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Failed Bank Liability Issues: What All Directors Need to Know

The nationwide recession of the past several years has impacted all segments of the economy in ways unprecedented since the Great Depression. Outside economic forces and their effects on bank customers have created challenges for all banks.

Loans that were good when made have been written down, CAMELS ratings have fallen and many banks have been forced by regulators to raise additional capital or obtain TARP funds. In 2009, the FDIC was appointed receiver of 140 failed banks, with 50 additional bank failures by mid-April 2010. With more than 700 banks on the FDIC's problem list as of Dec. 31, 2009, there are clearly more failures to come. In the current environment, where virtually every bank is under increased regulatory scrutiny and economic pressure, the issue of director liability is at the forefront of the minds of those in the boardroom.

Directors owe fiduciary duties of care and loyalty to a bank and its shareholders. Directors do not need to be perfect to fulfill these duties. As the economic downturn has shown, many decisions that were made in good faith have had negative consequences. Under the legal doctrine known as the business judgment rule, directors are presumed to have performed their duties if they acted in good faith, with reasonable care and in a manner they reasonably believed to be in the best interests of the organization. Acting within the BJR creates a strong presumption in

favor of a director. In addition, state and federal statutes and case law have established that plaintiffs must prove gross negligence for director liability.

Of particular importance to banks is *In Re Citigroup Inc. Shareholder Derivative Litigation*, a 2009 Delaware case that reaffirmed the gross negligence standard and reiterated the "extremely high burden" for personal liability against directors. In that case, the court dismissed the claims related to the board's decisions and oversight of risk in connection with eventual losses in the subprime lending area, reaffirming the principle that "only a sustained or systematic failure of the board to exercise oversight ... will establish the lack of good faith that is a necessary condition to liability."

The key to complying with the BJR is focusing on an informed decision making process because, as *In Re Citigroup* shows, even decisions that had unfavorable results are protected if made in good faith.

To avoid or successfully defend against liability, a board should focus on documenting its process. Board meeting packets should provide all pertinent information, they need to be reviewed prior to meetings, and directors should actively participate. A director's best weapon is ensuring that the bank's minutes fully describe the deliberation process so that if a decision is ever questioned, it is clear that the BJR applies. Minutes do not need to be a transcript, although a full description

is appropriate to document discussions of major actions. Thorough and accurate minutes will be the best evidence of the board's process and good faith, and should be a priority for all banks.

With proper documentation of a board's process, a director will be well positioned to receive BJR protection and defend against claims of gross negligence. Even so, it is important to be aware of the potential liability a director can face, particularly if the economic and regulatory pressures become so great that a bank fails. When a bank fails, there are various enforcement actions the FDIC and other banking regulators can take against directors. The most serious of these actions are prohibition orders and civil money penalties for engaging in unsafe and unsound banking practices and violations of law.

A prohibition order forbids an individual from being involved with any bank unless prior regulatory approval is received, which typically results in the permanent removal of the director from banking. In many cases, CMPs will be the personal obligation of a director because most D&O insurance policies do not cover CMPs. Even if covered, the regulators generally prohibit indemnification for CMPs under 12 C.F.R. 359.

In addition to the negative effects of the orders themselves, prohibition and CMP orders pose significant reputational risks due to their public nature. If a director disagrees with

the outcome of an enforcement action, he or she may follow the procedures for hearing and judicial review set forth in the Federal Deposit Insurance Act. In enforcement actions resulting from alleged violations of fiduciary duties, this affords a director the opportunity to have a neutral court determine if the director's conduct was so egregious as to fall outside of BJR protection.

In addition to enforcement actions, the FDIC as receiver can initiate lawsuits against directors. At this time, we are seeing demand letters sent to directors of failed banks for the losses to the deposit insurance fund, with a copy to the bank's D&O carrier. Based on the demands we have seen, the FDIC thoroughly reviews a failed bank's D&O insurance and narrowly drafts the claims to fall within the scope of the policy. Because it is clear the FDIC will be attempting to recover D&O insurance proceeds, all banks should review their policies to understand the terms of the policy and the effect a bank failure may have on coverage.

An important item to note is whether your policy has an "insured

versus insured" exclusion that would give the insurance company an argument for denying coverage once the FDIC steps into the bank's shoes as receiver. In addition to understanding its D&O policy, the board of a troubled bank should ensure it has sufficient coverage and that the policy remains in effect. A troubled bank should consult with its insurer and legal counsel well in advance of receivership to determine the coverage for potential claims against directors — waiting until the bank fails could be too late.

Beyond issuing demands to attempt to collect on D&O insurance policies, the extent to which the FDIC actually pursues claims against directors in litigation in the current cycle of failures remains to be seen. Due to the BJR presumptions in favor of directors, the FDIC will have a difficult time proving its claim against a director absent clear evidence of bad faith or other serious issues.

In a Financial Institution Letter dated Dec. 3, 1992, the FDIC acknowledged that lawsuits against directors are brought only after lengthy, detailed investigations

and only where the FDIC believes the suit has sound merits and will be cost effective. According to the 1992 letter, the FDIC brought suit or settled claims with 24 percent of the banks that failed between 1985 and 1992. Although FDIC litigation is unlikely to be brought, and even more unlikely to be successful, directors need to be aware of this risk.

Directors can further minimize liability with regular, honest, non-adversarial communication with the regulators demonstrating that the board is diligently working to correct violations and comply with regulatory orders. With the scope of regulatory compliance, insurance, and liability issues troubled banks face, it is important to have experienced legal counsel and other professionals involved from an early stage. If failure begins to look imminent, the board should work with counsel to prepare to defend against liability. In addition, individual directors should strongly consider utilizing separate legal counsel to protect their individual interests. **BN**

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