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Expert Analysis

Failed Banks Cast Long Shadows: FDIC Targets Insiders, Other Professionals

In the wake of the global financial crisis, the FDIC has commenced a wave of lawsuits against and criminal investigations of the officers and directors of failed banks, and those who did business with them. What can senior executives, companies, and their counsel expect? In addition to the increased general activity, they will have to be aware of how FDIC matters differ from more traditional areas. This is because the FDIC has powers that are broad in scope and reach, which it is now signaling it will use.

In civil litigation, the FDIC has the power to hold officers and directors of failed banks personally liable for bank losses caused by their negligence or other misfeasance. The standard of care can vary by jurisdiction and, in New York, bank directors are not protected by the business judgment rule. The FDIC also benefits from extended statutes of limitations in tort and fraud actions.

On the criminal side, investigations and prosecutions stemming from bank failures involve a broad range of charged offenses and a wide variety of underlying conduct.

Senior bank executives, directors, companies, and their counsel must monitor developments over the coming months and years. As the various investigations develop, there will likely be system-wide effects caused by the FDIC's expanded enforcement activities.

Background

In 2005 and 2006, there were no bank failures. In 2007, three banks insured by the FDIC became insolvent.[1] In 2008, as the subprime crisis began to make itself felt, 25 banks failed. As the crisis deepened, in 2009, there were 140 bank failures. And in 2010, the number was 157—the worst year for bank failures since 1992. These statistics do not include the hundreds of banks that the FDIC currently deems "at-risk"—some of which will also probably fail.

A significant number of failed banks are in Illinois, California, Florida, Minnesota, Washington, and Georgia. But failures have occurred throughout the country, including at least five in New York and four in New Jersey.

The country has not seen so many bank failures since the savings-and-loan crisis of the 1980s, when more than 1,000 banks collapsed, at a cost to the government of over $100 billion. In response to that crisis, Congress passed the Financial Institutions Reform, Recovery & Enforcement Act of 1989 (FIRREA). The supervision and enforcement tools created by FIRREA have been and will be used by the FDIC and other government agencies to respond to the current crisis.

Lawsuits Against Executives

Personal Liability. As the receiver for failed banks, the FDIC has authority to recover losses caused by unsound practices by bank officers and directors. The bank officers and directors are personally liable for such losses. See 12 U.S.C. §1821(k) (a "director or officer of an insured depository institution may be held personally liable for monetary damages in any civil action by…the FDIC as receiver").

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According to The Wall Street Journal, the FDIC has sent hundreds of "demand" letters notifying former bank employees of potential civil claims.[2] Lawsuits against 109 bank officers and directors seeking at least $2.5 billion were recently authorized.[3] "These numbers will continue to increase as time goes on," according to Richard Osterman, the FDIC's acting general counsel.[4]

Standard of Care. The applicable standard of care depends on state law. And 12 U.S.C. 1821(k) provides that recovery may be based on "gross negligence." However, the Supreme Court has held that the phrase "gross negligence" does not immunize directors and officers from liability for less culpable conduct—such as ordinary negligence—but rather "provides only a floor," with states free to enact more stringent requirements. *Atherton v. FDIC*, 519 U.S. 213, 227-28 (1997). Thus, no uniform standard of care applies to bank officers and directors, though the banks are federally insured, regulated and supervised. *Atherton*, 519 U.S. at 214.

The Business Judgment Rule May Not Apply. Although many states provide some protection to bank directors through the business judgment rule, New York does not. New York Banking Law §7015(1) provides that bank directors must act "in good faith" and exercise the "degree of diligence, care and skill" that an ordinarily prudent person would exercise under similar circumstances. Courts have interpreted this statute to mean that the business judgment rule does not apply in suits by the FDIC alleging misconduct. See *FDIC v. Bober*, 2002 WL 1929486, at 2, No. 95 Civ. 9529 (JSM) (SDNY Aug. 19, 2002) (Martin, J.) (interpreting the statute to mean that New York bank directors are denied the protection of the business judgment rule and are subject to a more stringent standard); *FDIC v. Ornstein*, 73 F.Supp.2d 277, 280 (EDNY 1999) (Gleeson, J.); *Resolution Trust Corp. v. Gregor*, 872 F.Supp. 1140, 1151 (EDNY 1994) (Ross, J.) (noting that defendants admitted they could not find any New York authority applying the business judgment rule to bank directors). Thus, New York bank directors facing personal liability in FDIC suits based on alleged negligence will have difficulty obtaining pretrial dismissals.[5]

