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

1. Introduction

As a result of the failure of over 200 banks and savings institutions in 2009—and the likelihood of 300 or more failures in the foreseeable future—the banking industry may be faced with another tsunami of litigation brought by the FDIC alleging liability against officers and directors for the failure of their respective institutions.

Although each failure has its own unique facts, the process by which the alleged liability of officers and directors is determined is relatively consistent regardless of the reason for the failure. This is due to the FDIC —as the receiver and insurer of the failed bank or thrift—viewing as one of its primary fiduciary duties the obligation to recover damages from the officers, directors and other "institution affiliated parties" of the failed institution.[1] 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 was a contributory factor to—the failure.

The decided predilection on the part of the FDIC towards bringing lawsuits potentially exposes former officers and directors to months or possibly years of investigations and litigation, including the forfeiture of personal assets should insurance coverage not be available to settle or pay alleged damage claims.[2]

Due to a hiatus of over 20 years since the last waive of "D&O" litigation, we have been requested by many clients and friends of the firm to summarize legal concerns that arise for officers and directors following the seizure of an institution by the FDIC.

For ease of discussion, this memorandum is divided into the following topics: (a) the investigative process conducted by the FDIC immediately following a bank failure, including the status of officers and directors during that investigation; (b) the standard of liability required for officers and directors in order to be found liable for damages; (c) special legal issues when defending alleged claims brought by the FDIC; (d) strategic considerations for officers and directors when being investigated by the FDIC, including litigation; and (e) observations and recommendations.

Each will be discussed separately below.[3]

2. Discussion

A. The Investigation of a Failure by the FDIC

(i) The FDIC Investigative Process

The single most important change that occurs following a bank or thrift failure is that the former officers and directors no longer constitute management and the board, but rather, become the targets of investigation by the FDIC. This is because the FDIC as insurer and the receiver of a failed bank or thrift is statutorily required to investigate why the failure occurred. Moreover, the FDIC in its role as the receiver of the failed institution has a fiduciary duty to the Deposit Insurance Fund and to the depositors and other creditors of the failed institution to recover assets to minimize losses.

While prior to the date that a bank or thrift is closed the FDIC will have developed an opinion regarding the principal causes of a pending failure, upon the closing of an institution, FDIC receivership investigators commence a formal inquiry that typically targets officers and directors to determine whether damages are recoverable.[4]

The FDIC's investigative process might be viewed as being comprised of three stages. The first occurs as of the date of closing and immediately thereafter, and includes taking control of all property and documents belonging to the failed bank, including materials that address the potential liability of directors and management. Simultaneously, the FDIC interviews employees of the failed bank, and FDIC representatives are often successful in obtaining anecdotal and opinion testimony concerning the causes for the failure. These interviews are reduced to written reports and frequently become unofficial roadmaps to further liability

investigations.

Following a short period of time that involves the above-described on-site inquiries, the FDIC conducts a forensic review regarding losses at a failed bank—which in the current failure environment has taken approximately 9 to 12 months.[5] This inquiry generally includes the use of outside counsel for the evaluation of potential claims, who conduct the local portion of an investigation, including depositions and related discovery, and make recommendations to the FDIC's professional liability unit.[6] Further, at the same time the FDIC Inspector General may be conducting an investigation of the causes of the failure, and may issue a public report. At the end of this period, the FDIC evaluates all data it has assembled, and tentatively targets individuals who are associated with the failed institution—which almost invariably includes some or all senior officers and directors of the failed bank or thrift.

Next, the FDIC transmits to individuals who have been targeted, a demand letter that notifies them that the FDIC may hold them liable for the failure, and includes an extensive list of theories of liability—which essentially are alternative formulations of breaches of the standard of care owed by the targeted individuals to the institution. Accompanying the demand letter is an investigative subpoena, discussed below, that requests documents related to the failed institution, as well as detailed personal financial information of the targeted officer or director. If necessary, the FDIC may elect to take depositions to gather additional information, including making inquiries of deponents regarding individual loan transactions and other matters that might assist the FDIC's liability analysis.[7]

At the conclusion of this process, the FDIC considers the evidence it has obtained and determines whether to initiate litigation against targeted individuals or attempt to settle alleged claims based upon available funds, such as an officers and directors liability policy. Among other things, directors and officers are always notified on the FDIC’s decision to sue prior to the filing of a complaint, which affords the targeted individuals the opportunity to negotiate a settlement of the case.

