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U P D A T E

News of Developments in the Financial Sector and Related Areas

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When an insured bank is closed, the Federal Deposit Insurance Corporation ("FDIC") is appointed the receiver to minimize the loss to the insurance fund from the closing of the bank. Between 2003 and 2007 there had been only 10 bank failures. This all changed beginning in 2008 when there were 25 bank failures with the largest being Washington Mutual Bank located in Utah with approximately $307 billion in assets and $188 billion in deposits. During 2009 there were 140 bank failures and during 2010 there were 157 bank failures.

For the first seven months of this year, there were 61 bank failures. Of the bank closures this year, there have been 16 bank closures in Georgia and 9 in Florida. At the end of the first quarter of this year, there were 888 insured institutions on the FDIC's problem list which is the highest level in eighteen years. Problem institutions are characterized as those institutions having a risk of failing and being closed by the FDIC. Although there were a number of large bank failures during 2008 and 2009, the recent trend has been toward smaller banks closures. In order to address bank closures and problem banks, the FDIC has increased its examiners and technical specialists from 1,200 in 2007 to approximately 1,900.
Once a bank is closed, the FDIC interviews employees concerning the causes of the failure, and the interviews are reduced to writing in connection with liability investigations by the FDIC. Section 1821(k) of the Federal Deposit Insurance Act ("Act") provides for suits against directors and officers for monetary damages in a civil action by the FDIC as the receiver of a failed bank for acts alleged to constitute gross negligence including any similar conduct that demonstrates a greater disregard of the duty of care including intentional torts, as determined in accordance with applicable state law.

Section 1818(b)(6)(A) of the Act, authorizes the FDIC to seek restitution or indemnification from directors and officers for who have been unjustly enriched by the bank or for who have engaged in reckless disregard of applicable laws, regulations or directives by a bank regulatory agency. During its investigation, the FDIC sends a demand letter to those directors and officers who may be held liable for a bank's failure along with a subpoena requesting documentation and personal financial information of the director or officer. Under Section 1818(i)(2) of the Act, civil monetary penalties may be assessed against officers and directors from $5,000 per day to a maximum of $1 million depending on the nature of the conduct and whether it arose out of reckless or intentional conduct.

During its investigation, the FDIC reviews the conduct of directors to determine if they

fulfilled their fiduciary duties to the bank or if they merely rubber stamped or failed to question or challenge decisions of the chairman or chief executive officer of the failed institution. The FDIC also reviews the conduct of directors in addressing concerns raised in bank regulatory examinations and in complying with the requirements of regulatory directives and orders. In a demand letter from the FDIC, it will generally allege that directors and officers breached their fiduciary duties to the bank in acting in a grossly negligent manner resulting in losses to the bank. The demand letter may include estimated losses on loans which provides the basis for damages in the FDIC's claim to the directors and officers.

The FDIC will generally only pursue claims if (1) the claim is sound on its merits and there is a likelihood of success in litigation and (2) it is cost effective considering the amount of insurance coverage and personal assets held by an officer or director as a defendant. It may take up to three years following a closure before a lawsuit is brought by the FDIC.

Possible defenses to claims by the FDIC would include expiration of the statute of limitations in order to bring a claim, reliance on management, comparative fault of others and the failure of the FDIC to establish liability. The business judgment rule may provide the most protection to directors and officers. This rule protects directors and officers even if a wrong or bad decision is made so long as they acted impartially and prudent under the circumstances. Under this rule officers and directors are permitted to rely upon management and others in performing their duties.

It is important to place the insurance carrier on notice of a potential claim. It is also important to determine if the insurance policy requires the insurance carrier to provide a defense or if the insurer only has a duty to defend which only obligates an insurer to reimburse legal costs. In those insurance policies that exclude intentional conduct claims, the insurer should still be placed on notice and required to pay defense fees since it is not known whether a director or officer acted intentionally until the litigation is concluded. Whether the claim appears to be excluded such as for fraud or not, the insurance carrier should be notified of potential claims likely to be made by the FDIC with a request for demand of coverage.

Once a bank is closed, regular bank counsel can no longer advise the directors and officers of the bank on matters that are adverse to the FDIC. As a result, the board of directors should consider retaining independent special counsel prior to the closing of the bank in order to assist directors and officers and in avoiding claims from both the FDIC and shareholders. Retention of bankruptcy counsel should be considered at the bank holding company level for banks that are owned by a bank holding company.

A bank facing closure by the FDIC should place the insurance carrier for its directors and officers liability insurance coverage on notice of potential claims by the FDIC for potential violations of banking laws and regulations for failure to take appropriate action. In connection with criticisms contained in regulatory examinations of the bank and actions required in formal agreements, the bank will want to document steps taken by it both in committee and board minutes and in communications with bank regulatory agencies in an effort to prevent potential liability.

With the number of bank failures that have occurred and that are continuing to occur, the FDIC will be actively pursuing claims against directors and officers. Our firm is available to answer questions involving

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directors and officers liability in connection with closed banks.

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