Even in states where the business judgment rule applies, bank directors have had limited success using the rule to their advantage. See, e.g., *FDIC v. Schreiner*, 892 F.Supp. 869, 875-84 (W.D. Tex. 1995) (denying bank directors' motion for summary judgment under Texas business judgment rule because the directors failed to thoroughly evaluate borrower's creditworthiness); *FDIC v. Gonzalez-Gorrondona*, 833 F.Supp. 1545, 1561 (S.D. Fla. 1993) (denying directors' motion to dismiss based on Florida business judgment rule where "bad faith and management," "failure to establish proper monitoring procedures," "failure to supervise" staff, and "abandonment of responsibility" were alleged); *FDIC v. Miller*, 781 F.Supp. 1271, 1277-78 (N.D. Ill. 1991) (denying motion to dismiss under Illinois business judgment rule where FDIC alleged that bank director "did not perform her duties with care and diligence").

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California bank directors ultimately prevailed under the business judgment rule in *FDIC v. Castetter*, 184 F.3d 1040, 1045-46 (9th Cir. 1999). But the victory came at significant cost, as it was obtained only after a trial, post-trial motions, a prior appeal, additional motion practice, and an affirmance by the U.S. Court of Appeals for the Ninth Circuit. In its final decision, the Ninth Circuit found that the board (a majority of whom were outside directors) had obtained expert advice regarding the bank's core business and that the FDIC relied primarily on "ad hominem attacks on the directors' capabilities, their decisions, and their inability to reverse negative earnings trends." The court opined that the rule should "protect well-meaning directors who are misinformed, misguided, and honestly mistaken." Id. at 1045-46 (internal quotation marks omitted).

Statutes of Limitations. The FDIC benefits from extended statutes of limitation under FIRREA, even when claims arise under state law. FIRREA provides a three-year statute of limitations running from the date the claim accrues under FIRREA or "the period applicable under state law"—whichever is longer. Even more helpful to the FDIC, FIRREA defines the date of accrual of an action as either "the date on which the cause of action accrues" or "the date of the appointment" of the FDIC as receiver—whichever is later. 12 U.S.C. §1821(d)(14).

In addition, FIRREA revives tort claims arising from "fraud" and certain other "intentional misconduct" for which a state statute of limitations has expired, if the expiration was "not more than 5 years before" the FDIC's appointment as receiver. 12 U.S.C. §1821(d)(14)(C); see also *FDIC v. Cohen*, 1996 WL 87248, at 7 (SDNY Feb. 29, 1996) (claim of breach of duty of loyalty alleges "intentional misconduct" and therefore benefits from revival under FIRREA).

Criminal Prosecutions

A civil lawsuit by the FDIC is not the only development that may confront bank officers and directors. Certain individuals may find themselves targeted by criminal investigations. The Wall Street Journal reported on Nov. 17, 2010, that the FDIC and FBI are working together on about 50 criminal investigations of former bank executives and directors. Where evidence of criminal conduct is found, the cases will be referred to the Department of Justice.

This process is just beginning. On average, it takes 18 months to complete an investigation from the time a bank is closed.[6] Although several prosecutions were brought in 2009 and 2010, past experience indicates that many more will follow: in the savings-and-loan scandal, more than 1,000 persons eventually went to prison.[7]

Types of Charges. Prosecutions arising from the current round of bank failures have alleged bank fraud, mail and wire fraud, and related crimes. Bank executives, and those doing business with them, have also been charged with making false statements to the FDIC or other federal agencies and making false entries in bank records.

