Why the Directors of a Troubled Bank Need Separate Legal Counsel

Background

Over the last three-plus years, there has been a great deal of focus placed on the lead-up to and immediate aftermath of bank receiverships - the regulatory enforcement orders, the sale of bank loans on DebtX, the use of loss-share arrangements, etc. As time has passed, there is now emerging an increasing focus on the longer-term fallout from bank receiverships and, in particular, the actions the FDIC takes against officers and directors, professionals and other related parties to try and maximize the government's recovery efforts. One of the reasons for this is the recent increase in publicized litigation activity by FDIC in its receivership capacity - both in terms of lawsuits actually filed and in the authorization by the governing board of the FDIC for additional suits to be brought against directors and officers in connection with bank receiverships of the past few years. As counsel for hundreds of community and regional banks across the country, including over 35 institutions that have been placed in receivership in this cycle, we can assure you that the investigations happening right now will continue for some time. The statutes of limitations for the actions that may be brought by FDIC are long, and the FDIC is generally in no hurry to bring actions. While every bank failure may have unique facts and circumstances, the basic claims of negligence, gross negligence, and breach of fiduciary duty against the officers and directors of the institution are similar across the spectrum of bank failures from the smallest community bank to the largest multi-state ones. *Historically, the FDIC has asserted claims against officers and directors in roughly one-third of all bank failures.*

As of August 4, 2011, the FDIC had authorized suits against 266 individuals for claims amounting to nearly $6.85 billion.[1] Through the end of August, 2011, the FDIC had filed eleven suits naming 77 individual directors and/or officers as defendants. In addition to these claims against directors and officers, the FDIC has also authorized fidelity bond, legal malpractice and appraiser malpractice suits. For purposes of reference, during the 1986-2009 time period, the FDIC and the RTC actually collected **$6.2 billion** from professional liability claims while spending **$1.5 billion** to fund the claims and investigations.

Immediately following a bank failure, a division of the FDIC is charged with the responsibility for examining what types of causes of actions may exist against the officers, directors and related parties of the failed institution. For example, while most directors are aware that they might be held liable for their actions, the FDIC can also choose to bring actions against a bank's outside accountants, lawyers and other professional advisors. Actions might also include ones against insurance brokers for selling the bank the wrong type of D&O coverage or against appraisers for

[1] Source: http://www.fdic.gov/bank/individual/failed/pls/ The FDIC currently updates this summary information on a monthly basis.

participating in loan flipping schemes which caused the bank to lend money against inflated property values. As part of these investigations, the FDIC will review the minute books of the institution and review decisions made on individual loans to determine if the board was providing the appropriate oversight to management on credits. The FDIC may pull out certain troubled loans for further investigation to point out weaknesses in loan underwriting which might serve to show an overall pattern of negligence on the part of the parties who approved the loans.

While the standards of conduct and duties owed by any bank director remain constant in the eyes of the law, as a practical matter, the decisions made by the board of a financial institution that has become distressed as a result of the current economic troubles will clearly receive increased scrutiny. In the event of a receivership of the bank, the FDIC has developed a sophisticated protocol for evaluating possible recoveries for the deposit insurance fund, and the decisions made by each director of a bank placed into FDIC receivership will be evaluated as a possible source of recovery.

Action Items

D&O Counsel. It is important to recognize the fact that your regular bank counsel represents the institution and not individual officers or directors. In the event that the bank is to fail and the FDIC is appointed the receiver, the FDIC will stand in the shoes of the former bank. As a result, all of the outside counsel's communications and records relating to their representation of the bank will then be available to the FDIC. Any communications that were previously covered by the attorney-client privilege now lose that protection because the FDIC, as receiver for the failed bank, holds the privilege.

In addition, the requirements of certain of the regulations within which a bank must operate often become much less intuitive as a bank's capital levels decline. Some of these regulations carry with them possible liability for bank directors in their individual capacity, and we as board counsel can provide dedicated guidance from this perspective. Moreover, particularly for banks with holding companies, directors need to be particularly conscious of the various "hats" that they are wearing at any given time and what obligations to which of the institution's constituencies (shareholders, creditors, customers and, after a particular point, the FDIC and the deposit insurance fund) are in play with respect to a particular decision being made. The attention of dedicated, independent counsel for the directors and/or officers can also aid in the board's awareness of possible tension as between these constituencies. In light of the above, we generally recommend that the directors retain separate D&O (director and officer) counsel prior to the failure of the institution in order to preserve insurance coverage and to allow full and frank conversation with counsel about potential liability for individual actions, in a privileged environment, and on an ongoing basis. D&O counsel can also assist in building the record for your possible defense if the FDIC later brings an action.

D&O Insurance Review. It is also vital that the board review its insurance coverage and make sure that the policy carried by the bank or the bank's holding company provides adequate coverage not only for the directors and officers but also for the bank itself on an ongoing, operational basis. We often find that directors and officers are not familiar with the various exclusions in their D&O insurance policy that may have a direct impact on the level of coverage provided in the case of a bank failure. D&O counsel can assist in making sure that you have the appropriate coverage in place and can advise you of all possible options to preserve existing coverages with respect to possible future claims. Depending on the insurance policy and the bank's particular facts and circumstances, it may be appropriate to provide notice of a potential claim when coverage under an existing policy is ending, whether or not the bank is facing receivership.

Review of Actions. At some point in this investigatory process you may realize that although you thought you were the "good guy" in serving on the board and trying to do your duties, the FDIC now looks at you as the "deep pocket." As a practical matter, most FDIC actions are an attempt to recover under the D&O insurance policy but, historically, in about 10% of the cases the FDIC also looks to the directors' personal assets. You might naturally ask: "What should I do to minimize my risk of liability such a situation?" One of the first things that directors should be thinking about prior to a bank failure is "How do I tell my story?" When a bank is taken over, the FDIC obtains complete control over all of the bank's documents including items such as board minutes. As a result, it is important to have conversations with D&O counsel related to the actions that the directors and officers of the Bank have taken while operating the Bank. These conversations may result in D&O counsel reviewing certain records of the Bank in order to better understand the history of actions taken by the directors and officers of the Bank. Because the directors and officers may not have ready access to these records following a failure of the Bank, it is important to review them while the Bank is open.

Post-Receivership. The FDIC has discretion in determining who it will sue once a bank fails. Managing the relationship with the FDIC investigators or outside counsel retained by the FDIC is essential. Separate D&O counsel can assist in this process because former bank counsel cannot represent you in any discussions you might have with the FDIC.

Conclusion. This summary only touches on a number of significant issues and is not intended to provide complete guidance on the matters set out above. Individual fact patterns such as whether actions were intentional or merely inadvertent can have immense impact on the outcome of any particular investigation. Likewise, there can be significant legal debate over whether in a particular state the proper trigger for potential liability for directors is "negligence" or "gross negligence." Similarly, insurance coverage may vary as to how legal fees are covered, whether existing coverage is adequate and whether additional reporting time periods may be purchased. We encourage you to consult with counsel and discuss your particular situation.

At Bryan Cave we represent both financial institutions and directors and officers of financial institutions across the country. We invite you to visit our blog at bankbryancave.com to keep current on legal and regulatory issues relevant to banks today.