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Banking Law

FDIC v. Bank Directors: Where Do We Stand?

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In a recent ruling, the federal court in Los Angeles found that directors of a failed credit union were not liable for acts alleged to be negligent because the actions of the directors were protected by the so-called business judgment rule.

The case was brought by the National Credit Union Administration, which is the federal regulator of federal credit unions. The defendants are the former directors of WesCorp FCU, a now defunct credit union that acted as a “banker’s bank” for other credit unions. The NCUA alleged that WesCorp had purchased very large amounts of Option ARM-based mortgage-backed securities without regard to conducting sufficient analysis of the creditworthiness of the underlying securities or concentration limits in the institution’s portfolio. The NCUA alleged that this failure was negligence and the proximate cause of the credit union’s subsequent collapse.

The former directors countered that they had acted in good faith and in the exercise of their business judgment in overseeing the credit union and that as a consequence the directors' actions were protected by the business judgment rule. The court agreed and dismissed the allegations of the complaint founded on negligence without leave to amend because multiple previous efforts to amend the complaint had been insufficient to allege director conduct that would support an exception to the protections of the business judgment rule.

The holding of this case is equally applicable to actions brought by the FDIC against former directors of a failed bank. In fact, the provisions of the Federal Deposit Insurance Act force the FDIC in these suits to allege facts which constitute "gross negligence," a higher requirement, or such acts as demonstrate an even greater disregard of the director's duty of loyalty. In effect, gross negligence in the context of director conduct would amount to an exception to the business judgment rule. The question is when does director conduct cross the line from protected acts to unprotected, and hence vulnerable, conduct. It should be noted that this protection is not afforded to officers of an institution and hence their conduct can be actionable even if only barely negligent.

A director owes a threefold duty to a corporation the director serves: a duty of obedience, a duty of loyalty and a duty of care. This threefold concept is encompassed in the doctrine of the fiduciary duty owed by a director. The duty of obedience requires that the director act in a manner that does not extend the entity's activities beyond those authorized by the entity's organization document and by law. The duty of care requires the director to be informed with all the material information concerning any issue before the board before making a business decision. The duty of loyalty raises the expectation of director independence and the lack of any conflict of interest. A failure by a director to adhere to these duties raises the specter of personal liability unless, as permitted in Delaware, the corporation has adopted an exculpatory provision in its certificate of incorporation. For bank directors, no such exculpatory protection is permitted because of the Federal Deposit Insurance Act.

For a bank director, gross negligence would encompass a complete disregard of the institution's statutory mandate and permitting it to engage in conduct which violates the law. Similarly, gross negligence would include participating in decision-making without knowledge of the material facts and circumstances surrounding the decision or without having performed any directorial oversight over the conduct of management with respect to the decision. Finally, when a director is motivated by a personal interest which overrides consideration of the best interests of the institution, the director would be judged to have acted with gross negligence. In each of these cases, the director would have acted recklessly or in a manner that showed that the director was "asleep at the switch." At the same time, it should be noted that under some state laws, a lower threshold of mere negligence applies.

That said, there are recurring themes that have emerged in the complaints that the FDIC has filed to date against former directors of failed banks. Whether these allegations can be proven, and if proven, would constitute reckless conduct or gross negligence not protected by the business judgment rule, remains to be seen. Nevertheless, the allegations made by the FDIC are instructive in understanding the current environment involving claims against former directors of failed banks.

Given that the predominant number of bank failures arose out of the crash of the residential and commercial real estate market, it is not surprising that most of the FDIC's claims are based on that market failure, one way or another. Here are some of the recurring themes:

- that directors permitted an unsustainable growth strategy designed to exploit the real estate market but failed to protect the bank from the substantial inherent risk associated with that growth, by

- overconcentrations in acquisition, development and construction loans, which in at least one case was over 80% of the bank's entire loan portfolio, or

- lack of supervision of senior management and undue reliance on them in loan originations without assurances of core competencies in areas of credit administration and risk underwriting and without adequate policies and procedures to enforce prudent lending, informed decisions and adequate monitoring.

- that directors neglected to heed warnings from bank regulators, particularly those contained in reports of examinations and exit interviews, about deteriorating asset quality and capital, or failed to make corrective changes in accordance with the directions of regulatory authorities.
- that directors permitted the making of "insider" loans without adequate analysis or documentation.
- that directors declared dividends payable to the bank's holding company at a time when asset quality was declining significantly and the required capital ratios were being reduced.

By the same token, it is important to note that, at least in jurisdictions where the standard of proof for alleged director misconduct is gross negligence, some of these allegations presume that the directors were completely unaware of a deteriorating real estate market or were blind to the urgings of the regulators. Even though conduct rising to the level of gross negligence does not necessarily mean that the directors acted in bad faith, it still means that the directors were aware of the issues before them and chose to ignore them. In many cases, no matter what an attentive, well-meaning and competent board of directors tried to do, the solutions to the problems facing the bank simply eluded them because of various market factors. In many ways, the FDIC is attempting to substitute its after-the-fact judgment for that of the board made in real time.

The cases make it clear that courts should not substitute the plaintiff's assessment for that of the board of directors. This principle is based on the premise that those to whom the management of a business enterprise has been entrusted are best able to judge what is the best strategy or course of conduct for the organization or the attainment of its business objectives. Or, as is sometimes said, the application of the business judgment rule is to prevent a court from second-guessing honest, if inept, business decisions.

The presumption of good faith embodied in the business judgment rule only is overcome when there is evidence of specific actions or failure to act by the directors because of improper motives or undue influence, as a result of a lack of reasonable inquiry or because of a conflict of interest. To analyze the attempts by claimants, including the FDIC, to get over this hurdle, courts are willing to give credence to allegations of conduct which are so clearly against the various interests of the institution that they must have arisen because of improper motives, undue influence, conflicts of interests or a failure of a director to meet the duty of care, i.e., to be fully informed before making decisions.

The lesson for directors or prospective directors of existing banks is that these FDIC-led challenges of past behavior help to delineate the boundaries of proper director fiduciary conduct expectations for banks. Current directors should take note and act accordingly as they face challenges within their institutions or in their markets. Here are some takeaways to be considered:

- Directors have a broad responsibility for oversight of a bank and therefore service as a member of the board should not be seen as a "hobby" or a prestigious pseudo-club membership; significant amounts of time need to be dedicated for a director to adequately perform in accordance with FDIC expectations.
- Directors must not merely rely on the actions or recommendations of senior management but are charged with holding management's feet to the fire in addressing strategic challenges and specific operational problems and proposing solutions.
- Directors must be exacting in their appraisal of the competency of senior management and must be in a position to make changes when incompetency is apparent, sooner rather than later.
- Directors must demonstrate that they are acting independently, free from any allegiance to management, and cannot allow themselves to be managed by a dominant CEO or controlling shareholder.

- Directors may not turn a blind eye to unsafe or unsound practices or to potential violations of law, particularly in those areas identified by bank examiners as warranting further attention or action.
- Directors must be very sensitive to the appearance of a conflict of interest and must leave all self-interest at the door.

Most bank directors understand their job and the demands under which they operate. Still, to date the FDIC officially has authorized lawsuits against 266 individuals with total damage claims totaling about $6.8 billion. Thus, failures of a few are now being trotted out as a warning to the many bank directors serving today.