Scope of Conduct. The recent criminal prosecutions have involved a wide variety of conduct, including alleged schemes to overvalue bank assets, cause the bank to make improper loans, or make false statements to state or federal agencies.

For example, a former executive at Omni National Bank (taken over by the FDIC in March 2009) recently pled guilty in the Northern District of Georgia to making false entries in the bank's books and records. He admitted making false entries regarding underperforming loans. Three borrowers were also charged: two pled guilty to fraudulently obtaining loans, while a third pled guilty to identity theft and false statements to the FDIC in an effort to obtain FDIC approval of "short sales" of properties purchased with loan money. (Documents supporting the short sales had been forged and certain loan commitments had been obtained by identity theft.)

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Another recent prosecution, pending in the Eastern District of Virginia, charges an executive of a loan servicing company with bank, wire and securities fraud. The government alleges that the executive conspired with executives of Colonial Bank (taken over by the FDIC in August 2009) in schemes to conceal his company's losses.

Several of the schemes required the active assistance of bank employees, including the temporary movement of funds from one account to another to conceal overdrafts, sales to Colonial of loans experiencing losses, creation of documentation falsely showing that the loans were sold to other investors, and appropriation of loan sale proceeds. Allegedly, the loan-servicing executive and bank employees also conspired to fraudulently obtain TARP funds by giving the false impression that the bank had secured definitive agreements to raise $300 million in private capital. (Colonial did not succeed in obtaining TARP funds.)

In New York, a former president and chief executive officer of The Park Avenue Bank (taken over by the FDIC in March 2010) recently pled guilty to defrauding the FDIC, securities fraud, embezzlement from the bank, conspiracy to commit mail and wire fraud, and bank bribery (corruptly soliciting and accepting items of value in exchange for approving bank transactions). According to the criminal information, in response to an FDIC determination that his bank was not well-capitalized, the former president devised a scheme to make it appear that he had invested $6.5 million of his personal funds in the bank.

In truth, however, he caused the bank to loan that amount to entities controlled by a co-conspirator, who then transferred the funds to the president's company. The president then transferred the funds to his personal account and used them for the sham investment. This manufactured capital infusion was intended to enhance the bank's effort to obtain TARP loans, but federal authorities discovered the scheme before approving any TARP funds.

As part of his plea agreement, the former president agreed to forfeit more than $11 million in cash and his interests in real and personal property; he currently awaits sentencing.

Conclusion

Given the wide range of alleged wrongdoing in the prosecutions already undertaken, and the number of federal and state regulators and agencies involved in the prosecutions announced to date, it is likely that more prosecutions will be forthcoming this year, and into the future. When monitoring and, if necessary, responding to civil and criminal investigations, it will be important for senior executives, directors, companies, and their counsel to be mindful of the broad powers available to the FDIC.

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1. The statistical information in this article is derived from the FDIC's website, www.FDIC.gov.
2. Jean Eaglesham, "U.S. Sets 50 Bank Probes," Wall St. J., Nov. 17, 2010, at A1.
3. Dave Clarke, Regulators Want $2.5 Billion from Bank Execs, abcnews.com (Jan. 4, 2011), http://abcnews.go.com/Business/wireStory?id=12540772.
4. Eaglesham, "U.S. Sets 50 Bank Probes, Wall St. J.," Nov. 17, 2010, at A1.
5. By contrast, at least one court has held that when the FDIC acts as a receiver for a New York bank, it is entitled "to the deference of the business judgment rule" when its management decisions are challenged. G*olden Pacific Bancorp. v. FDIC*, 2002 WL 31875395, at *9, No. 95 Civ. 9281 (NRB) (SDNY Dec. 26, 2002).
6. See FDIC website, "Professional Liability Lawsuits."
7. Eaglesham, "U.S. Sets 50 Bank Probes, Wall St. J.," Nov. 17, 2010, at A1.

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