(ii) The Reaction of Officers and Directors to an FDIC Investigation

It is not unusual for officers and directors to be totally surprised by the aggressive litigation posture displayed by FDIC representatives when they are targeted for investigation by the FDIC—including the broad and sweeping use by the FDIC of its subpoena powers.

During the initial stages of the FDIC's investigative process, former officers and directors frequently find themselves unable to reasonably respond to the FDIC allegations. Immediately following a failure, the FDIC as receiver stands in the shoes of the failed institution, its shareholders and its management.[8] All documents pertaining to the institution that are not legally held by former officers and directors become the property of the FDIC—and the FDIC typically exercises its discretion at this stage of the process by refusing to provide copies of critically important documents necessary for officers and directors to respond to alleged negligent or intentional acts that caused the institution's failure.[9]

Next, the status of the legal representation changes immediately following a bank failure. Specifically, any bank counsel that formerly provided regular advice to the directorate and management now represents the FDIC as receiver for the failed institution—and the FDIC will generally instruct 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 or law firm. 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 may constitute a viable source of identifying potential factual bases for liability.

Lastly, and most importantly, an unprepared board of directors and management may have not obtained sufficient officers and directors liability insurance (“D&O Insurance”) to cover the scope of potential claims made by the FDIC as receiver. An important use of D&O Insurance is that it provides a source of payment for legal expenses that can become overwhelming to individual members of management and a board—and legal expenses increase exponentially for former board members and officers immediately following a bank failure.[10]

B. The Standard of Liability Required for Officers and Directors to be Found Liable for Damages

While the FDIC conducts its investigations on a national basis, it is important to note that the FDIC is bound by state law standards of liability as a result of a seminal Supreme Court decision.

In the case of *Atherton v. FDIC*, 519 U.S. 213 (1996), the FDIC alleged that Section 11(k) of the FDI Act entitled it to a national standard of liability when recovering against officer and directors of failed institutions. Specifically, the FDIC argued that Section 11(k) set a national standard of mere negligence in order to recover against officers and directors of failed institutions.

The Supreme Court disagreed with the FDIC's legal position, and determined that local state law controlled the establishment of the duties owed by officer and directors of banking institutions, subject to a significant qualification. In that regard, the Court interpreted Section 11(k) of the FDI Act as setting gross negligence as the minimum ceiling for liability—with each state being empowered to set a stricter standard such as mere negligence. Stated another way, the Court had recognized a partial preemption of state law by which state

law could set a liability level higher than the federal standard (i.e., mere negligence), but the federal standard would trump a state law standard should the local standard exceed gross negligence.

In order to establish liability, therefore, the FDIC must reference state law to determine the duty owed by officers and directors to an institution, as well as the standard for judging whether a breach of that duty creates liability for the member of the board or management. In instances in which liability is based upon mere negligence, the state law standard of care prevails. In those instances in which malfeasance or a similar standard is established by state law, federal law preempts state law and gross negligence is the rule for determining liability.[11]

C. Special Legal Issues Following a Failure

While the scope of this memorandum does not permit an exhaustive review of all legal considerations that are of a concern regarding the liability of officers and directors of a failed institution, the following legal concerns are frequently presented:

(i) Analyzing and Avoiding Legal Conflicts for Defense Counsel.

Although the area of legal conflicts is somewhat arcane, this issue is a critical element that must be carefully considered by officers and directors when engaging defense counsel. Unfortunately, in most jurisdictions, regular bank counsel will be prevented from representing officers and directors once a bank failure occurs. This is because the FDIC as receiver becomes the "client," and the representation by bank counsel defending former officer and directors constitutes a conflict of interest under most rules of professional responsibility governing the conduct of lawyers.

