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SEVEN LESSONS LEARNED FROM D&O LITIGATION ARISING FROM THE FINANCIAL CRISIS

The 2008 financial crisis generated a large amount of litigation, in particular by the FDIC, as receiver of failed banks, against former officers and directors. The authors describe the "hard-earned" lessons for bank directors from this litigation, and from FDIC position papers and other corporate litigation. They begin by warning directors not to be potted plants and end by noting the advantages to directors of retaining independent counsel when litigation is threatened.

By Dennis Klein, Tyler Grove, and Jeffrey Goldberg *

While litigation against directors and officers from the recent financial crisis is winding down, the cases have led to some hard-earned lessons. Between January 2009 and December 2015, the FDIC alone authorized 150 lawsuits against 1,207 former bank directors and officers.[1] This experience has created a wealth of knowledge as to how current directors and officers can limit their exposure to potential liability going forward. This article discusses seven "lessons learned" from litigating directors and officers lawsuits arising from the recent crisis.

STANDARDS OF LIABILITY

State law dictates the applicable standard of liability. Typically the standard will be ordinary negligence or gross negligence. The common law standard of care applicable is often described as "the same degree of care and prudence that men prompted by self-interest generally exercise in their own affairs."[2] The standard can, however, differ substantially between states. For example, Delaware requires the plaintiff to show gross negligence, which is less than bad faith.[3] In contrast, for

[1] *See* Federal Deposit Insurance Corporation, Professional Liability Lawsuits, *available at* https://www.fdic.gov/bank/individual/failed/pls/ (last visited Jan. 28, 2016).

[2] *Hun v. Cary*, 82 N.Y. 222, 223 (1880); *Litwin v. Allen,* 25 N.Y.S.2d 667 (1940).

[3] *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985); *Stone v. Ritter*, 911 A.2d 362, 363 (Del. 2006) ("a failure to act in good

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directors, Florida law requires more than gross negligence,[4] although determining precisely what this entails remains elusive.

State statutes may also specify the applicable standard of care. For example, the Model Business Corporation Act, which is followed in 24 states, requires that directors act in a manner that is informed, in good faith, and in the best interest of the corporation.[5] Directors must "discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances."[6] Directors and officers may also be liable for breaches of the fiduciary duties of care and loyalty.

LESSON #1 – A DIRECTOR CANNOT BE A POTTED PLANT – DOING NOTHING IS OFTEN WORSE THAN DOING SOMETHING.

To new bank directors, it may be tempting to follow the lead of other, more experienced leaders on the board. Too often, many new directors find themselves in a position where they feel overwhelmed by unfamiliar terms and issues. They may have been invited to join the board by a high-ranking leader in the bank – perhaps the chief executive officer or the board chairman – and may feel inclined to simply rubberstamp approval for his or her preferred choices.

This can be a recipe for disaster. While a director who is not an expert on the nuances of banking finance may feel that he or she can do no harm by doing nothing, this is contrary to the duties directors owe their corporations. Directors have obligations to monitor and oversee the corporation's business, including overseeing the corporation's management. Although the standard for failing to oversee a bank's management is high – the failure to exercise oversight must be "sustained or systematic"– a director can be liable for his or her "unconsidered failure. . . to act in circumstances in which due attention would . . . have prevented the loss."[7] In cases arising from the recent banking crisis, district courts have recognized that the FDIC as receiver for a failed bank can state a valid claim against directors for failing to supervise the bank's activities.[8]

A director must be proactive in ensuring that the bank has adequate policies and practices in place, and that those policies and practices are being followed. A failure to do so could result in liability; the FDIC identifies "[c]ases where directors failed to establish proper underwriting policies and to monitor adherence thereto" as an area where directors may be subject to litigation.[9] A bank director must therefore actively monitor the bank's loan portfolio to protect against excessive concentrations, such as concentrations of specific types of commercial real estate loans.[10] Bank directors should also require regular stress tests to be performed on the bank's loan portfolio to determine how vulnerable it may be in an economic downturn. If the stress tests reveal weaknesses, the directors should make adjustments to loan approval criteria and loan loss reserves.[11] Bank directors should also closely monitor the aggregate number of loan policy exceptions in the

footnote continued from previous page…

faith requires conduct that is qualitatively different from, and more culpable than [gross negligence]").

[4] *FDIC v. Gonzalez-Gorrondona*, 833 F.Supp. 1545, 1556 (S.D. Fla., 1993).

[5] M.B.C.A. § 8.30.

