Preparing for the Next Wave of FDIC Suits Against Bank Directors and Officers

In the wake of the greatest financial crisis since the Great Depression, it is not surprising that directors and officers of financial institutions find themselves under intense scrutiny.

The Federal Deposit Insurance Corporation (“FDIC”) recently announced that it has authorized suits to recover more than $7.2 billion in damages from at least 294 former executives of 32 of the more than 390 banks that regulators have closed since January 1, 2008. Currently, there are over 884 banks on the FDIC’s watch list, and losses to the Deposit Insurance Fund are projected to reach $45 billion for the period June 30, 2009 through 2013.

Directors and officers are the most likely FDIC targets for recovery claims since, in many cases, they are covered by “D&O” insurance. Typically, the FDIC asserts claims for negligence, gross negligence and breach of fiduciary duty. The most common claims are for dishonest conduct or approval of abusive insider transactions, violations of law and regulations or internal bank policies, failure to heed warnings from regulators and advisors, and poor bank underwriting policies and practices. The FDIC may also seek restitution or indemnification from executives for unjust enrichment or reckless disregard of any law, regulation or regulatory directive, and civil penalties of up to $1 million.

Thus far, the FDIC has filed fourteen suits against 103 directors and officers of banks both large and small, including FDIC v. Killinger, et al. (W.D. Wash., Mar. 16, 2011), against three former senior executives of Washington Mutual and their wives. It is expected that another 80 suits will be filed in the next two years. According to the FDIC’s 1992 Policy Statement regarding the responsibilities of bank executives, it only authorizes a suit if it concludes, after a rigorous investigation of the circumstances surrounding a bank’s failure, that (i) the claims are meritorious, and (ii) the litigation would likely be cost-effective.

The FDIC’s investigation may take 18 months or more to complete, so a lawsuit is usually not filed until two to three years after the bank has failed. Often, the FDIC sends a pre-litigation demand letter to the bank executives asserting claims for damages arising out of the bank’s failure. The purpose of such letters is to put the executives on notice of a potential lawsuit so that they can in turn provide the requisite notice to their D&O insurers, whose policy proceeds are usually the target of the suit and the largest potential source of recovery, and to see if the claims can be settled short of a lawsuit.

How can directors and officers of failed and failing lending institutions prepare to defend themselves for the day the FDIC comes calling?

Of course, the surest way to avoid FDIC lawsuits is to prevent the bank from failing, but severe economic reversals such as the recent plunge in real estate and capital markets can thwart a struggling bank’s survival. Among the steps bank directors, officers and their counsel should take now to defend themselves from possible claims are the following:

1. Retain Separate Counsel. Because the bank’s existing lawyers are usually conflicted once it fails, directors should consider retaining independent counsel to assist them in dealing with regulators and to provide independent advice on the bank’s options going forward and avoiding a receivership. Potential conflicts of interest may require individual directors and officers to engage their own counsel. Conflicts may also develop between the bank and its holding company.

2. D&O Insurance. Directors and officers should review their D&O insurance with their counsel and the bank’s broker to determine whether there is adequate coverage for defending and settling potential FDIC and related litigation. Policy limits should be at least $10 million (preferably more) to cover attorneys’ fees and other defense costs. Of particular concern are standard exclusions for fraudulent, intentional and criminal misconduct, as well as the “regulatory” and “insured v. insured” exclusions, which may preclude coverage for claims by the FDIC or other regulators/receivers. Once the bank has become “troubled,” it may be too late or cost prohibitive to place coverage, increase limits, or negotiate with the D&O insurer to minimize or remove these exclusions and other provisions that limit coverage.

3. Articles of Incorporation and Bylaws. The bank’s articles of incorporation and bylaws should be reviewed to see that its executives have the broadest indemnification rights available for advancement of defense costs and payment of any settlements and judgments in FDIC or other litigation.
However, such rights may be of little value after the bank has failed and the FDIC has taken over. In addition, Washington banks’ articles of incorporation can eliminate the personal liability of directors (but not officers) to the bank or its shareholders, and thus potentially to the FDIC as receiver, for money damages for breach of a director’s duty of care, unless a director (i) did not act in good faith, (ii) engaged in intentional misconduct or a knowing violation of law, or (iii) approved or received an unlawful distribution by the bank.

4. Fiduciary Duties and the Business Judgment Rule. Directors and officers must discharge their duty of loyalty by acting in good faith in a manner they reasonably believe to be in the bank’s best interests, and may not act primarily for a non-bank purpose or put their personal interests ahead of the bank’s. They must also fulfill their duty of care and ensure that the bank is operating in accordance with regulators’ safety and soundness guidelines. This means that they must (i) monitor the bank’s operations and inform themselves of all reasonably available material information, including “red flags” of existing or potential problems in bank actions and in reports provided by management or regulators, (ii) carefully consider that information and all reasonable alternatives, and (iii) act with the requisite care, including formulating, implementing and monitoring appropriate policies to clearly guide the bank’s operations.

Directors and officers may rely on professional advisors who have been reasonably selected and are acting within their area of expertise. However, they must still ask questions and evaluate the information they receive, establish and follow an appropriate decision-making process and maintain good records, such as complete and accurate Board minutes and reports, to document their compliance with the duty of care and reflect any disagreement with management’s approach or the Board’s decisions. The “business judgment rule” protects directors and officers in their decision-making process by creating a presumption that they acted on an informed basis, in good faith, and with the honest belief that they did so in the bank’s best interests. Nevertheless, this protection for their decisions may be lost if there is evidence of self-dealing or improper interest, lack of good faith, fraud, recklessness, failure to act reasonably or exercise reasonable judgment, or abdication of their responsibilities.

5. Preserving Documents and Information. Directors and officers should inform themselves of the particular issues confronting the bank through a review of internal reports, examination and third-party reports, and other documents available while the bank remains open. Board minutes, resolutions and reports; loan committee minutes and loan files; underwriting and other policies, remedial and other action plans; and other bank documents and business records are critical evidence in defending bank directors and officers against FDIC allegations and proving that their actions met the required standard of care, but these records may be subject to confidential treatment or restricted access under state or federal law. Directors and officers should consult with their counsel about maintaining their access to and preserving such documents and information while avoiding any allegation that they improperly obtained or removed records and information from the bank.

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