It is also noteworthy that this area of law is particularly challenging because judicial precedence is generally over 20 years old, and is based upon conflict rules applicable to attorneys that have undergone significant amendment. For example, a prominent legal conflict case in California, *Christensen v. U.S. District Court*, 844 F. 2d 694 (1988), was based upon California rules of professional responsibility that were amended in 1989 to eliminate the basis for that decision. In *Christensen*, the then-applicable California professional rules employed the "substantial relationship" test that permitted a balancing of interests that was found by the court to permit the continued representation of former bank management by regular bank counsel. Subsequent amendment to the California rules of professional responsibility, however, now would appear to require an affirmative waiver be obtained from the FDIC prior to regular bank counsel commencing the representation of former officers and directors of a failed institution.[12]

Accordingly, care must be exercised when selecting defense counsel by analyzing in advance whether the FDIC might assert a conflict of interest that would prevent counsel from continuing to represent targeted officers and directors. Among other things, should a conflict be asserted, counsel would be precluded from further communication with the officers and directors. Moreover, the FDIC could order counsel to turn over all documents held by that attorney or law firm—which could be particularly prejudicial to the interests of targeted officers and directors.[13]

In order to avoid this potentially prejudicial result, it may be prudent to retain defense counsel that have not previously represented the failed institution, or that have limited representation relating to the troubled condition of the failed bank. Alternatively, a joint engagement might be considered whereby existing bank counsel participates in the defense of targeted individuals, but special counsel having no conflicts arising from prior representation of the failed institution would also be retained.

Finally, it should be noted that all prior representations of a failed bank by legal counsel may not result in conflicts of interest. For example, the representation of a bank by special counsel engaged for purposes of addressing safety and soundness concerns, including failing bank issues, should not be deemed adverse to the interest of the FDIC.[14] In any event, reference must be made to applicable rules of professional conduct for lawyers to determine whether a conflict might be deemed to exist, as well as whether the alleged conflict might be waiveable by the parties.

(ii) Bank and Thrift Holding Company Concerns

While beyond the scope of this article, the complexity of possible claims that might be brought by the FDIC is exacerbated by the existence of a bank holding company or savings and loan holding company—whose principal asset (i.e., the failed bank or thrift) has been seized by the FDIC and subsequently sold to a third party acquiror.

In addition to considering whether the holding company requires separate counsel from a law firm engaged to defend the officers and directors of the failed institution, additional legal concerns arise, including: (a) the possibility of bankruptcy on the part of the holding company; (b) the obligation of the holding company to indemnify and or provide a defense for the failed bank's officers and directors; (c) securities law claims, including claims filed by the holding company's shareholders; and (iv) direct claims by the FDIC against the holding company, such as claims arising from capital maintenance agreements and similar regulatory obligations.

(iii) Securing D&O Insurance Coverage

It is particularly important for officers and directors to fully and clearly understand the scope and coverage provided by a D&O liability policy. In that regard, it is very useful to engage legal counsel who specializes in the complexities of managing the relationship between covered officers and directors and the insurance company.

Among other things, following a bank failure, officers and directors must verify that the insurer has been properly placed on notice of potential FDIC claims, and that the insurer accepts coverage—or at least issues a reservation of rights notice that permits the payment of defense costs. Further, former directors and management must also understand the role of the insurer in the FDIC investigative process. For example, it is necessary to distinguish between policies that require an insurer to provide a defense—which places the insurer in the position to actively participate in defending claims brought by the FDIC, such as by requiring the use of panel counsel—versus a duty to defend that obligates an insurer to reimburse for legal costs (but counsel is retained directly by the targeted officers and directors). Similarly, it is important that the rights of the insurer be understood when participating in settlement negotiations with the FDIC, including the contractual authority of the insurer to directly engage the FDIC in discussions.

(iv) Investigative Subpoenas

In the past few months, the FDIC has issued dozens of investigative subpoenas that are directed at targeted officers and directors. These subpoenas are extraordinarily broad in scope, and seek records held by the recipient, as well as detailed financial records of the individual.[15]

It should be noted that these subpoenas are not self-enforcing, which means that to enforce the subpoena in regard to objectionable requests, the FDIC is required to seek enforcement by a federal district court.