[6] *Id.*

[7] *In re Caremark Int'l Deriv. Litg.*, 698 A.2d 959, 967 (Del. Ch. 1996); *see also Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

[8] *See, e.g., FDIC v. Miller*, No. 12-cv-00042-WCO, Order on Motion to Dismiss (N.D. Ga. Dec. 26, 2012) (ECF No. 20); *FDIC v. Spangler*, 836 F.Supp.2d 778 (N.D. Ill., 2011); *FDIC v. Baldini*, 983 F.Supp.2d 772 (S.D.W. Va. 2013).

[9] *Statement Concerning the Responsibilities of Bank Directors and Officers, FDIC Financial Institution Letter (FIL-87-92)*, December 3, 1992.

[10] *See, e.g., FDIC v. Spangler*, 836 F.Supp.2d 778, 789-90 (N.D. Ill. 2011) (finding allegations that directors failed to address excessive loan concentrations despite warnings stated a claim for gross negligence).

[11] To implement the Dodd-Frank Act, the FDIC recently required annual stress tests for banks with assets over $10 billion. 12 C.F.R. § 325.204.

loan portfolio, and require regular reports on the number of policy exceptions.[12]

The requirement for proactive director participation is especially important for banks that experience periods of rapid growth. It is critical that directors of rapidly growing banks be ready to recognize when the growth becomes dangerous and take appropriate action. A recent statistical analysis of FDIC litigation from the recent banking crisis concluded that the directors most likely to be sued by the FDIC as receiver of failed banks were those who were overly optimistic about their bank's financial condition and gambled on the bank recovering, despite clear evidence of financial decline.[13] Often, however, the directors of banks going through growth spurts fail to install safeguards commensurate with the bank's expanded presence and portfolio. For example, while it may be common for local community banks to have a chief loan officer oversee both loan production and underwriting, these functions must be segregated as the bank expands. Loan officers producing loans are inherently at risk with a bank's credit-risk-protection function, and should be separated as soon as is practical.[14] Similarly, it is also important for directors to address issues of concentrations of institutional knowledge as the bank expands. As the bank grows, a division of labor and responsibilities among high-ranking officers will ensure that key information is not lost if one of those officers quits or unexpectedly departs. Bonuses and incentives should also be reviewed and revised as necessary. In particular, larger banks should be wary of incentives based on loan production, which could encourage the approval of inappropriate loans (i.e., loans with missing documentation, excessive policy exceptions, or those with a speculative source of repayment, etc.).[15]

Furthermore, as banks grow, customers may demand online banking services. As a result, the bank may move to digitize its files, and the bank's online presence and visibility may increase. All of this works to make the bank's data a potential target for online attacks from thieves and activists. It is therefore imperative that directors enact cyber-security policies to protect sensitive data. Directors who procrastinate or ignore enacting these policies can find themselves liable in the event of a data breach. For example, following a cyber-attack against Home Depot in September 2014 that compromised approximately 56 million credit cards, a shareholder sued 12 of its directors and officers in September of 2015 for failing the ensure that the company reasonably protected its customers' personal and financial information.[16]

All this is not to say that bank directors must be experts in, for example, underwriting, finance, corporate structure, and cyber-security. However, they should take steps to inform themselves, especially when they are not experts in the industry field. The FDIC Statement of Policy Concerning the Responsibilities of Bank Directors and Officers is clear that "Directors must require and management must provide the directors with timely and ample information to discharge board responsibilities."[17] At a minimum, a director should read industry periodicals and review other sources of information to stay up to date on developing trends. (Before accepting a post, prospective directors should consider if the industry is something in which they wish to be immersed for as long as they sit on the board.) The bank's management is also an excellent resource that should be utilized – in particular, if an officer uses an unknown term or references an obscure concept, the

[12] FDIC, DSC Risk Management Manual of Examination Policies ("FDIC Examination Manual") at 3.2-9 (Dec. 2004), *available at* https://www.fdic.gov/regulations/safety/manual/ ("Institutions should also establish limits for the aggregate number of policy exceptions.").

[13] Christoffer Koch and Ken Okamura, *Why Does the FDIC Sue?*, Said Business School RP 2015-24 (Dec. 31, 2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2711679.

[14] FDIC Examination Manual at 3.2-2 – 3.2-3 ("Although smaller institutions are not expected to maintain separate loan-review departments, it is essential that all institutions have an effective loan-review system. . . . Larger institutions typically establish separate loan-review departments staffed by independent credit analysts.").

