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GUEST COMMENTARY

THE PAPER CHASE: EFFECTS OF FDIC DOCUMENT RETENTION POLICIES ON D&O SUITS

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As the Federal Deposit Insurance Corporation continues

to pursue professional liability suits against directors and officers of failed banks, the agency's recent regulatory guidance addressing the removal or copying of internal bank documents for both failed *and troubled* banks has further tilted the playing field in favor of the FDIC.

By severely limiting the instances in which bank directors and officers may remove or copy documents for their own personal defense, the FDIC has significantly impeded their ability to defend themselves against potential administrative, civil, and criminal proceedings. These disadvantages are most pronounced at troubled community banks, where directors and officers generally lack the background and resources to navigate FDIC investigations and litigation.

Interpreted in light of both the FDIC's recent litigation on this issue and the historical patterns of FDIC lawsuits, the new FDIC guidance allows the FDIC to build a robust case without having to turn to discovery or other traditional investigative or litigation techniques. The FDIC's new guidance gives the agency more documentary information than a potential defendant, and as a result, not only stacks the litigation deck against defendants but also significantly impairs their ability to negotiate fair and reasonable settlements.

FDIC's NEW GUIDANCE

On March 19, the FDIC issued Financial Institution Letter FIL-14-2012. In the FIL, the FDIC asserts: "Financial institution records belong exclusively to the financial institution," and that directors and officers may only use them to carry out their official duties "while [the] financial institution remains open." If the FDIC elects to close a bank and thereafter places it in receivership, the FDIC (citing 12 U.S.C.A. § 1821(d)(2)(A)) claims that this exclusive right of possession, custody, and control of all records — and all copies of records — vests automatically in the FDIC as receiver.

According to the FDIC, directors and officers have no right to collect records for "their own personal use in anticipation of or following the failure of a financial institution." However, in spite of this forceful language, the FDIC describes neither "personal use" nor "anticipat[ed]" failure, leaving directors and officers unsure precisely how the FIL will apply and when they may retain and use bank documents in litigation. The FIL also restates the FDIC's position that bank supervisory records and examinations are the property of the FDIC at all times.

However, the FDIC goes further than just claiming that these records are the property of the financial institution.

It argues that directors and officers who remove these documents may violate Gramm-Leach-Bliley, the Fair Credit Reporting Act, and FDIC regulations. The FDIC also asserts that removing these documents for personal use may breach the director's or officer's fiduciary duties to the financial institution and may be considered unsafe and unsound banking practices.

A HISTORY OF LITIGATION

Although the FDIC articulates a strong position on bank records in this letter, the FIL is merely the latest FDIC action to limit directors' and officers' access to records. In *FDIC v. Bryan Cave, LLP*, 10-cv-03666 (N.D. Ga., *complaint filed* 11/09/10, dismissed w/prejudice 08/18/11) bank directors deposited copies of bank books and records with their own outside counsel to defend their conduct in the event the FDIC decided to initiate enforcement proceedings or litigation. Once the bank went into receivership, the original documents remained with the bank and were transferred to the FDIC.

Even though no harm was done to either the FDIC or the bank, the FDIC filed suit to have these copies returned. Two *amici* — the Ad Hoc Committee of Bank Counsel and the American Association of Bank Directors — filed briefs in this case, arguing that the FDIC was not entitled to these documents as a matter of both law and policy. Approximately three months later, the parties reached a settlement, the terms of which are non-public, and the case was dismissed with prejudice.

Similarly, in *McKenna Long & Aldridge LLP v. FDIC*, 10-cv-3779 (N.D. Ga., *complaint filed* 11/17/10, *dismissed w/prejudice* 04/12/11), an outside law firm received copies of documents from executives of four banks that failed in 2010. The FDIC claimed that these copies violated the Computer Fraud and Abuse Act and demanded that the firm return both the documents and any legal fees paid from the bank's funds. The firm sought a declaratory judgment affirming its right to continue to possess the documents and defend its clients. Ultimately, the parties settled, and the case was dismissed last year. The terms of that settlement have not been made public.

