

UPDATE

News of Developments in the Financial Sector and Related Areas

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Directors and Officers Liability

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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. There were 507 bank closures during the period 2009 through 2019. For the first three months of this year, there was 1 bank failure. At the end of the fourth quarter of 2019, there were 51 insured institutions on the FDIC's problem list. Problem institutions are characterized as those institutions having a risk of failing and being closed by the FDIC.

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.

Some recent court rulings have not dismissed ordinary negligence claims by the FDIC against directors and officers of failed banks even when otherwise acting in good faith. Regardless, the FDIC is able to pursue claims against directors and officers of failed banks for gross negligence. Gross negligence involves actions to justify the presumption of willfulness and wantonness by directors and officers in their conduct. Ordinary negligence is the failure to act in the exercise of care of an ordinarily prudent person in a similar situation. Gross negligence rests on the assumption that directors and officers knew or should have known the results of their reckless actions

and conduct. Gross negligence is harder to prove than simple negligence.

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 may continue to occur, the FDIC will be actively pursuing claims against directors and officers. Our firm is available to answer questions involving directors and officers liability in connection with claims by the FDIC.