[15] In December 2012, the FDIC, as receiver for IndyMac bank, won a $168.8 million jury verdict against former officers of that bank in part by arguing that the officers approved risky loans despite warning signs because their bonus compensation was tied to loan production. Kevin LaCroix, *FDIC Wins $168.8 Million Jury Verdict Against Former IndyMac Officers*, The D&O Diary (Dec. 10, 2012), http://www.dandodiary.com/2012/12/articles/failed-banks/fdic-wins-168-8-million-jury-verdict-against-former-indymac-officers/.

[16] Complaint, *Bennek v. Ackerman et al.*, No. 1:15-cv-2999 (N.D. Ga. Sept. 2, 2015).

[17] *Statement Concerning the Responsibilities of Bank Directors and Officers, FDIC Financial Institution Letter (FIL-87-92)*, December 3, 1992.

director should ask him or her to explain it. Before taking any action, a director should understand why he or she is taking that action, and ask questions.

To limit future potential liability, directors should also consider retaining independent third-party consultants. These consultants can render unbiased opinions on practically any subject, such as the health of the bank's loan portfolio or the strength of its loan policy. There are a few pitfalls, however, in retaining consultants. First, bargain-rate consultants in general are less likely to put in the time critical to rendering a reliable opinion. For example, if a consultant claims to have reviewed the bank's loan portfolio in only a day or two, the resulting report is likely to be less reliable than a report from a consultant who spends a month reviewing the same loans. Second, caution is needed in considering consultants that may have a conflict of interest, especially directors that offer consulting services or are associated with consulting firms. Third, if the board retains a consultant independently from the bank, the scope of the consultation should be clearly reflected in the engagement letter. This issue can be especially important in future litigation. Finally, it is not sufficient that the board merely retains a consultant; if the consultant identifies any issues, it is critical that the board follow up (or explicitly address in the board minutes why it will not follow up). A failure to address known issues could cause the board to be liable in future litigation.[18]

Finally, directors should be wary of blindly following strong leaders. All too often, a growing bank or other corporation will be dominated by an aggressive personality.[19] These individuals usually hold one or more high-ranking officer positions at the bank, and may have helped found the company. Directors should especially be wary of such individuals who try to pack the board with friends, family, and directors whom they can otherwise influence or control. The board is typically the highest level of approval within the corporation, and the last line of defense against actions that could be injurious to the corporation. Although it can be especially difficult for new directors to resist – especially when other established board members are under the influence of a high-ranking executive – directors nevertheless have an obligation to stand up to "strong man" executives when his or her actions would not be in the bank's best interests.

LESSON #2 – MAINTAIN A DOCUMENTED RECORD OF CORPORATE DECISIONS

In determining whether the duty of care has been satisfied, courts emphasize the process by which the decision at issue was made.[20] Directors and officers should therefore take measures to properly inform themselves, and make a record of the steps they took to do so, prior to taking an action.

In particular, the minutes and other records of meetings should document the details of discussions concerning a decision to act or not act.[21] Directors and officers seeking to limit future liability can follow several "best practices" in writing and maintaining minutes and other records. First, at a minimum, the minutes should reflect basic information about the meeting. For example, the minutes should identify who attended the meeting (including non-members), which members were absent, and whether any attendees arrived late or left early (including noting the time that they arrived or left). The minutes should reflect the starting and ending time of the meeting, as well as the time of any breaks. The minutes should also record the time spent deliberating on discrete issues – often this can be indicative of whether the board thoughtfully considered an issue or merely rubberstamped a proposal from management. Finally, especially for corporations with multiple offices, the minutes should reflect where the meeting was held (including whether anyone was present by phone, videoconference, etc.). The location information can help establish whether the board had certain documents or resources available to it during the meeting or, for members attending remotely, whether they could visually see information such as a Power Point presentation.

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[18] *FDIC Financial Institution Letter*, *supra* note 16 (listing "[c]ases where . . . , in the case of outside directors, . . . the board failed to heed warnings from regulators or professional advisors" as a category of common litigation).

[19] *See, e.g.*, *FDIC v. Aultman*, No. 2:13-cv-00058-FtM-99SPC, Complaint at ¶ 3, 17 (M.D. Fla. Jan. 29, 2013) (alleging bank CEO dominated bank and defendant directors "never made more than token attempts to monitor, supervise, and restrain him"); *FDIC v. Coburn*, No. 7:12-cv-00082-BO, Complaint at ¶¶ 14 (E.D.N.C. Apr. 4, 2012) (alleging that the bank's CEO "dominated the Board and the Bank's lending").

[20] *See, e.g.*, *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir. 1981).