The task of complying with an investigative subpoena requires care to ensure that the FDIC is not allowed to engage in a fishing expedition in order to identify deep pockets that justify proceeding with litigation.[16] However, if settlement negotiations appear to be reasonable, the FDIC will frequently insist that some financial information be provided prior to negotiations taking place. Should a strategic decision be made that some financial information should be provided, care must be exercised so that inadvertent misstatements are not included in any financial disclosures—particularly since federal criminal laws apply to false statements made to the FDIC.[17]

(v) Transfers of Assets by Officers and Directors

The FDI Act contains a very punitive provision that the FDIC views as authorizing it to negate any personal transfers of assets held by former officers and directors of a failed institution. Because the FDIC conducts an investigation, which includes identifying asset transfers through the use of public records, caution and sensitivity is warranted when electing to engage in personal financial planning by targeted individuals.[18]

(vi) Institution Affiliated Parties

Unlike the thrift failures of the 1980s, there have not emerged many allegations that losses caused at institutions that have failed were based in part on negligence by attorneys, accountants and other IAPs other than officers and directors.

However, while this area of potential liability of other categories of IAPs does not currently appear to be a focus by the FDIC, there may be instances in which alleged claims may be directed at such IAPs. For example, it has been the long-standing position of the FDIC that a law firm performing legal work for a failed bank that also has a member of that firm on the failed bank's board of directors may have direct liability (*i.e.*, attributable to the law firm as a whole) based upon the knowledge of the law firm's member being a member of the failed institution's board of directors. Similarly, alleged accounting practices that hid losses from the banking regulators generally arise only after the completion of a detailed forensic analysis.

At this time, it is too early in the cycle to evaluate whether—and to what extent—the FDIC will seek to recover damages from IAPs other than officer and directors. Should such claims arise, IAPs that provided professional services may be subject to duties of care that are different than those that apply to officers and directors—and the FDIC as receiver of the failed institution may ultimately elect to pursue such claims.

D. Strategic Considerations for Officers and Directors Following a Bank Failure

Several critical actions need to be initiated immediately following the failure of a bank. First, if notice to an insurer has not been provided prior to a bank failure, it is critically important to place insurance carriers on notice of claims and seek coverage determinations immediately following the closing of a bank or thrift. All liability and fidelity bond insurance carriers should be notified of potential claims likely to be made by the FDIC, and a demand for coverage for individual members of management and the board of directors should be made. (As noted above, the area of insurance coverage is highly specialized, and the use of qualified coverage counsel is strongly recommended.)

Second, officers and directors of a failed institution should immediately engage legal counsel knowledgeable in the FDIC investigative process. Because the FDIC will commence an investigation regarding the causes of a failure, retention of competent counsel is essential. Significantly, as of 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.

Finally, once defense counsel has been engaged, counsel should immediately begin to assemble bank-related documents and to initiate an investigation paralleling the investigation being conducted by the FDIC. As previously stated, immediately after a failure, the FDIC will 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 counsel obtains copies of bank or thrift records pertinent to the performance of management's and a board's responsibilities during the time the bank or thrift was open and operating. 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.[19] Further, because employees of the failed institution will quickly move on to other employment, interviewing those employees and evaluating their views of the failure—and possible availability as witnesses—can be of significant assistance when formulating a defense.

E. Observations and Recommendations

Assuming that officers and directors are able to navigate through the initial phases of an FDIC investigation, several observations are offered:

The last significant number of director and office claims were litigated 20 years ago as a result of the thrift failures of the late 1980s. This means that that there are not many experienced individuals employed at the FDIC, the insurers and other stakeholders with institutional wisdom. Thus, if this is the case, some or all of the FDIC's investigative process and related litigation strategy may be subject to being "reinvented" by participants. This will create a degree of uncertainty until stakeholders once gain reacquire experience in this area.[20]

Next, while the disruptive nature of a bank or thrift failure is significant, that disruption is minor compared to the difficulties experienced by individual officers and directors who are targeted individually by the FDIC following a failure. Although it is recommended that many of the pre-litigation steps discussed in this memorandum should be addressed prior to an actual failure, numerous tasks remain following a failure and require the use of qualified counsel.

