DechertOnPoint

November 2010 / Issue 5

A legal update from Dechert's Financial Institutions Group

FDIC Brings Second Action Against Directors or Officers of Failed Banks

Industry observers have been waiting to see when bank failures arising out of the recent financial crisis would produce a wave of Federal Deposit Insurance Corporation ("FDIC") litigation similar to that seen in the early 1990s after the savings and loan crisis.

The FDIC has significantly increased its legal staff in the last few years and has engaged outside law firms to perform professional liability investigations and to conduct litigation in connection with recently failed institutions. Moreover, an FDIC spokesman recently stated that the FDIC has authorized legal actions against seventy former directors and officers of failed banking institutions in an effort to recoup more than $2 billion in losses. The FDIC also has reportedly sent hundreds of demand letters to former directors and officers of failed institutions and their insurance carriers advising them of investigations or potential lawsuits.

The S&L crisis in the late 1980s brought into sharp focus the potential liability of directors and officers when an insured depository institution fails. The FDIC has stated that it and the Resolution Trust Corporation recovered approximately $6.1 billion from professional liability claims and brought claims against directors and officers in approximately 25% of all bank failures during the S&L crisis period.

Heritage Community Bank

On November 1, 2010, the FDIC, as receiver of Heritage Community Bank, Glenwood, Illinois ("Heritage"), filed suit in federal district court in Illinois seeking to recover losses of at least $20 million allegedly suffered by Heritage, an institution that had approximately $230 million in assets that was closed by Illinois banking regulators in February 2009. The complaint alleges that eleven of Heritage's former directors and/or officers engaged in negligence, gross negligence, and breach of fiduciary duty by, among other things, failing to properly manage and supervise Heritage's commercial real estate ("CRE") lending program. The eleven defendants include former members of Heritage's board of directors, including five outside directors, and former officers.

The complaint alleges that the defendants failed to protect Heritage from the substantial inherent risks of large-scale CRE lending. The complaint also alleges deficiencies in Heritage's CRE lending program, including deficient loan underwriting and monitoring. The complaint claims, among other things, that Heritage routinely financed CRE projects without any meaningful analysis of their economic viability and often with inadequate appraisals, repeatedly made loans with excessive "loan-to-value" ratios, and failed to properly evaluate the creditworthiness of CRE borrowers and guarantors to ensure they could reliably repay their loans.

The FDIC alleges that the defendants tried to mask Heritage's mounting problems by making new CRE loans and making additional loan advances on existing troubled loans, allegedly often replenishing "interest reserves," which the FDIC alleges allowed borrowers to pay interest with more borrowed funds.

The FDIC further alleges that the director defendants breached their fiduciary duties by approving dividends and incentive awards to senior management at a time when they should have increased loan loss reserves and bank's capital.

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The Heritage action shows the FDIC's willingness to seek to recover losses from directors and officers of even relatively small community banks in order to recoup, what may be considered by some to be, relatively small losses. The FDIC estimated that the resolution of Heritage would cost the Deposit Insurance Fund approximately $42 million.

The FDIC's action in Heritage is particularly noteworthy because it extends to outside directors and shows the FDIC's willingness to bring an action to recover losses against directors and officers of failed institutions for simple negligence. During the S&L crisis, the FDIC reportedly applied a threshold review standard of "gross negligence" in determining whether to pursue director liability claims.

In this case, the FDIC suit alleges negligence and breach of fiduciary duty by five outside director defendants. Under Financial Institutions Reform Recovery and Enforcement Act of 1989, a director or officer of a federal or state insured depository institution may become personally liable for money damages in any civil action brought by or on behalf of the FDIC for "gross negligence", including any similar conduct or conduct that demonstrates a greater disregard of a duty of care, as such terms are defined and determined under applicable state law. 12 U.S.C. § 1821(k). The Supreme Court has interpreted this provision to mean that if state law provides for a lesser showing of culpability (such as mere negligence) to establish a breach of care by directors and officers, the FDIC need only prove such lesser standard of care (and need not prove gross negligence) to establish liability. *Atherton v. FDIC*, 519 U.S. 213 (1997).

In a prior action that was also brought in federal court in California, the FDIC sued the directors of a national bank to recover losses sustained by the failed bank under a theory of simple negligence. *FDIC v. Cassetter*, 184 F.3d 1040 (9th Cir. 1999). Under the circumstances of that case, the Ninth Circuit Court of Appeals held that the directors had acted in good faith and with the belief that their actions were in the best interests of the bank, and that as a result, California's business-judgment rule insulated the directors from liability. Thus, in appropriate circumstances, the business-judgment rule may shield directors and officers of failed institutions from suits brought by the FDIC based upon a theory of negligence or breach of fiduciary duty.

In a 1992 Policy Statement Concerning the Responsibilities of Bank Directors and Officers ("Policy Statement"), the FDIC stated that in determining whether to bring an action against a director, the FDIC distinguishes between inside and outside directors. The Policy Statement notes that in contrast to an inside director, who is generally an officer of the institution or a member of a control group, an outside director usually has no connection to the bank other than his directorship and, perhaps, is a small or nominal shareholder, and generally does not participate in the conduct of the day to day business operations of the institution.

According to the Policy Statement, the most common suits brought by the FDIC against outside directors involve insider abuse or situations where the directors failed to heed warnings from regulators, accountants, attorneys or others of a significant problem in the bank that required correction. In the latter instance, if the directors failed to take steps to implement corrective measures, and the problem continued, the Policy Statement states that directors may be held liable for losses incurred after the warnings were given. In the Heritage action, the FDIC alleges that defendants failed to heed regulatory criticism warning them to control their CRE lending and set appropriate limits to avoid over-concentration in that area.

IndyMac Bank

On July 2, 2010, the FDIC filed its first lawsuit against a director or officer of a recently failed depository institution. In its capacity as receiver of IndyMac Bank F.S.B ("IndyMac"), the FDIC filed suit in federal district court in California seeking damages for alleged negligence and breach of fiduciary duties against four senior officers of IndyMac's Homebuilder Division ("HBD"). The defendants include, among others, HBD's former Chief Executive Officer, Chief Compliance Officer, and Chief Lending Officer.

The complaint, which runs over 300 pages and includes 68 counts of alleged wrongdoing, centers on HBD's alleged pursuit of a high-risk growth strategy and high-risk credit underwriting strategy. The allegations made by the complaint include, among other things, that the defendants negligently approved loans (i) where one or more of the sources of repayment of the loan were not likely to be sufficient to fully retire the debt; (ii) that violated applicable laws and regulations and/or the IndyMac's internal policies; (iii) to borrowers who were or should have been known to be not creditworthy and/or in financial difficulty; (iv) with inadequate or inaccurate financial information regarding the creditworthiness of the borrower and/or guarantors; (v) with inadequate

appraisals; (vi) to be renewed or extended to borrowers who were not creditworthy or were known to be in financial difficulty and without any reduction in principal and without taking proper steps to obtain security or otherwise protect the IndyMac's interests; (vii) negligently continuing and even expanding HBD's homebuilder lending despite knowledge of deteriorating market conditions; (viii) despite the IndyMac's having a high geographic concentration of loans in the same market; and (ix) where there was very little likelihood of the loan repaying within the term of the loan. The FDIC estimated in the complaint that IndyMac's losses on HBD's portfolio exceed at least $500 million.

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