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THE FDIC PREPARES TO THROW DOWN: ISSUES FOR D&O INSURERS TO CONSIDER

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"We're ready to go," Richard Osterman, the FDIC's acting general counsel recently declared in an interview with Bloomberg regarding the FDIC's readiness to file lawsuits against the former director and officers (D&Os) of several failed banks.[1] "We could walk into a court tomorrow and file the lawsuits."

The ongoing "credit crisis" has ravaged the United States banking industry at a level not seen since the Savings and Loan (S&L) crisis of the late 1980s and early 1990s. Since January 1, 2008, 325 banks have reportedly been shut down and taken over by the FDIC.[2] Despite having filed only four lawsuits against the D&Os of failed banks since the onset of the credit crisis in January 2008, the FDIC is reportedly in the planning stages of filing numerous lawsuits. As of January 2011, the FDIC has authorized legal actions against 109 former D&Os of failed banking institutions in an effort to recoup more than $2.4 billion in losses.[3] As a practical matter, the FDIC is targeting the D&O insurance policies issued to failed banks as a key source of recovery.

Using the S&L crisis of the 1980s as a backdrop, this article explores the impact of the credit crisis on the U.S. banking industry; examines the factors influencing the FDIC's decision to pursue enforcement actions against the D&Os of failed banks; and highlights certain coverage and liability issues that D&O insurers should consider when evaluating strategies to resolve FDIC enforcement actions.

MORE LAWSUITS ON THE WAY?

Despite closing 325 banks since 2008, to date, the FDIC has filed only four lawsuits against the D&Os of failed banks. As a general matter, not all bank failures administered by the FDIC lead to litigation against the failed bank's D&Os. During the S&L crisis, the FDIC filed lawsuits against the D&Os of one out of every four failed banks.[4] Some commentators have suggested that the FDIC is likely to pursue claims against bank D&Os as "vigorously" as it did during the S&L crisis, which means that the FDIC could file in excess of 100 additional lawsuits arising from those banks that closed since the beginning of 2008.

The FDIC's lengthy investigatory and decision-making process, which typically takes up to 18 months, but can last as long as three years,[5] likely explains why the FDIC has only filed four lawsuits to date. Once the FDIC is appointed as a receiver for a federally insured bank, the FDIC's Professional Liability Group, which is responsible for investigating and prosecuting civil claims against the D&Os of the failed bank, reviews internal bank documents and conducts preliminary interviews relevant to potentially dishonest conduct, violations of federal or state banking law, and failures to establish or to adhere to proper underwriting procedures.[6] Depending on the results of its investigation, the FDIC may issue a non-public civil demand letter[7] to the failed bank's D&Os, which demands civil money damages resulting from the alleged breaches of fiduciary duty and negligence of the failed bank's former D&Os.[8] Following the civil demand letter, the FDIC may issue administrative subpoenas to the failed bank's former D&Os directing them to produce documents and/or provide testimony relevant to their personal financial affairs.

THE S&L CRISIS VS. THE CREDIT CRISIS

Despite fewer overall bank failures, the credit crisis has already resulted in a comparatively higher severity of losses. From 1980 through 1995, more than 1,600 banks insured by the FDIC were either closed or received FDIC assistance, which represented 9% of all U.S. banks chartered at the time.[9] Total assets of all failing banks during this period were over $500 billion,[10] as small and medium-sized regional banks (total assets under $100 million) constituted the majority of bank failures. Overall, almost 90% of all banks that failed in that time period had less than $1 billion in assets.[11]

The distribution of failing banks during the S&L crisis stands in stark contrast to that of the current credit crisis. During the current credit crisis, 22% of all bank failures have involved banks with assets greater than $1 billion—a 120% increase in the percentage of large bank failures over the S&L crisis.[12] Also striking is the increase in failure rates for banks with total assets between $100 million and $1 billion. Whereas only 37% of bank failures during the S&L crisis had total assets of between $100 million and $1 billion, this demographic has resulted in 59% of all bank failures during the credit crisis.[13] Due to the increased rate of large bank

failures, insured losses per bank have also increased. Currently, economists estimate that insured losses per bank average $303 million, up from $94 million per bank during the S&L crisis.[14]

