Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Know The Standard Of FDIC Liability For Community Banks

Benjamin Saul

Law360, New York (February 05, 2013, 9:48 AM ET) -- Over 400 financial institutions have failed since the financial crisis began in September 2008, causing hundreds of billions of dollars in losses to the Deposit Insurance Fund (DIF).[1] On July 2, 2010, the Federal Deposit Insurance Corporation began its efforts to recover losses to the DIF when it sued officers of IndyMac Bank, then the second largest bank to fail in U.S. history.[2] The FDIC has filed a total of 41 professional liability lawsuits against former bank directors and officers of failed institutions.[3] A majority of the complaints have involved small or medium size banks.

The recent developments in FDIC professional liability litigation warrant close attention from community bankers. For example, consider the FDIC's focus in those lawsuits on director approval of individual loans. If courts ultimately hold that directors have an independent obligation to ensure that loans they approve as a member of the board or a loan committee were underwritten properly by the bank, then directors would face pressure to curtail or even avoid loan approvals, to exponentially increase the amount of time taken to verify proper loan underwriting, or both. Such outcomes would be especially acute at institutions with high concentrations of commercial real estate, the former directors of which have been the focus of over 90 percent of the FDIC lawsuits to date.[4]

This article discusses (1) how the FDIC litigates cases against former directors and officers of failed banks, (2) the results of recent federal district court rulings in these FDIC cases, and (3) how these decisions might impact community bank directors and lending.

Background

When an FDIC-insured bank fails, the FDIC guarantees the bank's deposits against losses up to $250,000 per account. The FDIC takes the bank into receivership, a process that replaces federal bankruptcy for insured banks, and pays depositors for their losses. The depositors receive the money from the DIF.[5] The DIF, in essence, is an insurance pool much like property or health insurance. When an insured bank fails, it submits a "claim" against the DIF, and the FDIC pays the claim.

The FDIC, acting as a receiver on behalf of the failed institution, operates like a trustee would in a bankruptcy matter. In its receivership capacity, the FDIC attempts to minimize the losses suffered to the DIF in various ways. The agency may attempt to sell bank assets, find another institution to assume the failed bank's deposits, sue to recover certain assets of the failed bank, and — in certain cases — sue bank directors (and sometimes other institution affiliated third parties) for negligence or other conduct.[6]

The statutory provision for the FDIC's power to sue bank directors when a bank fails is found in federal banking law.[7] After an initial investigation, the board of directors of the FDIC must authorize a lawsuit against specific directors.[8] Then, the FDIC will typically hire outside counsel to draft a complaint and manage the litigation against the directors. The FDIC itself, however, will continue to supervise the litigation, including whether and at what dollar value to settle a case.

Such cases proceed as civil — not criminal — litigation and are typically based on theories of ordinary or gross negligence and breach of fiduciary duties under state law.[9] Although defendants do not face criminal penalties in FDIC civil lawsuits, the monetary and reputational damages associated with these lawsuits can be significant. Monetary damages are generally based on losses suffered from specific loans approved by the directors.[10]

Common Allegations in the Complaints

Typically, the FDIC has asserted at least two counts against former directors in professional liability complaints. First, the FDIC has often alleged that directors were grossly negligent by approving specific loans with underwriting deficiencies, by ignoring suggestions and comments from regulators, or by adopting risky strategies that encouraged excessive growth or resulted in high portfolio concentrations of either commercial real estate or construction loans. Second, the FDIC has usually claimed that the same conduct by the directors constituted a breach of their fiduciary duties to the bank. In addition, some of the FDIC complaints have alleged ordinary negligence against directors for approving individual loans where borrowers ultimately defaulted.

The difference between ordinary and gross negligence is crucial to assessing the risk of liability in FDIC lawsuits. Ordinary negligence can be established by showing that a director did not act as an ordinary or reasonable director would have acted under the circumstances. In contrast, gross negligence is harder to establish because it typically requires a disregard for a director's duties[11] or an extreme deviation from expected behavior.

Note that these standards are defined under each state's law and may differ from state to state. Note also that the FDIC often alleges that the same conduct by directors was grossly negligent or, in the alternative, negligent. For example, the FDIC has alleged in various complaints that directors were negligent or grossly negligent in approving loans with purportedly outdated appraisals.[12] Further, the FDIC has claimed that directors were negligent or grossly negligent in approving loans with loan-to-value ratios that were allegedly incorrect or exceeded the ratios provided for in underwriting guidelines.[13]

In addition to allegations that directors negligently approved loans without sufficient independent diligence, the FDIC's complaints to date most frequently contain allegations that: (1) directors ignored regulatory warnings; (2) directors failed to ensure managers and staff complied with bank underwriting policies; (3) directors adopted an aggressive growth strategy focused on risky investments; and (4) directors allowed excessive concentrations in commercial real estate and construction lending.[14]

Recent Decisions

In the past 13 months, federal district courts have issued a handful of opinions regarding the standard of care applicable to directors in FDIC litigation. The consequences for corporate directorates of these fiduciary duty rulings are potentially far reaching.

