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The FDIC: Breaking Banks with Broken Rules


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Community bank directors and senior officers take heed: the Federal Deposit Insurance Corporation (FDIC), obligated by statutory and fiduciary obligations and supported by the American public who hold "Wall Street" partially responsible for the economic meltdown and forced taxpayer bailouts, is commencing formal actions against former officers and directors of failed banks to recover losses incurred by the FDIC Deposit Insurance Fund.[1] However, in assessing liability and assigning blame, two factors, in our opinion, are often overlooked: (i) a vast majority of smaller, community bank failures stemmed from market factors, including a recession only rivaled by the Great Depression and an unexpected downturn in the real estate markets rather than egregious misconduct on the part of bank leadership; and (ii) the FDIC played a supporting role in the financial crisis.

All banks are subject to annual regulatory examinations that provide examiners the opportunity to (i) inspect the bank's loan portfolio, risk management practices, and accounting practices; and (ii) assign a composite CAMELS rating reflecting the bank's overall condition and risk management. However, a number of FDIC targeted financial institutions (*e.g.*, Washington Mutual and IndyMac Bank) were placed into receivership after receiving favorable or satisfactory CAMELS ratings **the previous year**. Even though the FDIC was not the primary regulator responsible for supervising these institutions on a day-to-day basis, this fact nonetheless suggests that the FDIC contributed to the financial crisis by failing to properly exercise its backup supervisory authority and assess potential risks to the Deposit Insurance Fund.[2] However, the FDIC's hands-off approach is not being accounted for when transactions and policies are reviewed in hindsight and blame is assigned.

Instead, former directors and officers should expect heightened scrutiny of the failed bank's loan portfolio, internal loan policies, and specific lending transactions that, when reviewed in hindsight, opens the window for the FDIC to argue that some form of improper conduct, on the part of bank leadership caused, or helped cause, the bank's failure.[3]

In evaluating the underlying merits of an FDIC claim, it is important to recognize critical, yet often overlooked, truths:

1. The FDIC is aggressively pursuing "competency based" claims that extend beyond the scope of the type of actionable conduct outlined in FDIC guidance and established under statutory and common law;

2. The FDIC is aggressively and inequitably targeting smaller, community banks; and
3. The FDIC relies on inequitable tactics that impede the ability of at-risk directors and officers to prepare a proper defense.

Overextended Claims

An important threshold that arises in FDIC failed bank litigation is the degree of wrongdoing that the FDIC must prove in order to establish personal liability. In *Atherton v. FDIC*,[4] the Supreme Court held that the FDIC must establish that the former officers and directors acted with gross negligence or intentionally committed actionable conduct unless state law permits the FDIC to establish liability under a lower standard. The FDIC in its *Statement Concerning the Responsibilities of Bank Directors and Officers*[5] represented the same, stating it "will not bring civil lawsuits against directors and officers who fulfill their responsibilities...," and that the FDIC will only pursue claims based on: (i) dishonest conduct; (ii) abusive insider transactions; (iii) violations of internal policies, law, and regulations; (iv) a failure to establish, monitor, or follow proper underwriting procedures; and (v) a refusal to heed and respond to regulatory warnings. In practice, however, the FDIC has, at times, taken a more expansive position, attempting to hold former officers and directors liable under "competency related" claims as well (*e.g.*, pursuing an overly aggressive growth strategy or maintaining a loan portfolio overly concentrated in commercial and construction real estate loans).[6]

Most people would agree that individuals managing financial institutions should be required to understand financial indicators and other financial risk based metrics. However, one has to question the fairness of FDIC lawsuits that seek to hold former senior management of smaller, community banks personally liable for not predicting the collapse of the financial markets or the unexpected downturn in the real estate markets when the FDIC, despite its resources and "macro" viewpoint, was unable to definitively do so. Certainly the FDIC would not now take the position that it foresaw the economic downturn and choose not to inform its member institutions of the depressed economic climate that was to come.

