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Liability Considerations for Officers and Directors of Failed FDIC-Insured Institutions

In light of the possibility that several hundred FDIC-insured banks and thrifts may fail in the next two- to three-year period, many clients and friends of the firm have requested a summary of the legal concerns that arise for officers and directors immediately following the seizure of an institution by the FDIC, as well as steps that may be taken to be better prepared before a failure.

Although each failure has its own unique facts, the liability of officers and directors is relatively consistent regardless of the reason for the failure. This is because the FDIC—as the receiver of the failed bank or thrift—views as one of its primary fiduciary duties, the obligation to seek provable damages from former officers and directors. This means, among other things, that the FDIC will closely scrutinize former members of management and a board of directors whenever it is arguable that some form of malfeasance or misfeasance caused or helped to cause the failure. Moreover, this decided predilection on the part of the FDIC toward bringing lawsuits, exposes former officers and directors to months or years of investigations and litigation, including the possible forfeiture of personal assets should insurance coverage not be available to settle or pay alleged damage claims.

This summary is intended to be a starting point and might be the basis for members of a board of directors or management to develop a strategy to address their liability should a failure become probable. Please note, however, that a detailed discussion of the various theories of culpability (*i.e.,* gross negligence, intentional wrongdoing, etc.) are beyond the scope of this summary—but are essential factors to be evaluated to determine whether liability might be alleged. Of course, as noted below, consultation with competent counsel is essential.

General

The single most important change that occurs following a bank or thrift failure (a “Bank Failure”) is that officers and directors no longer constitute management, but may instead become the targets of investigations by the FDIC. This is because the FDIC as the receiver of a failed bank or thrift (a “Failed Institution”) is statutorily required to investigate why the Bank Failure occurred. Moreover, the FDIC in its role as the receiver of the Failed Institution has a fiduciary duty to its Deposit Insurance Fund and to the depositors and other creditors of the Failed Institution to recover assets to minimize losses.

It is not unusual for officers and directors who are unable to avoid a Bank Failure to be totally surprised by the aggressive litigation posture displayed by FDIC representatives when they are targeted for investigation by the FDIC, which has broad and sweeping subpoena powers. Such investigations often take years to complete, following which the FDIC considers whether to files lawsuits aimed at recovering damages allegedly caused by the officers or directors of the Failed Institution.

During this initial investigative process, former officers and directors frequently find themselves unable to reasonably respond to FDIC allegations. First, immediately following a Bank Failure, the FDIC as receiver stands in the shoes of the Failed Bank, its shareholders and its management. Accordingly, all documents pertaining to the Failed Institution that are not legally held by its former officers and directors becomes the property of the FDIC and the FDIC frequently refuses to provide copies of critically important documents necessary for officers and directors to respond to allegations of negligent or intentional acts that were allegedly a cause of the Bank Failure.

The availability of full and complete documentation is of particular importance because statutory and judicial precedent requires that breaches of an officer's or director's duty must be proven and, depending upon the nature of the loss, the breach of the duty must exceed mere negligence. Stated another way, access to the records and files of a Failed Institution enables a member of management or a board of directors to more effectively argue at an early stage of an investigation that no breach of a duty or obligation occurred.

Second, the status of the legal representation changes immediately following a Bank Failure. Specifically, any bank counsel that formerly was providing officers and directors with legal assistance prior to the Bank Failure—including advice to prevent the FDIC from placing the institution into receivership—now represents the FDIC as receiver for the Failed Institution and the FDIC instructs the former legal counsel to have no further contact with the officers and directors of the Failed Institution (including providing documents in the possession of the attorney). In addition, because the client of the former bank counsel is now the FDIC, potentially damaging communications that would ordinarily be deemed attorney/client privileged are now owned by the FDIC and could constitute a fruitful source of identifying potential factual bases for liability.

Third, and most importantly, an unprepared board of directors and management may not have obtained sufficient directors and officers liability insurance ("D&O Insurance") to cover the scope of potential claims made by the FDIC as receiver. As discussed below, an important use of D&O Insurance is that it provides payment for legal expenses that can become overwhelming to individual members of management and a board since legal expenses increase exponentially for former board members and officers immediately following a Bank Failure.

Avoiding and Minimizing Liability

While the determination whether to seek damages against officers and directors belongs to the FDIC, there are several proactive steps that individual members of a board of directors and management should consider to prepare for the inevitable FDIC investigation and possible litigation. For ease of discussion, the topics are divided below between actions to be considered prior to a Bank Failure and comparable actions that might be taken immediately following a Bank Failure.

a. Prior to a Bank Failure

Prior to the failure of a bank or thrift, the board of directors and management remain in control of the institution, and can significantly improve their potential litigation positions should a Bank Failure occur. Several actions to consider include the following:

Engage Special Counsel. As the possibility of a Bank Failure approaches, it is important to note that the current legal counsel of a bank or thrift owes his/her duty of loyalty to the institution itself rather than to officers and directors as potential individual litigants. More importantly, efforts to save the bank or thrift from being placed into receivership oftentimes may require bank counsel to provide advice that may be contrary to advice that is intended to protect officers and directors from individual liability.