In large part, the causes of bank failures during the S&L crisis and the credit crisis are notably similar. In the aftermath of the S&L crisis, the FDIC and the Office of the Comptroller of the Currency (OCC) determined that the primary cause of the S&L-era bank failures was the combination of inadequate management and volatility in the interest rate and real estate markets.[15] In addressing management issues, the FDIC and OCC both concluded that senior management in many failed banks exhibited a lack of oversight, developed inadequate credit risk controls, adopted high-risk lending and business strategies, allowed the bank's portfolio to become concentrated in high risk real estate lending markets, and failed to properly staff certain segments of the bank's risk assessment department.[16] Although in-depth studies of bank failures during the S&L crisis have not yet been performed, an examination of the allegations of the lawsuits filed by the FDIC and the publicly-available "civil demand" letter reveals similar problems at failed banks during the credit crisis. For example, in *FDIC v. Scott Van Dellen et al.*,[17] the FDIC alleges that the former executives of IndyMac's Homebuilder Division (HBD) breached their fiduciary duties by: (1) repeatedly disregarding HBD's credit policies and approving loans to borrowers who were not credit worthy; and (2) pushing loan growth despite their awareness that a significant downturn in the market was imminent and warnings from IndyMac's management regarding the likelihood of a market decline. Similar to the root causes of the bank failures during the S&L crisis, the FDIC alleges that HBD's management continued homebuilder lending in deteriorating markets even after becoming aware of the market decline.[18]

LIABILITY AND DAMAGES ISSUES

The Financial Institution Reform, Recovery and Enforcement Act of 1989 (FIRREA) provides that bank D&Os are personally liable for "monetary damages"[19] arising from the "improvident or otherwise improper use or investment of any insured depository institution's assets."[20] Indeed, a civil demand letter issued by the FDIC typically includes a list of foreclosed loans and estimated losses on those loans as support for demanded monetary damages.

The U.S. Supreme Court has held that FIRREA "provides only a floor —a guaranty that officers and directors must meet at least a gross negligence standard. It does not stand in the way of a stricter standard that laws of some states provide."[21] Accordingly, courts are free to apply a less culpable standard of conduct, such as "simple" or "ordinary" negligence, where state law establishes such conduct as the measure of liability.

The relatively low standard of liability, which is in stark contrast to the requisite proof of scienter under the Securities Exchange Act of 1934 or civil fraud statutes, combined with potential damages in the hundreds of millions, creates the potential for significant exposure to D&Os of failed banks.

D&O COVERAGE CONSIDERATIONS

Historically, D&O insurance has been one of the main sources of financial recovery for the FDIC.[22] Because the FDIC only pursues litigation where the potential recovery outweighs the costs of investigation and litigation, the available limits of D&O insurance to fund a settlement or a judgment is an important consideration. D&O insurance is a particularly important part of the FDIC's decision-making process given that the D&Os of failed banks often lack personal assets sufficient to satisfy the FDIC's claims. In fact, litigation is unlikely to pass the FDIC cost-effectiveness test if little or no D&O coverage is identified and/or the bank D&Os have few liquid personal assets.[23]

For the most part, D&O policies no longer contain provisions that specifically limit coverage for enforcement actions by the FDIC. During the S&L crisis, D&O insurers asserted that FDIC lawsuits triggered the "regulatory exclusion," which barred coverage for lawsuits or administrative proceedings initiated by regulatory agencies. Indeed, by 1995, 50 to 75 percent of all D&O policies contained the "regulatory exclusion."[24] However, as the sting of the S&L crisis waned, insurers began to remove the regulatory exclusion from D&O policies, to the point where the majority of bank D&O policies no longer routinely include the regulatory exclusion. The "insured v. insured" exclusion is also inapplicable to bar coverage for FDIC lawsuits in most D&O policies. During the S&L crisis, many D&O insurers denied coverage for lawsuits brought by the FDIC because the FDIC, in its capacity as receiver, "stepped into the shoes" of the insured bank, which effectively means that the bank (an insured) asserts claims against other insureds (*i.e.*, the bank's D&Os). Today, the applicability of the "insured v. insured" exclusion is somewhat limited because many D&O policies now specifically carve out claims asserted by the FDIC or a bankruptcy trustee from the scope of the exclusion.

Fines or penalties sought by the FDIC may not constitute covered "Loss" under a D&O policy. The FDIC is empowered to seek fines or penalties from the D&Os of failed banks as a result of their negligence or breaches of fiduciary duty.[25] While "civil damages" may be covered, D&O policies typically exclude fines and penalties from the definition of "Loss."

