and credit administration."

With respect to the directors and officers of the institution, the Letter asserts that they:

(i) adopted an overly aggressive and reckless growth strategy by investing most of the bank's assets in Option ARM lending products;

(ii) failed to provide the bank with adequate reserves for potential loan losses resulting from its investments in Option ARM lending products;

[4] *Failed Banks: The D&O Diary*, Feb. 2, 2010.

[5] Typically, these letters are confidential; however, the FDIC filed this particular letter with a bankruptcy court in Florida.

(iii) engaged in reckless, high-risk and limited scrutiny lending;

(iv) failed to oversee the bank's affairs, including the failure to monitor the rising volume of loan delinquencies and to establish lending policies that would adequately protect the bank; and

(v) failed to provide adequate personnel and administrative capacity to appropriately monitor loan appraisals and to carry out diligent underwriting reviews.

Most damaging, the Letter accuses the former bank directors and officers of authorizing an overly aggressive lending mentality "to make the loan as long as the borrower had a pulse." This is the sort of allegation that, if proven, could tie the current financial crisis to the historic standards of director culpability for bank failure. A key component of the culpability analysis in this crisis is the huge and largely unexpected downturn in the residential and commercial real estate markets. Defendant directors and officers will have a hard time arguing that "no reasonable person could have foreseen how residential values would plummet" if the FDIC can show that the bank gave loans to anyone with a heartbeat.

The Letter also stated that the bank's compensation policies were designed to encourage loan production with a blind eye toward delinquencies. Specifically, it said the compensation policies "created personal financial incentives for bank officers and directors to engage in risky, aggressive and short-sighted lending practices." This allegation may prove to be key, as the FDIC will attempt to prove the executives were financially incented to disregard safety and soundness concerns.

The Law

Both federal and state statutory law impose duties on directors and officers of banks. The statutes and their implementing regulations cover key topics such as lending limits, false reports, loans to insiders and other such matters. One key but sometimes overlooked statutory requirement regards making false statements to regulatory officials. Bank officers sometimes forget this obligation during examination discussion with regulators.[6] It is also possibly a criminal violation if intentional.

In addition, bank directors and officers must comply with applicable fiduciary duties. Courts have held directors and officers of banks to a higher common-law standard of care and loyalty than their counterparts in other industries. When the FDIC as plaintiff in bank director liability lawsuits sues for breach of the duties of care and loyalty, it relies on 12 U.S.C. § 1821(k). This statute permits the FDIC as conservator or receiver of a failed institution to sue the directors and officers for gross negligence, or for simple negligence if applicable state law allows. In addition, the FDIC has aggressively pursued directors and officers suspected of self-dealing for breach of the duty of loyalty.

Under the common law, individual bank directors are considered fiduciaries and are subject as such to the common-law duties of care and loyalty. Bank directors are often held to a higher standard than directors of non-bank corporations, on grounds that bank directors are in a trust relationship with depositors, as well as stockholders, and are insured by the government.[7]

Despite this strict standard for breaches of fiduciary duties, other common-law doctrines limit the liability of individual bank directors. Bank directors may be shielded by the "business judgment rule," although not necessarily to the degree enjoyed by non-bank directors. Courts have also held that individual "[b]ank directors are not insurers for losses which were not caused by their fault or neglect of duty." As one court noted, no persons "of sense would take the office, if the law imposed upon them a guaranty of the general success of their companies as a penalty for any negligence."[8]

In *Briggs vs. Spaulding*,[9] the Supreme Court defined the duty of care as the care that "ordinarily

[6] *See* 18 U.S.C. § 1001.

[7] 3A Fletcher Cyclopedia Corporations §1042.10.

[8] *Barnes v. Andrews*, 298 F .614, 617 (S.D.N.Y. 1924).

[9] 141 U.S. 132 (1891).

prudent and diligent men would exercise under similar circumstances," taking into account "the restrictions of the statute and the usages of business." The *Briggs* standard of care is the "wellspring from which more specific duties flow."