While the law in this area may prohibit a bank or thrift from paying for separate counsel solely to avoid individual liability, in many jurisdictions retaining separate counsel for a board and management is justified in order to ensure that members of management and a board have complied with their respective fiduciary obligations to the institution. As part of that engagement, special counsel can assist in: (a) assembling critical documents necessary to defend against potential claims following a Bank Failure; (b) reviewing D&O Insurance policies and determining the extent of available coverage; and (c) ensuring that board minutes and other bank records contain adequate information that supports the legal position that management and board members have acted reasonably and responsibly.

If the option of retaining special counsel is available, permitting special counsel to become familiar with the legal issues that form the basis for a potential Bank Failure prior to its occurrence can substantially facilitate the defensive posture of a board and management should claims be made by the FDIC following a Bank Failure.

Review D&O Insurance Policies and Obtain Additional Coverage if Possible. The law regarding director and officer liability coverage varies from state to state, and requires knowledgeable insurance coverage counsel to make a detailed review of existing policies and terms of coverage.

Following a Bank Failure, targeted officers and directors frequently discover that, prior to the failure, the Failed Institution had elected to be "penny wise" by purchasing a minimum amount of D&O Insurance coverage with the result that expected coverage—particularly coverage that might be used as a source to pay legal fees—is not available. While the cost for additional coverage must be considered, seeking additional coverage is possible and can result in coverage for claims filed by the FDIC.

In additional to the foregoing, it is also critical to note that most D&O Insurance policies impose strict, and oftentimes enforceable, notice provisions in order to obtain coverage that has already been purchased. Review by competent insurance coverage counsel and coordination to ensure complying with notice requirements cannot be overemphasized.

Obtain Bank or Thrift Documents Necessary to Prepare a Defense. As noted above, immediately after a Bank Failure, the FDIC will change the locks on the Failed Bank and prohibit officers and directors from having access to documents necessary to respond to charges that might be brought against them.

Accordingly, it is very useful if officers and directors obtain copies of bank or thrift records pertinent to the performance of their responsibilities prior to a Bank Failure. Copies of records that may prove to be valuable include: (a) board minutes; (b) loan committee minutes; (c) documentation of compliance with regulatory criticisms; (d) copies of pertinent D&O policies; and (e) formal and informal communications with state and federal banking regulators.

It should be remembered, however, that this is a particularly sensitive area, and care should be exercised to avoid an allegation that official institution records were removed from the premises of a bank or thrift. This can be accomplished by determining categories of records that could reasonably be retained as copies by individual officers and directors, and copying the same in a timely manner. For example, bank regulators may object to copying actual reports of examination, but an institution's correspondence with its banking regulator may be a proper record that may be copied by a member of management or a board. In addition, the institution should be paid for all administrative charges incurred in coping records, and an inventory listing documents provided to bank management or to individual board members should be included as an official record of the institution.

b. After a Bank Failure

Assuming that management and board members do not have the ability to take one or several of the steps discussed above prior to a Bank Failure, several critical actions need to be initiated immediately following the creation of the FDIC receivership, as follows:

Place D&O Insurance Carriers on Notice of Claims and Seek Coverage Determinations. All liability and blanket bond carriers should be notified of potential claims that will likely be made by the FDIC, and a demand for coverage for individual members of management and the board of directors should be made.

Engage Competent Legal Counsel. Because it is highly likely that the FDIC would institute an investigation regarding the causes of the Bank Failure, retention of competent counsel is essential. ***The moment that the FDIC seizes the bank or thrift, all communication with the FDIC and its representatives should be deemed to be adversarial and made in anticipation of litigation.***

Other Considerations

The discussion above is only a starting point when analyzing the specialized legal considerations that arise for management and directors following a Bank Failure. For example, in the instance in which intentional conduct might be alleged to be a cause of the failure, potential defenses among management and individual directors may require that separate legal counsel must be retained for individuals accused of special claims of liability. Alternatively, the FDIC or the Bank's primary regulator could elect to seek administrative claims against "institution affiliated parties" of the Failed Institution, which could include removal and prohibition orders, civil money penalties or other administrative enforcement actions that must be defended. Similarly, other state and federal enforcement agencies such as the Department of Justice or the SEC could elect to initiate parallel investigations that could themselves target members of management or a board of directors.

Finally, please note that this summary focuses on the liability concerns for officers and directors of FDIC-insured institutions. A Bank Failure scenario frequently includes a bank or savings and loan holding company, in which case the competing interests of the holding company—including the availability and willingness of a holding company to indemnify officers and directors—must be carefully reviewed.

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We trust that this summary is useful as an educational and informational tool. We would be pleased to discuss any questions that arise from a review of this summary.

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