What constitutes gross negligence or actionable conduct is state specific and requires an intensive facts-and-circumstances analysis. However, the following is unquestionably clear: traditional, fundamental protections for well-informed, business judgment decisions remain intact under state law regardless of the financial institution's financial or operational state. The Business Judgment Rule presumes that directors and officers acted on an informed basis, in good faith, and in the best interests of the financial institution. For this reason, the FDIC's decision to initiate preliminary or formal legal proceedings against a former officer or director should not be: (i) based on factors that were outside their control (*e.g.*, market factors); or (ii) controlled by its predilection to recover losses from anyone that happened to be affiliated with the failed bank at the time it was closed irrespective of any such individual's responsibility for the bank's failure or its losses.

Targeting Smaller, Community Banks

The fact that smaller, community banks, often governed by local business owners vested in the community, are having to defend themselves against accusations of overly aggressive growth strategies and/or that they made too many real estate loans illustrates the higher standard being applied by the FDIC and fails to take into account the important role that community/local banks serve in the credit markets.

– Higher Standard

The fairness of FDIC lawsuits that seek to hold former senior management responsible for pursuing an aggressive growth strategy or maintaining a loan portfolio highly concentrated in commercial and construction real estate loans is questionable when financial institutions like now defunct Lehman Brothers, despite employing some of the most intelligent, financially competent individuals available, were forced to declare bankruptcy, due to large holdings in securities based on subprime mortgages and other risky debt. Further, Lehman attempted to conceal its highly leveraged financial condition from the marketplace, by entering into what are referred to as "Repo 105" transactions[7] prior to releasing its financials to the marketplace each reporting period. Given the retroactive, unforgiving position the FDIC has taken against the directors and senior officers of a number of smaller banks, one would presume a similar, perhaps even harsher, position was taken towards the former directors and officers of Lehman. This presumption would be incorrect. With respect to Lehman, the appointed examiner's prepared report concluded that while certain business decisions "**may have been in error**," these decisions "**were within the business judgment rule and do not give rise to colorable claims**."[8] As opposed to many large Wall Street firms, a significant percentage of the smaller, community banks that are being targeted by the FDIC failed as a result of external forces (*e.g.*, collapse of the financial markets, real estate downturn), not insider misconduct or dodgy investment strategies (*e.g.*, securitizations of toxic assets).

– Community Banks and the Credit Markets

It is important not to lose focus of the important role played by community banks in arranging financing for the small - to mid-size businesses that employ and serve the community. According to the Independent Community Bankers of America, community banks comprise 97 percent of all banks in the United States and hold more than half of all outstanding small business loans.[9] Community banks are able to arrange financing for the small - to mid-size businesses that employ and serve the community by taking into account a variety of factors in reviewing loan applications, including the character of the borrower and special features of the local market. In many instances, financing for these businesses would otherwise be unavailable through a metric-focused regional or national bank.

Officers and directors managing small banks across the country are often faced with a difficult decision: approving a perhaps "imperfect" loan to a successful, highly respected small business owner that is well known in the community or denying the loan and running the risk of having a direct competitor approve the loan and squeeze the bank out of an already small niche in the market. Further, the FDIC would likely concede that community banks simply cannot compete with larger banks in connection with attracting "conforming" loans from the strongest class of borrowers. Therefore, it is particularly important that the FDIC consider the context in which a lending transaction was initially entered into when evaluating it in hindsight.

Inequitable Tactics: Impeding the Preparation of a Proper Defense

The FDIC's over-extension of its powers combined with the dilatory manner in which formal actions are brought places former executive officers and directors of a failed institution in a challenging, if not unfair, position. The unfortunate reality is that a significant percentage of at-risk individuals lack a proper understanding of the extent of their liability or that there may be an extended delay between the three primary stages of failed bank litigation: (i) the date of the bank's failure; (ii) the date a "demand letter" is sent to certain former officers and directors; and (iii) the date on which a formal action is brought against them personally by the FDIC.

– Extended Exposure

By law, the FDIC has at least three years from the date a financial institution fails and the receivership begins to bring a breach of fiduciary or gross negligence case.[10] However, the FDIC's stated position is that a decision as to whether or not it will pursue professional liability claims against a failed institution's former directors, officers, and other professionals will be made within 18 months of the institution's failure.