Courts have been divided over whether bank directors who are sued for disinterested business decisions are liable for gross negligence or also for simple negligence. Certain jurisdictions, including Illinois, have declined to assess bank directors with common-law liability for anything short of gross negligence and have held that the business judgment rule bars suits for simple negligence. In negligence suits by the FDIC under 12 U.S.C. § 1821(k), a gross negligence standard will apply unless applicable state law imposes liability for a lesser standard. It remains unclear to what extent a gross negligence standard would actually exonerate a bank director who was otherwise guilty of simple negligence.

In *Atherton v. FDIC*,[10] the Supreme Court unanimously held that the gross negligence standard in Section 1821(k) sets a floor in liability suits brought by the FDIC against financial institution officers and directors, unless the law of the state has a more stringent standard. In other words, at a minimum, bank directors must be found grossly negligent before they are found culpable, unless the state standard is less stringent, e.g., simple negligence. As a result, Section 1821(k) has two effects. First, in FDIC damages suits against officers and directors of failed financial institutions, Section 1821(k) preempts more lenient state standards of conduct (in terms of exonerating directors), such as recklessness or intentional conduct. Second, where the applicable state law standard is stricter than gross negligence, the state law standard controls pursuant to the savings clause of Section 1821(k). As a result, officers and directors defending FDIC suits for damages can be sued for simple negligence, notwithstanding the gross negligence test in Section 1821(k), *if the relevant state law so permits*.

[10] 519 U.S. 213 (1997).

What's a Director to Do?

There is no better source of guidance for directors than the OCC publication *The Director's Book: The Role of the National Bank Director* (the "Book"). The Book urges directors to focus their time and attention on major policy areas. From this simple perspective, sound business judgments can be made. Suggestions by the authors regarding the major issues facing the institution in crisis are noted below.

(a) *Loan Portfolio Management***.** The board should oversee the management of the loan portfolio to control risks and maintain profitable lending operations. While lending traditionally has been at the core of a bank's activities, providing the greatest single source of earnings and accounting for the largest volume of assets, it also has posed the greatest single risk to the bank's safety and soundness. Whether due to lax credit standards, inadequate loan review practices, or weaknesses in the economy, loan portfolio problems have been a major cause of bank losses.

Not surprisingly, most failures are the result of bad loans. But a key question is whether they were made by "bad bankers."

(b) *Loan Policy*. A bank's loan policy should address the composition of the loan portfolio as a whole and should have standards for individual credit decisions. Risk tolerances and limits should be specified. These elements of a sound loan policy set parameters for the loan portfolio, including:

- The portion of the bank's funding sources that may be used for lending.
- The types of loans to be made
- The percentage of the overall loan portfolio that should constitute each type of loan.
- The geographic trade area in which loans will be made.

Commercial real estate and land development loan losses are at the heart of the crisis, and the regulators focus on the concentrations in those categories. In addition, the "sunshine states" and Illinois have seen the most failures.

(c) *Loan Review Program*. Attention to this area is key. Resources must be developed by the bank at the board's direction for this function to do its job.

(d) *Allowance for Loan and Lease Losses*. The board must ensure that the bank has a program to establish and regularly review the adequacy of its allowance for loan and lease losses (ALLL). Regulators have recently focused very heavily on inadequate provisioning. Where they will draw the line on director culpability is unclear.

Regulators will be very critical of management that fails to use sound judgment on provisions, write-offs and appraisal practices.

The Book provides particular advice in terms of urging board attention to certain loan activities as areas of concern and the key red flags are:

- Failure to have systems that properly monitor compliance with legal lending limits.
- Relaxed standards or terms on loans to insiders and affiliates.
- Failure to institute adequate loan administration systems.
- Overreliance on collateral or character to support credit decisions.
- Uncontrolled asset growth or increased market share.
- The purchase of participations in out-of-area loans without independent review and evaluation.
- Generating large volumes of loans for resale to others.

When a bank relaxes standards or terms on loans to insiders, culpability may follow. Other key areas to monitor are uncontrolled asset grown and out-of-area loans, especially when coupled with brokered deposits.