[21] FDIC Examination Manual at 4.2-9 ("Decisions regarding these considerations [regarding whether to undertake financial statement audits, internal control reviews, or additional auditing procedures], and the reasoning supporting the decisions should be recorded in committee or board minutes.").

Any description of a deliberation in the minutes should reflect the consideration that went into the decision. Specifically, the minutes should summarize the points made during the deliberation and note who made them. Similarly, it can be useful to record the members in favor and against a particular action, rather than holding an anonymous vote. If an action of the board or committee is later challenged in litigation (for example the decision to approve a loan that later defaulted), a record of directors and officers who opposed the action could shield those individuals from liability. The minutes should also reflect any materials that were distributed during the deliberation and attach a copy of the materials to the minutes.

Of course, it is also critical that directors and officers insist that the minutes accurately reflect the meeting. As a general rule, if something is left out of the minutes, for purposes of future litigation, it could be difficult to decipher exactly what occurred. It is therefore essential that directors and officers carefully review the prior meeting's draft minutes for accuracy before approving them.[22] Audio or video recording the meetings could be useful for ensuring that the minutes are accurate. (Tapes or memory cards could be recorded over and reused after the minutes are approved.) If a description of a deliberation is inaccurate or insufficiently described, the director or officer should insist on edits before approving the minutes.

In the context of bank boards and loan committees, documentation for loan approvals can be especially crucial for avoiding future litigation. If a loan approval packet is distributed prior to the meeting, it should be carefully reviewed. If documents are referenced in the packet, but not attached, the reviewing director or officer should ask for them, and make sure the minutes reflect his or her request. At a minimum, all documents required under the bank's policies should be included in the packet. Beyond the documents required under the bank's policies, a best practice is to demand a level of documentation commensurate with the risk presented by the loan. Larger loans may require a higher level of documentation (e.g., audited financial statements rather than self-prepared financial statements). Similarly, for new borrowers without a history at the bank, the board should pursue additional verification measures (e.g., calls to other financial institutions, appraisals of non-liquid assets), and stress-test analyses before approving the loan. Finally, if the proposed loan would require an exception to the bank's policies, that exception should be explicitly noted in the minutes, along with the justification for approving the exception. As a corollary, bank directors and officers who are involved in approving loans must be intimately familiar with the bank's policies to be able to identify when a proposed loan would require an exception; they should not solely rely on the loan officer to identify the exception.

LESSON #3 – ENSURE THAT THE CORPORATION HAS AND FOLLOWS ADEQUATE DOCUMENT-RETENTION POLICIES.

Directors and officers must demand that the corporation has policies for maintaining the minutes and records, and that those policies are followed. As discussed above, well-documented minutes that establish a thoughtful deliberative process can be a shield against future liability. But such minutes can do directors and officers no good if they are lost or destroyed prior to litigation.

A document-retention policy is therefore critical for ensuring that minutes and other records are kept and organized. In particular, minutes – and all attachments – should be retained indefinitely. Any attachments to the minutes should not be separated from the minutes. The policy should vest a specific individual, perhaps a dedicated records manager, with responsibility for executing the document-retention policy. The policy should also specify a location where records should be kept, and the directors and officers should ensure that sufficient resources (particularly storage space) are dedicated to records management. Third-party consultants can be retained from time to time to conduct audits of the corporation's records and record policy to ensure that the policy is being followed. For long-term storage, consider using an off-site records management firm.

The document-retention policy should also extend to documents taken home by individuals. Sensitive information (such as the personal information of borrowers) could be contained in such information. The regulations of the FDIC and other regulatory agencies prohibit the disclosure of non-public personal information of borrowers.[23] At a minimum, the document-retention policy should require that such information be redacted before being removed from the bank. In no event should original documents ever be permitted to be removed from the bank and taken home. In general, the practice of taking documents home

[22] FDIC Examination Manual at 4.1-5 (stating that review of minutes "should be a standard part of the board meeting agenda.").

[23] *See, e.g.*, 12 C.F.R. § 332.10.

should be avoided, especially for directors and officers. Such documents could be the subject of discovery requests or future litigation. For example, in 2010, the FDIC filed suit to recover copies of bank books and records that had been provided by the bank's directors to their law firm for use in anticipated future litigation.[24] Even though the original documents remained in the bank's files, and therefore with the FDIC as receiver, the FDIC sought the return of the copies.

LESSON #4 – ALTHOUGH MANY STATE LAWS PROVIDE A SHIELD AGAINST DIRECTOR AND OFFICER LIABILITY, THEY ALL HAVE LIMITATIONS.

