Banking Law

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Director Loan Committees Are Special Targets of the FDIC

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Over 400 banks have been closed since the onset of the financial crisis in mid-2008. During that time, more than 300 lawsuits have been authorized to be brought against officers and directors of the failed banks, according to the FDIC. Presumably, the vast majority of authorized suits seek recoveries from D&O insurance carriers for the alleged negligence and gross negligence of former officers or directors. A sizable number of those suits – those actually filed and those authorized but not filed – have targeted directors who were members of the directors' loan committee of the failed bank. We have seen cases where the FDIC targeted only those committee members and not directors who were not on such a committee.

The FDIC acknowledges that in making decisions whether to sue a director, among other things, it makes a distinction between so-called inside and outside directors. An inside director usually is a member of the board who also is an officer of the institution, such as the Chief Executive Officer. An outside director is one who does not participate in the conduct of the day-to-day affairs of the bank, though he or she serves as a director and may own a relatively small amount of stock. This suggests that there could be circumstances in which some outside directors will be treated differently from other directors.

Given recent experience and anecdotal evidence, it seems that the FDIC is drawing a bull's-eye around those outside directors who serve on a bank's directors' loan committee. These committees usually are charged with considering loans over a certain size or that present certain complexities that, under the bank's internal policies, are thought to warrant a higher level of scrutiny. In many institutions, the directors' loan committees are not merely advisory but, in fact, are the final approving authority. Executive management cannot override or ignore a declination determination of the committee. In this circumstance, are the members of the committee acting as part of executive management and, if they are, do they attract greater liability for losses if their decisions are later challenged as a result of a bank failure?

The FDIC's presumption seems to be that loan approvals are a function of management, while an outside director's function is one of oversight, not decision-making. In effect, the FDIC's position is that there really are two classes of outside directors and the closer that an outside director's activities get to executive management functions, the more those decisions – or at least the decisional functions they perform – should be judged differently than under the business judgment rule that protects other director actions taken in good faith. The FDIC is

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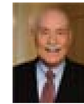

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suggesting that these credit decisions are subject to a simple negligence standard of conduct.

The business judgment rule protects a director from liability for an honest mistake of business judgment that later proves to have been wrong and that causes a loss to the bank. In banking, the most obvious example is a loan that goes bad and results in a loss to the bank. A mere mistake rather than a reckless act or decision will not give rise to director liability when the business judgment rule is applied. The FDIC is well aware that, given the business judgment rule, it is extremely difficult to prove that hardworking and dedicated directors were so deficient in meeting their responsibilities that they acted recklessly, without regard for the safety and soundness of the bank that eventually failed. However, if a higher standard were to be applied to some outside directors so that mere negligence is sufficient to give rise to liability, the FDIC's bargaining power would be significantly enhanced, especially with D&O insurance carriers.

The standard of care for the conduct of directors varies from state to state, with most jurisdictions applying the business judgment rule. In the *O'Melveny & Myers* case in 1994, the U.S. Supreme Court unequivocally reaffirmed its 1938 decision that there is no federal common law and rejected the notion of a separate federal standard being applied in FDIC receiverships. Thus, the business judgment rule is generally applicable, either as a function of a state's common law jurisprudence or is a matter of state statute.

State law varies as to whether the principles of the business judgment rule apply to the conduct of officers in addition to those of directors. To the extent they do not, and officers are held to a higher standard, then applying stricter officer standards to those outside directors who engage in executive management functions will be a matter of concern for those directors. It may not be enough for those outside directors to take care to do their job with that higher standard in mind so as to avoid possible liability for decisions. When FDIC lawsuits target directorial decision-making after the fact, it is simply too late to take corrective measures.

Courts in a number of states, such as Florida or Washington, have held that as a matter of state law, when considering the actions of a corporate officer, the business judgment rule applies rather than a standard of ordinary care. However, other states have decided the issue differently. For example, in California, in 1989 a Court of Appeal decided that the business judgment rule does not apply to officers and officer-directors acting in their capacity as officers. The court was construing the California Corporations Code's codification of the business judgment rule, which by its terms only applies to directors.

Recently, a senior FDIC official stated that, where the FDIC had targeted members of a bank's director's loan committee, "the loan committee members had been delegated the authority to approve the loans at issue by their board of directors, but they breached their duties of care and, in some cases, their duties of loyalty to the bank when they approved loans that violated the bank's loan policy and underwriting standards, among other things, and in some instances that were abusive insider transactions." This statement seems to ignore the

applicability of the business judgment rule.

That said, are directors who act like officers likely to face liability for simple negligence in states like California while, in other states, they would be protected by the business judgment rule? The FDIC seems to think so, but this is not a foregone conclusion. Even if a court were to conclude that the conduct of directors who act like officers is to be judged by a mere negligence standard, the FDIC would still have to prove that the director's conduct fell below the required standard and that the bank's losses were caused by the negligent acts of these outside directors. This is likely to be harder to prove than to assert, but, with the FDIC making these claims, the issue is likely to be faced squarely in the coming days or months.

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