The impact of this extended exposure is twofold: (i) it subjects all potentially at-risk directors and officers to negative consequences, both professionally (*e.g.*, the inability to secure employment in the financial industry or a harmed reputation) and personally (*e.g.*, mental anguish); and (ii) it hinders the ability of a targeted officer or director to informatively respond to FDIC allegations and questions relating to the bank's failure. Former officers and directors cannot reasonably be expected to recollect pertinent details relating to the nature of or the decision-making process behind a transaction that occurred, in certain instances, 10 plus years ago. This disadvantage is compounded by the fact that (as discussed below) at-risk officers and directors are not provided access to bank records or board/committee minutes that may help them recollect important facts, decisions and events, all of which are necessary to mount a proper defense.

– No Access to Key Books and Records

The FDIC, as receiver, has legal ownership of all documents, corporate records and/or corporate books of the failed bank.[11] The FDIC leverages these rights to place at-risk former officers and directors at a disadvantage from the beginning by: (i) taking exclusive possession of all bank records upon closure of the bank; (ii) requiring the immediate return of any bank records located outside the failed bank's premises (*i.e.*, held personally or offsite); (iii) instructing the failed bank's legal counsel (who now owes a duty to the FDIC) to have no further contact with and provide no assistance to the former officers and directors of the failed bank; and (iv) refusing to provide copies or access to critically important documents that may be necessary to respond to allegations in an FDIC demand letter.[12]

Directors and officers have a fiduciary obligation and are held to a high standard of care that obligates them to make well informed, prudent decisions in good faith. The ability of the FDIC to deny access to key documents, bank records, and/or policies at the early stages of an FDIC investigation is an unfair practice that hinders the fundamental right of at-risk officers and directors to defend decisions being reviewed after-the-fact. Former directors and officers have a right to demonstrate at the investigation or demand letter stage that they satisfied their fiduciary obligations and merit protection under the business judgment rule despite the unfortunate outcome associated with certain historical decisions.

Recommendations Moving Forward

It is important that at-risk directors and officers arm themselves with the tools and knowledge necessary to decrease their liability exposure in the unfortunate event that he or she is, or faces the possibility of being, the target of an FDIC proceeding. By implementing the following practices, management will be better prepared to demonstrate reasonable due diligence in processes relating to understanding risk, setting risk parameters, and monitoring risk.

1. Focus on Keeping "Good" Minutes: In assessing liability, the key issue is not whether "bad loans" were made, but whether loans were made using "bad practices." Therefore, in determining the merits of initiating a formal action, the FDIC will carefully review management's conduct and decision-making process, which is primarily reflected in board and committee minutes. Minutes should comprehensively describe the deliberation process and reflect active participation by each director and/or committee member.
2. Form Independent Directors Committees: Committees comprised solely of independent directors should be formed to separate oversight responsibilities and ensure proper checks and balances.

3. Review and Understand D&O Policies: Management should review and understand the scope and coverage of in-place D&O policies, including whether the policies contain an "insured versus insured" exclusion that may allow the insurance company to deny coverage.
4. Stay Proactive: Even if failure appears inevitable, management should continue taking all reasonable steps to "save" the financial institution (*e.g.*, responding to exam criticisms, complying with enforcement actions, raising capital, and actively managing nonperforming assets).
5. Engage Special Counsel: The bank's attorney owes a duty of loyalty to the financial institution itself, not the individual officers and directors. The FDIC, as receiver, is the bank's successor-in-interest and becomes the attorney's client upon the bank's closure. As a result of this shift in the attorney-client relationship, the bank's attorney will be prohibited from taking actions inconsistent with the FDIC's position. In contrast, special counsel engaged to represent the officers and directors can: (i) advise the officers and directors as to the best way to fulfill their fiduciary obligations to the bank and its shareholders and (ii) help at-risk management by assembling documents that may be critical in defending against potential claims, reviewing D&O insurance policies and adequacy of coverage, and ensuring that records (*e.g.*, minutes and policies) are sufficient to support a legal contention that leadership acted in accordance with its fiduciary duties.
6. Maintain a Proper Perspective: Simply stated, in order for the FDIC to prevail in a suit against a director or officer it must prove that the losses incurred by the failed bank were caused by the gross negligence of the director or officer. Without regard to the facts and circumstances of any specific financial institution, there is a strong argument that the collapse of the world's financial markets, the real-estate downturn, and the ongoing recessionary environment caused the failure. Absent clear evidence of bad faith or other serious misconduct, the FDIC will have a difficult time proving claims against individual members of management.