Finally, in *FDIC v. Liberty Financial Group*, No. 2010cv06280 (D. Or., *complaint filed* 08/27/10, *dismissed w/prejudice* 02/23/11), the holding company for LibertyBank, wary of an FDIC lawsuit, copied all of the bank's loan files prior to the FDIC seizing the bank and transferred them to the holding company. After the FDIC demanded the files back, the holding company agreed, so long as the FDIC immediately filed a declaratory action to determine its ownership rights to the files. The case ultimately settled and, as in *Bryan Cave* and *McKenna*,

the terms of the settlement have not been made public.

STORM CLOUDS GATHER AGAIN

Disputes over the possession, custody, and control of documents like those described above will only intensify as more directors and officers are sued in the wake of recent bank failures.

Between January 2008 and April 2012, a total of 439 banks failed. The FDIC has authorized director or officer suits related to the closure of 54 of these institutions, with suits contemplated against 469 individual directors and officers, and damage claims of nearly $8 billion. In addition to these lawsuits, the FDIC has 156 residential mortgage malpractice/fraud lawsuits pending, with the FDIC board having authorized a further 29 lawsuits. These numbers likely omit other potential actions, including pre-filing settlements.

If the past is prologue, the FDIC is laying the groundwork for a round of D&O suits not seen in a generation. After the savings and loan crisis during the late 1970s and early 1980s, the FDIC and the Resolution Trust Corporation obtained $2.5 billion from directors and officers after years of litigation. The FDIC's and RTC's pattern during the savings and loan crisis was first to seize insured institutions to protect deposits, and then to use the records obtained to file waves of director and officer lawsuits. With a three-year statute of limitations from the date of seizure to file tort actions, six years to file contract actions, and ten years for certain criminal actions, the FDIC and the U.S. Department of Justice have ample time to review records and proceed with subsequent D&O suits in a similar pattern following the more recent bank failures.

A potential repetition of the trends following the S&L crisis may mean that directors and officers may only be witnessing the beginning of a vastly-expanded campaign of FDIC lawsuits. Between 1985 and 1992, the FDIC elected to file suit or obtain a settlement in an astounding 24 percent of all bank closures. To date, the FDIC only has approved director and officer lawsuits for 12 percent of the recently failed banks. If the ratio from the savings and loan period repeats itself, the number of lawsuits could more than double in the coming years.

FDIC'S FLAWED APPROACH – FROM BAD TO WORSE

In this heightened enforcement environment, the FDIC's position on bank records and documents will

harm directors, officers, banks, and ultimately consumers.

An FDIC action against a director or officer begins when the FDIC's board authorizes a lawsuit to proceed. During the pre-suit period, the FDIC frequently contacts the potential defendant directly to discuss settlement. At this point, many potential defendants — who are often directors and officers of small community banks and lack the effectively limitless resources and substantial experience of the FDIC — settle, rather than confront timely, costly, and inherently unpredictable litigation.

Because so many FDIC lawsuits settle, pre-suit (and often pre-discovery) negotiations become critical. To engage productively and on a level playing field during these discussions, directors and officers need access to bank records as early as possible. Although formal litigation likely would permit directors and officers to use traditional discovery tools (*e.g.*, subpoenas *duces tecum*, interrogatories, depositions, etc.) to obtain necessary documents, these tools are not available to potential defendants in early settlement negotiations.

Even after litigation, including discovery, commences, the imbalance of information and power continues to weigh grossly in favor of the FDIC. At this point, the FDIC has enjoyed the benefits of having analyzed documents that potential defendants and their counsel have not yet seen. If the FDIC deposes a defendant before permitting him or her to review such documents, the search for truth is ill-served. Because depositions often occur years after a transaction at issue, and because memories fade, documents grow more critical as a suit progresses. In fact, some complaints filed during the early 1990s by the RTC claimed that directors had breached their fiduciary duties more than 10 years prior to filing the complaint. It is simply unfair to assume that a director remembers an individual transaction from over a decade ago.