As an initial matter, it is helpful to note some general principles on which these courts have premised their decisions. First, courts have acknowledged that the Supreme Court has held that under 12 U.S.C. 1821(k), directors are, at a minimum, subject to a gross negligence standard.[15] Second, courts have observed that state law may provide the FDIC with claims against directors based on an ordinary negligence standard and, if any such state law standards exist, then the FDIC can take advantage of them.[16]

Finally, in evaluating the claims in the FDIC cases, courts have focused heavily on the business judgment rule (BJR), a procedural and substantive defense that most states have implemented either through statute or court decisions. The BJR allows directors to make informed decisions without having the courts second guess the directors' exercise of their business judgment.[17] A number of courts have held that the BJR operates as a defense to ordinary negligence liability by creating a presumption that directors made decisions based on the best information available to them at the time the decision was made.

As to the specific rulings to date, district courts in Florida, Georgia and California (the three states with the highest rates of bank failures) have held that the BJR protects bank directors from ordinary negligence claims so long as the directors can show a minimum amount of diligence or reliance went into their decisions.[18] These courts have dismissed ordinary negligence claims in the early stages of litigation but have allowed gross negligence claims to proceed to fact discovery.

Conversely, a federal district court in North Carolina held that ordinary negligence claims could survive a motion to dismiss despite the BJR.[19] Similarly, a federal district court in Illinois ruled that the BJR and other affirmative defenses to negligence are to be considered at the summary judgment stage as opposed to the motion to dismiss stage.[20] When both ordinary and gross negligence claims are allowed to proceed to fact discovery, the litigation process may be more expensive and time consuming. The directors also face increased uncertainty as they may be required to wait until summary judgment or trial to know whether the BJR will protect them from the ordinary negligence claims.

The collective weight of the case law to date seems to indicate that, notwithstanding the BJR, most FDIC lawsuits that include gross negligence counts are likely to proceed to discovery. As a result, most FDIC cases will take longer for defendants to resolve (especially in cases requiring analysis of individual loan decisions).

Effect on Community Bank Directors and Lending

The recent rulings in the FDIC cases present mixed results for bank directors. In some states, the rulings clarify that the FDIC cannot maintain ordinary negligence claims against the directors, a positive development for directors given that an ordinary negligence claim is easier to establish. Directors still face potential liability for gross negligence, however, and without any final decisions in the FDIC lawsuits against directors, it remains unclear what specific conduct courts will find constitutes gross negligence.[21] To the extent these cases settle before summary judgment or trial, it could be some time before these fact sensitive issues are resolved by the courts. Given the risk of personal liability, current bank directors should be aware of and scrutinize the factual allegations in these cases to reduce that risk.

In this regard, bank directors may want to consider seriously whether they should have continued involvement in approving individual loans. If bank directors continue to approve individual loans, it seems clear that they need to conduct a reasonable amount of independent diligence to the extent they are involved in loan approvals. Directors should not rely solely on loan officers who present loans for approval. Banks should adopt comprehensive loan approval policies specifying directors' roles in approving individual loans. Potential red flags, including deviations from the loan policy or regulators' suggestions, should be documented and explained. Lastly, a careful examination of board minutes should be completed for any sessions where individual loans were approved.

Finally, the FDIC litigation and the increased duties these cases might impose on directors could have a negative effect on community bank lending and development. First, the heightened risk of personal liability will make it more difficult for community banks to attract quality directors to serve on community bank boards. Further, if bank directors are held personally and financially accountable for bad loans by the FDIC when a bank fails, there is a strong chance that directors will extend significantly less credit in an effort to avoid approving loans with any discernible risk. Contraction of credit is most likely to occur in construction and commercial real estate lending — areas the FDIC has branded as inherently risky. Such a result would, in turn, likely reduce funding for local development and affordable housing — areas where community banks have historically played a vital role. Given the nation's precarious economic recovery, such outcomes, while perhaps unintentional, are also highly undesirable.

--By Benjamin P. Saul, Aaron C. Mahler and Jared Kelly, BuckleySandler LLP

Benjamin Saul is a partner, Aaron Mahler is a counsel and Jared Kelly is a law clerk in the Washington, D.C., offices of BuckleySandler LLP. The authors represent banks, troubled banks, and their directors and officers in special investigations, government enforcement, complex civil and class action litigation, and parallel proceedings involving private litigants and federal and state enforcement agencies.

