Fox Rothschild LLP
ATTORNEYS AT LAW

DECEMBER 2011

LITIGATION DEPARTMENT

ALERT

NAVIGATING THE LIABILITY MINEFIELD

GUIDANCE FOR OFFICERS AND DIRECTORS OF TROUBLED BANKS

By Eric E. Reed and Patrick J. Egan

With bank failures and FDIC[1] enforcement and civil actions at all-time highs, directors and officers of FDIC insured banks – the "institution-affiliated parties" most commonly pursued by the FDIC – must be more vigilant than ever to avoid potential exposure to regulatory and civil action by the FDIC.

FDIC Regulatory Enforcement Action

On the regulatory front, the FDIC may commence a removal and prohibition action under 12 U.S.C. § 1818(e), seeking the debarment of the individual from the banking industry (at least from any FDIC insured institution). As part of such proceeding, the FDIC can also assess a civil monetary penalty.

To prevail in such a regulatory enforcement action, the FDIC must prove that the institution-affiliated party:

1. Violated a law or regulation, participated in an "unsafe or unsound banking practice," or breached a fiduciary duty;

2. Caused loss to the bank or gain to the individual by reason of such action or omission; and

3. The action or omission demonstrates personal dishonesty or demonstrates willful or continuing disregard for the safety and soundness of the bank.

As compared to a civil lawsuit, relatively limited discovery is available to the targeted individual in a regulatory enforcement action. Whereas a jury trial is available in a civil lawsuit, a regulatory proceeding is heard by an administrative law judge. Further, the initial appeal from the administrative judge's ruling is to the FDIC itself, then to a federal district court.

If the FDIC prevails in a regulatory action, the issues resolved in the proceeding may bind the parties in the follow-on civil lawsuit. If the FDIC's charges included intentional or self-dealing conduct, an adverse result in the regulatory action could trigger exclusions under the bank's D&O policy and threaten coverage.

FDIC Civil Action as Receiver

The FDIC, in its capacity as receiver for the failed bank, may also bring a civil lawsuit against those it alleges are responsible for the bank's failure. Generally, liability exists for gross negligence that caused losses to the bank. Under recently adopted rules, the FDIC as receiver may also claw back compensation from senior executives and directors whose actions or omissions "materially contributed" to the bank's failure. The clawback can reach back two years from the beginning of the receivership and for an unlimited period in the case of fraud.

How to Prepare?

The time to prepare for the possibility of regulatory and/or civil action by the FDIC is not after the agency bolts the bank's doors on a Friday afternoon. Well before this event, officers and directors of troubled banks should:

1. **Review the bank's loan manual and other**

oversight policies and procedures. Does the manual lay out best practices for the underwriting and administration of loans? If not, update it. The FDIC will be unmoved by an argument that its prior audits failed to point out deficiencies in the loan manual.

2. **Confirm that the bank actually follows the manual and policies.** A strong manual is irrelevant if its requirements are ignored.

3. **Document your remedial actions.** Be sure that meeting minutes reflect objections to and scrutiny of loans and other bank actions, and generally show that the officers and directors are doing their jobs. Confirm that such documentation is stored in a manner that will be accessible after the FDIC assumes control of the bank. The bank's records will be inaccessible for a period following the FDIC takeover, so consider storing a copy of materials with counsel.

4. **Consider engaging personal counsel separate from the bank's existing counsel.** Once the FDIC takes over the bank as receiver, the bank's counsel becomes the FDIC's counsel. Once it assumes control of the bank, the FDIC must be considered an adversary. Personal counsel is particularly important if the FDIC seeks an interview.

5. **Review your D&O coverage.** Do not assume that you will be covered for defense costs and liabilities resulting from an FDIC removal and prohibition action. Many policies have regulatory exclusions for civil monetary penalties in regulatory actions and for civil liability for violations of banking regulations. Some carriers also use "insured against insured" exclusions to attempt to deny coverage for claims brought by the FDIC as receiver against former officers and directors under the theory that the bank is essentially suing itself. If the existing coverage is lacking, consider obtaining better coverage while you are still in a position to do so.

Conclusion

Through FDIC audit reports and familiarity with the bank's operations, officers and directors should know long before the FDIC closure that the institution is facing potential failure. Following the above recommendations and documenting your good faith efforts to address issues can go a long way towards avoiding regulatory and civil liability if and when the bank fails.

If you have questions about this Alert, please contact Eric E. Reed at 215.299.2741 or ereed@foxrothschild.com or Patrick J. Egan at 215.299.2825 or pegan@foxrothschild.com or any member of Fox Rothschild's Litigation Department.

[1] The FDIC regulates most state-chartered but federally-insured banks, while the Office of the Comptroller of Currency regulates national banks and the Office of Thrift Supervision handles savings and loan associations.

Attorney Advertisement

Fox Rothschild LLP
ATTORNEYS AT LAW

© 2011 Fox Rothschild LLP. All rights reserved. All content of this publication is the property and copyright of Fox Rothschild LLP and may not be reproduced in any format without prior express permission. Contact marketing@foxrothschild.com for more information or to seek permission to reproduce content. This publication is intended for general information purposes only. It does not constitute legal advice. The reader should consult with knowledgeable legal counsel to determine how applicable laws apply to specific facts and situations. This publication is based on the most current information at the time it was written. Since it is possible that the laws or other circumstances may have changed since publication, please call us to discuss any action you may be considering as a result of reading this publication.

California Connecticut Delaware District of Columbia Florida Nevada New Jersey New York Pennsylvania

www.foxrothschild.com