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[1] According to information posted on FDIC's website, as of December 8, 2011, FDIC had authorized suits against 373 individuals in connection with 41 failed banks and had filed 17 court actions that, in the aggregate, named 135 former directors and officers of failed banks as defendants. FDIC, Professional Liability Lawsuits, Dec. 9, 2011, http://www.fdic.gov/bank/individual/failed/pls/index.html.

[2] The FDIC is authorized to take action against a bank in certain circumstances when the bank's primary federal regulator fails to act. *See* 12 U.S.C. § 1818(t). The FDIC's Office of Inspector General criticized the agency's failure to adequately use this authority for Washington Mutual and IndyMac. Department of the Treasury, FDIC, *Evaluation of Federal Regulatory Oversight of Washington Mutual Bank*, Report No. EVAL-10-002 (April 2010) *available at* http://www.fdicoig.gov/reports10/Eval-10-002-508.shtml; FDIC, *The FDIC's Role in the Monitoring of IndyMac Bank*, Report No. EVAL-09-006 (Aug. 2009) available at *http://www.fdicoig.gov/reports09/Eval-09-006-508.shtml*. In an article published by The Center for Public Integrity, Francis Grady, a former FDIC lawyer, was quoted as saying "just because the FDIC didn't catch something in 2005 and now it looks like that something was complete stupidity, that's not a defense." Ben Hallman, *FDIC Slow to Pursue Failed Bank Directors, Recover Tax Dollars*, Center for Public Integrity, iWatch News (March 15, 2011) *available at* http://www.iwatchnews.org/2011/03/15/3523/fdic-slow-pursue-failed-bank-directors-recover-tax-dollars.

[3] As of December 31, 2011, the FDIC has closed 249 financial institutions (since January 1, 2010). All indications suggest that this trend will continue considering that more than 800 institutions remain on the FDIC's "problem bank" list. FDIC, *Quarterly Banking Profile: Third Quarter 2011* at 4 (Sept. 30, 2011) *available at* http://www2.fdic.gov/qbp/2011sep/qbp.pdf.

[4] *Atherton v. FDIC*, 519 U.S. 213 (1997).

[5] FDIC, *Statement Concerning the Responsibilities of Bank Directors and Officers*, FIL-97-92 (Dec. 3, 1992) *available at* http://www.fdic.gov/regulations/laws/rules/5000-3300.html.

[6] *See FDIC v. Van Dellen*, No. 10-cv-04915, (C.D. Cal. filed Jul. 2, 2010); *see also FDIC v. Skow*, No. 11-cv-00111 (N.D. Ga. filed Jan. 14, 2011); *FDIC as Receiver for Wheatland Bank v. Spangler*, No. 10-cv-04288 (N.D. Ill. filed July 9, 2010).

[7] Lehman Brothers, the fourth largest investment bank in the United States prior to filing for bankruptcy, used Repo 105 transactions, which were essentially short-term secured loans, to sell toxic assets on a short-term basis (often overnight) to a third-party firm under an agreement to repurchase those toxic securities at a premium in the immediate future. Traditional repo transactions are characterized as loans and the underlying securities/assets securing the transaction remain on the firm's books and financials; however, through its creative application of accounting rules, Lehman Brothers was able to record these transactions as "sales," allowing them to remove $39 billion from their balance sheet at the end of the fourth quarter of 2007, $49 billion at the end of the first quarter of 2008 and $50 billion at the end of the second quarter of 2008.

[8] Report of Anton R. Valukas, Examiner, *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. March 11, 2010) (Docket No. 7531).

[9] According to information posted on the Independent Community Bankers of America's website as of June 30, 2011 *available at* http://www.icba.org/files/ICBASites/PDFs/cbfacts.pdf.

[10] 12 U.S.C. § 1821(d)(14)(A)(ii).

[11] 12 U.S.C. § 1821(d)(2)(A).

[12] In the event a formal legal or administrative action is instituted, named officers and directors would likely gain access to certain documents through discovery procedures. However, there is absolutely no right to such access prior to that time, including the period following receipt of an FDIC demand letter.