Finally, it is important to understand that the strategic goal of a board and management following a failure is either to completely avoid being identified as a potential target for damages or to convince the FDIC and its representatives during the course of an investigation that any liability concerns are not meritorious. Accordingly, it is strongly recommended that some or all of the strategies discussed herein be adopted in anticipation of the FDIC's review of liability following a failure.

FOOTNOTES:

1 Although the discussion in this memorandum is generally applicable to all institution-affiliated parties or "IAPs," the focus of the discussion will be on liability claims that are frequently brought against officers and directors of failed banks and savings associations. *See* Section 3(u) of the Federal Deposit Insurance Act (the "FDI Act").

2 In the past several months, the FDIC has significantly increased the number of lawyers for its professional liability unit that is responsible for evaluating directors and officers liability claims—which is an indication that the FDIC is preparing to commence litigating claims arising out of recent failures.

3 This memorandum is part of a series of three articles addressing legal concerns for officers and directors of FDIC-insured institutions, and will be published in an upcoming edition of the *Banking Law Journal.*

4 Section 11(k) of the FDI Act specifically authorizes the FDIC to seek damages from officers and directors of failed institutions.

5 Note that these time frames and procedures are based upon current experiences with the FDIC investigative process, and may vary depending upon each situation, such as the complexity of the causes relating to the particular failure.

6 Local counsel engaged by the FDIC report to an FDIC staff attorney assigned to oversee the investigation.

7 During this time period, the FDIC attempts to determine the availability of "D&O" and fidelity bond coverage, and places the carriers on notice of the FDIC's potential claims. Copies of the claims letters, which are also provided to directors and officers, are usually sent prior to the completion of the FDIC's investigation and before subpoenas for testimony or documents are served.

8 *See,* Section 11(d)(2) of the FDI Act.

9 Although the FDIC may provide some limited access to bank documents as the investigative process proceeds, the ability of the FDIC to deny access to documentation at the early stage of an investigation is a significant tactical advantage.

10 Note that Section 11(e)(13) of the FDI Act validates the enforceability of so-called "regulatory exclusion" provisions in D&O insurance contracts. While the inclusion of a regulatory exclusion provision varies widely among liability insurance contracts, the existence of such a provision provides insurers the basis to deny coverage, and increases the risk that the personal assets of officers and directors may be exposed to FDIC damage claims.

11 Even in the instances in which gross negligence is the standard for establishing liability, state law, including judicial precedent,

will define what constitutes gross negligence, including the burdens of proof imposed on parties attempting to prove or disprove the same. Further, it should be noted that, depending upon the state jurisdiction, different duties may exist for independent, outside directors and management of an institution.

12 *Compare*, California Rules of Professional Conduct, Rule 4-101 (1975-1989) to Rule 3-310 (2010).

13 *See, RTC v. Miramon,* 1993 U.S. Dist LEXIS 16389 (Ongoing representation of a failed bank grounds for disqualification under substantial relationship test.)

14 *See*, *FDIC v. Amundson,* 682 F. Supp 981 (1988) (Lawyer acting as special counsel for a failing bank immediately prior to a failure not disqualified.)

15 *See*, Section 11(d)(2)(I) of the FDI Act.

16 Courts have generally refused to allow the FDIC to request detailed financial records for the sole purpose of identifying sources of recovery; at the minimum, the FDIC has been charged with a higher burden of establishing that the information is germane to an investigative concern other then determining the financial capability of the targeted individuals. *See*, In re McVane, 44 F.3d 1127 (2d Cir.1995).

17 It should be noted that FDIC subpoenas requesting bank documents also include electronic communications such as emails, which means that personal computers used by outside directors must be accessed and emails and documents provided to the FDIC for bank-related materials. (Computer experts experienced in retrieving emails are recommended for this task.)

18 *See*¸ Section 11(d)(17) of the FDI Act.

19 Note that the Federal Banking Agencies take the position that reports of examination and related materials are the property of the regulator, and copies of such reports and materials cannot be retained by officers and directors of a failed institution.

20 Note that, in order to address this knowledge and experience deficit, the FDIC is actively recruiting and rehiring former employees who worked on officer and director claims in the period immediately following the thrift failures of the 1980s, as well as outside counsel.

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