[1] FDIC: Failed Bank List, FDIC, http://www.fdic.gov/bank/individual/failed/banklist.html (last visited Jan. 9, 2013).

[2] ABE CHERNIN ET AL., CHARACTERISTICS OF FDIC LAWSUITS AGAINST DIRECTORS AND OFFICERS OF FAILED FINANCIAL INSTITUTIONS (2012) available at http://www.cornerstone.com/pubs/xprPubResultsCornerstone.aspx? xpST=PubRecent (last visited Jan. 9, 2013).

[3] FDIC: Professional Liability Lawsuits, FDIC, http://www.fdic.gov/bank/individual/failed/pls/index.html (last visited Jan. 9, 2013). The FDIC has authorized lawsuits against 89 failed institutions and 742 individuals for director and officer liability.

[4] DAVID BARIS & JARED KELLY, FDIC DIRECTOR SUITS: LESSONS LEARNED 13 (2012).

[5] See generally FDIC, A BRIEF HISTORY OF DEPOSIT INSURANCE IN THE UNITED STATES (1998) available at http://www.fdic.gov/bank/historical/brief/brhist.pdf (last visited Jan. 9, 2013). The DIF is completely funded by premiums paid by member institutions; no tax dollars are used to fund the DIF.

[6] FDIC Financial Institution Letter, FIL 87-92 (Dec. 3, 1992).

[7] 12 U.S.C. § 1821(d)(2)(A), (k).

[8] FDIC FIL 87-92 (1992).

[9] 12 U.S.C. § 1821(k) guarantees that the FDIC can bring a gross negligence claim but this is still defined and established under state law.

[10] See generally DAVID BARIS & JARED KELLY, FDIC DIRECTOR SUITS: LESSONS LEARNED (2012).

[11] Bank directors' duties are governed by federal and state law. The FDIC has outlined some of these duties in various publications. FDIC FIL 87-92 (1992); see also FDIC Pocket Guide for Directors (2007) available at http://www.fdic.gov/regulations/resources/director/pocket/index.html (last visited Jan. 9, 2013).

[12] E.g., Complaint, FDIC as Receiver for Benchmark Bank v. Samuelson, No. 1:12-cv-07907 (N.D. Ill. Oct. 2, 2012); Complaint, FDIC as Receiver for 1st Centennial Bank v. Appleton, No. 2:11-cv-00476-JAK-PLA (C.D. Cal. Jan. 14, 2011); Complaint, FDIC as Receiver for Haven Trust Bank v. Briscoe, No. 1:11-cv-02303-SCJ (N.D. Ga. Jul. 14, 2011).

[13] E.g., Complaint, FDIC as Receiver for Westsound Bank v. Johnson, No. 3:11-cv-05953-RBL (W.D. Wash. Nov. 18, 2011); Complaint, FDIC as Receiver for Community Bank & Trust v. Miller, No. 2:12-cv-00042-WCO (N.D. Ga. Feb. 24, 2012); Complaint, FDIC as Receiver for Florida Community Bank v. Price, No. 2:12-cv-00148 (M.D. Fla. Mar. 13, 2012).

[14] See DAVID BARIS & JARED KELLY, FDIC DIRECTOR SUITS: LESSONS LEARNED 11-17 (2012).

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

[16] Atherton, 519 U.S. at 216. If state law standards are more relaxed, however, such as an intentional misconduct standard, Section 1821(k) ensures that the FDIC can at least sue directors and officers for gross negligence. Id.

[17] See generally, Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985).

[18] See e.g., FDIC v. Skow, Case No. 1:11-cv-0111 (N.D. Ga. Feb. 27, 2012), reconsideration denied (N.D. Ga. Aug. 14, 2012); FDIC v. Blackwell, No. 1:11-cv-03423 (N.D. Ga. Aug. 3, 2012); Order, FDIC as Receiver for Florida Community Bank v. Price, No. 2:12-cv-00148 (M.D.Fla. Aug. 8, 2012). In California, however, only directors are protected by the business judgment rule, not officers. FDIC v. Castetter, 184 F. 3d 1040 (9th Cir. 1999).

[19] See Order, FDIC as Receiver for Cooperative Bank v. Rippy, No. 7:11-cv-00165-BO (E.D.N.C. Oct. 3, 2012).

[20] Memorandum Opinion and Order, FDIC as Receiver of Heritage Community Bank v. Saphir, No. 1:10-cv-07009, Doc. 135 (N.D. Ill. Sept. 1, 2011).

[21] A recent jury verdict found officers — not directors — liable for ordinary negligence in approving certain loans, but that verdict neither involved directors, nor included consideration of the gross negligence standard. See FDIC v. Van Dellen, No. 10-4915, Doc. 596 (C.D. Cal. Dec. 7, 2012)