(e) *Funds Management Policy*. When considering funds management activities, the following practices or conditions should trigger additional board scrutiny:

- Excessive growth objectives. This is particularly hazardous when coupled with high risk loan programs and/or more risky or complicated investment strategies.
- The recent heavy reliance by some institutions on CRE pools and bank trust preferred securities pools has been a real problem. This is especially so when very risky subordinated tranches were purchased.
- Heavy dependence on volatile liabilities. Excessive holdings of violate liabilities, such as large certificates of deposit, out-of-area funding sources, brokered deposits, and other interest-rate-sensitive funding sources may pose a problem to a bank. Liquidity concerns triggered by the sudden withdrawal of such deposits can require the costly liquidation of assets. In addition, a bank typically must pay a higher interest rate to attract out-of-area funds, thereby lowering net interest margins on loans and investments made with those funds. Lower margins can create pressures on management to seek higher yielding, and potentially riskier, loans and investments to maintain earnings.
- Gaps between asset and liability maturities or between rate-sensitive assets and liabilities at various maturity time frames.
- Asset/liability expansion, both on- or off-balance-sheet, without an accompanying increase in capital support.
- Failure to diversify assets or funding sources.
- Inadequate controls over securitized asset programs.
- Lack of expertise or control over off-balance-sheet derivative activities or other complex investment or risk management transactions.

Liquidity management has become a vital issue for banks in crisis. As regulatory ratings drop, access to brokered deposits becomes more difficult. Reliance on other sources (e.g., Federal Home Loan Banks, state funds) is put at risk due to declining capital and ongoing operational issues.

If you have any questions, please contact **Daniel O'Rourke** (312-609-7669) or any other Vedder Price attorney with whom you have worked. ■

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BOARD/MANAGEMENT STEPS TO TAKE PRE-FAILURE

1. Do your best; work as hard as you can.
2. Fighting with the regulators is, at best, useless and, at worst, damaging to the institution. If the bank is going to fail, don't blame the regulators.
3. Search hard for solutions. Short of buying out the bad loans with personal funds, be as aggressive as reasonably practicable. Prove to the regulators you know what is at stake: the insured deposits.
4. Cooperate with the bidders in any assisted transaction.
5. Attend to the regulatory sanctions and requirements imposed on the institution with diligence and common sense. Do not feed the regulators false promises or unrealistic prognostications.
6. Do not resign, unless you discuss it with independent counsel and the regulators first.
7. Document, document, document everything you do to help save the bank.

There are a number of ways directors and officers can get ready personally for potential FDIC litigation.

DIRECTORS STEPS TO TAKE, PERSONALLY, PRE-FAILURE

1. Take steps to understand the bank's D&O insurance policies before the bank is closed. Determine whether policy coverage is offset by the fees for defense of claims. If so, understand the FDIC wants recovery, not protracted litigation.
2. Realize that the terms of D&O insurance policies are not well understood. In some cases, D&O policies may require an actual lawsuit to be filed for the coverage to go into effect. That might leave a director without coverage if the FDIC is merely in the investigative stage of the case or just sends out a notice letter, some or all of which may occur after the bank has failed.
3. Directors should seek "tail coverage" for claims brought after the policy's expiration, but during an extended notice period. The coverage should be at both the bank and holding company level. If the holding company remains solvent, its ability to indemnify the bank's directors could prove important if the D&O policy is unavailable.
4. Obtain copies of bank records that can document your role at the bank before it failed, including board minutes, loan committee minutes, documentation of compliance and correspondence with regulators. Obtain copies of charters, bylaws, D&O policies, indemnification agreements and other such items. Once the FDIC takes over a bank, it will not let officers and directors have access to any bank records without a subpoena.
5. Retain new legal counsel for the board before the bank closes. Such counsel will act for you as your counsel, not the bank's, in helping you prepare for the closing of the bank. Such counsel may, potentially, identify issues and help correct them pre-failure. As discussed above, the former attorneys for the bank will now owe their allegiance to the FDIC, not the former board.

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