Although defendants in active litigation can use discovery to obtain these documents, the litigation adage that "possession is half the battle" remains true. Discovery takes time, perhaps the most important currency in D&O lawsuits. The FDIC is likely to "run out the clock" by requiring that certain conditions be met before releasing bank records. Because the FDIC will have the most time with these important documents, and because of the FDIC's large budget and deep bench of experience, defendants face an uphill climb.

NO COMFORT IN CONDITIONS

The FDIC has noted that, under certain conditions, it will permit directors and officers access to documents. However, these conditions offer little comfort. The FIL

states that the FDIC will allow directors and officers to obtain documents under "a suitable confidentiality agreement with the FDIC as receiver, or other acceptable assurance of confidentiality such as a protective order." It is unclear, however, what the FDIC would consider a suitable agreement. In other circumstances, the FDIC has pressed its position to its advantage; the FDIC has a history of requiring potential defendants to toll the statute of limitations in exchange for the FDIC continuing to investigate rather than filing an immediate suit. It is likely that the FDIC will use the retention of documents as yet another bargaining chip to extract concessions from current and former directors and officers.

Moreover, the FDIC has a history of not providing documents to defendants even when necessary. After the FDIC took over IndyMac, F.S.B., the FDIC retained all documents. In its lawsuit against two former executives, the defendants have argued that the FDIC has not preserved essential documents, and that the loss of these documents has adversely affected the defendants' ability to mount a successful defense. Although the Court ultimately found the defendants' argument to be premature, had the defendants been able to retain their own copies of these highly relevant documents, it is much more likely that they would have been preserved for trial.

In addition, rather than issue its opinion through a one-sided FIL, the FDIC should have sought such a change through legislation or, at a minimum, an open rulemaking process. Almost all states have laws that give directors and officers unfettered access to corporate records; the FDIC's policy represents an important deviation from the norm in director and officer independence and will reduce the incentives for individuals to serve as bank directors at the very time when banks most need the best and brightest at the helm. Because of the conflicting interests and real costs to the FDIC in taking a more aggressive position on bank records, a robust debate or comment period would have allowed the FDIC to fully explore the ramifications of its position.

LESSIONS FOR DIRECTORS AND OFFICERS

With the FDIC's new approach to depository institution records, directors and officers of troubled banks face considerable risks. Notwithstanding the FDIC's current position, we believe that there are steps that directors and officers can take to better protect themselves.

- First, directors and officers should retain their own personal counsel, independent from the bank's attorneys. This should be done early in the process, ideally before their bank is seized by the FDIC. Bank counsel is required to protect the interests of

the bank above all others, including the needs of individual directors and officers. To prevent confusion or ambiguity, and to preserve essential defense documents, directors and officers should retain personal counsel with experience in all areas where adverse actions may arise: civil suits, white collar criminal prosecution, internal investigations, and regulatory matters.

• Once retained, director and officer counsel can seek to negotiate a document retention agreement with the bank and the FDIC prior to the potential failure of the bank. This period provides directors and officers with a critical window when they may access documents necessary for a robust defense, but are prohibited from taking them for their own use. It is important to ensure that there is no break in document custody, and that directors and officers have the information necessary for their defense from the outset.

The number of such lawsuits is likely to rise, and without an experienced attorney advocating for directors' and officers' rights prior to their bank failing, the difficulty of defending individual D&O actions grows exponentially — especially in light of the FDIC's recent guidance. An ounce of prevention, in the form of advice from skilled counsel before the FDIC intervenes, is often worth a pound of cure.

Put another way, the time to repair the roof is when the sun is shining.