The prevalence of Side A Difference-In-Condition (DIC) policies, which provide so-called "sleep" insurance to D&Os where the insured entity cannot indemnify its D&Os, has changed the landscape of D&O coverage in the years following the S&L crisis. DIC policies that sit in excess of the standard A/B/C tower of insurance generally provide a wider scope of coverage to bank D&Os in the context of an insolvency of the insured bank. Of particular importance in the context of FDIC enforcement actions, DIC policies may provide coverage for some fines and penalties that standard A/B/C D&O policies specifically exclude from coverage.

CONCLUSION

During the first half of 2011, the FDIC will likely file several lawsuits against the D&Os of failed banks to recover hundreds of millions of dollars of losses. D&O insurers should be mindful of the coverage issues (or lack thereof) and potential exposures presented by these lawsuits given that D&O insurance likely constitutes the primary source of recovery for the FDIC. Further complicating the prospects of resolving an FDIC lawsuit is the fact that other plaintiffs, including those who have filed securities class actions, ERISA actions, or adversary proceedings against the failed bank's D&Os, also view the

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D&O policy as the primary source of their recovery.

Moreover, investigations and/or enforcement proceedings brought by federal and state regulators such as the Department of Justice, Securities & Exchange Commission, or state attorney general, with life spans that often outlast the settlement process of civil lawsuits, including those brought by the FDIC, may necessitate that D&O insurers hold back a portion of their limits of liability to reimburse defense costs incurred by D&Os of failed banks in connection with the regulatory investigations.

Overall, the number of potential claimants and the probable lack of indemnity in favor of the bank's D&Os render efforts to resolve the various lawsuits filed in the wake of a bank failure a challenging prospect.

[1] Phil Mattingly, "FDIC May Seek More Than $1 Billion from Failed Bank Executives," October 8, 2010, Bloomberg News.
[2] Kevin LaCroix, "FDIC Files Civil Suit Against Former Integrity Bank Officials," The D&O Diary, January 19, 2011.
[3] FDIC, "Professional Liability Lawsuits," updated January 4, 2011, available at http://www.fdic.gov/bank/individual/failed/pls/index.html.
[4] Out of 2,744 failures from 1980 to 1995, 702 institutions faced D&O claims. See Paul J. Hinton, "Failed Bank Litigation," NERA August 16, 2010 ("NERA") at p. 20.
[5] Mary C. Gill, Mark C. Kanaly, Michael J. Hartley, and Robert R. Long, "Claims Against Bank Directors And Officers Arising From The Financial Crisis," The Review of Banking and Financial Services, July 2010.
[6] Id.
[7] The civil demand letter, which the FDIC typically issues directly to the bank's D&O insurer, may trigger coverage depending on the definition of "Claim" in the D&O policy.
[8] Id.
[9] FDIC, "Histories of the Eighties - Lessons for the Future," Vol. I. at P. 1, available at http://www.fdic.gov/bank/historical/history/index.html
[10] FDIC, Historical Series on Banking, available at http://www2.fdic.gov/hsob/
[11] Id.
[12] NERA at 15
[13] Id. at 20-22.
[14] Id. at 15.
[15] FDIC "Banking Crisis of the 1980s and Early 1990s: Summary and Implications," available at http://www.fdic.gov/bank/historical/history/3_85.pdf
[16] Officer of Comptroller of the Currency, "Bank Failure, An Evaluation of the Factors Contributing to the Failure of National Banks," June 1988.
[17] Case No. 2:10-cv-04915 (C.D. Cal.)
[18] Complaint at p. 6. Filed in FDIC v. Scott Van Dellen et al., Case No. 2:10-cv-04915, Central District California, July 2, 2010.
[19] 12 U.S.C. § 1821(k)
[20] 12 U.S.C. § 1821(i)
[21] Atherton v. FDIC, 519 U.S. 213, 227 (1997).
[22] NERA at 15.
[23] Id.
[24] Milo Geyelin & William Power, "Insurers Get Lift From Court in S&L Case," Wall St. J., Sept. 24, 1991, at B5 (estimating that 75% of bankers' D&O policies contain regulatory exclusions).
[25] NERA at p. 18 nn. 92-102.

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