There are numerous state laws that can provide protection for directors and officers in litigation. While directors and officers should take advantage of all of these laws where available, they should also be aware of their limitations.

Perhaps the most powerful law for defending directors and officers is the business-judgment rule. Every state has its own version of the business-judgment rule. In general, the rule protects good-faith business decisions. For example, Delaware law defines the rule as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interest of the company."[25] The rule, however, is not without its limits. Although the rule insulates the decision makers from ordinary negligence,[26] it can typically be overcome by a showing of gross negligence.[27] In addition, while some states apply the rule to both directors and officers (e.g., Delaware[28]), other states apply it only to directors (e.g., Florida[29]), and some states limit the rule to only "outside" directors who hold no officer position within the corporation (e.g., California[30]).

Many states also have insulating statutes that can exculpate directors from liability for certain actions. Some of these insulating statutes are "mandatory," such as Florida's statute, which automatically applies to limit directors' liability to only breaches of duty that were, *inter alia*, reckless or in bad faith.[31] Other states, such as California, have "permissive" insulating statutes, which only apply if the corporation includes an exculpatory clause in its Articles of Incorporation.[32] Insulating statutes, whether mandatory or permissive, typically do not provide protection for certain conduct, such as intentional wrongdoing. For example, California's statute does not insulate directors for, *inter alia*, intentional conduct, conduct not in good faith, or conduct where the director received an improper benefit. Insulating statutes also do not typically extend to breaches of the fiduciary duty of loyalty. This is significant for directors and officers who find themselves as the target of a *Caremark* claim for failure to adequately supervise a corporation, which is premised on a violation of the fiduciary duty of loyalty.[33] Finally, certain states, like California, do not extend their insulating statute to officers.[34]

Further, state law could allow a corporation to indemnify a director or officer. The indemnification is typically provided for in the corporation's charter documents (such as the bylaws). As with insulating statutes, indemnification statutes can be mandatory or permissive (which generally require a vote of a majority of the directors who are not parties to the action, or if that cannot be obtained, a written opinion from independent counsel or a shareholder vote). State law may also limit the type of indemnification possible. For example, in Delaware, a corporation can indemnify

[24] *FDIC v. Bryan Cave, LLP*, No. 10-cv-03666, Complaint (N.D. Ga. Nov. 9, 2010).

[25] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

[26] *See e.g., FDIC v. Rippy*, 799 F.3d 301 (4th Cir. 2015).

[27] *Smith v. Van Gorkom*, 488 A.2d at 872-75.

[28] *See, e.g., Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. Supr., 1995).

[29] Fla. Stat. § 607.0830.

[30] *Van Dellen I*, No. CV-4915, 2012 WL 4815159, at *6-8 (C.D. Cal. Oct. 5, 2012); *FDIC as Receiver for County Bank v. Hawker*, No. 1:12-cv-00127, slip op. at 7-10 (E.D. Cal. June 7, 2012); and *FDIC as Receiver for IndyMac Bank, F.S.B. v.*

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Perry, No. 11-cv-05561, 2012 WL 589569 (C.D. Cal. Feb. 21, 2012).

[31] Fla. Stat. § 607.0831. Recklessness is defined as acting "in conscious disregard of a risk" that was "[k]nown to the director, or so obvious that it should have been known, to be so great as to make it highly probable that harm would follow" from such breach. *Id.* At least one court has said that this statute prevents liability except for breaches of duty that amount to "more than gross negligence." *FDIC v. Gonzalez-Gorrondona*, 833 F. Supp. 1545, 556 (S.D. Fla. 1993).

[32] California Corporate Code § 204(10).

[33] *In re Caremark Int'l Deriv. Litg.*, 698 A.2d 959 (Del. Ch. 1996); *see also Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006).

[34] California Corporate Code § 204(10)(C).

"expenses (including attorneys' fees), judgments, fines, and amounts paid in settlement" from civil litigation, as long as that person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation."[35] Delaware law allows for indemnification in criminal proceedings only if the corporation has no "reasonable cause to believe the person's conduct unlawful."[36] Corporations may also choose to enter into indemnification agreements with individual directors and officers, which may give greater rights than provided by state statute. However, indemnification clauses and agreements are worthless if the bank fails. Federal law prohibits indemnification for civil or administrative judgments instituted by any federal banking agency.[37]

State statutes of limitations also act to limit the claims that can be asserted against directors and officers. The limitations periods are typically short for negligence and gross negligence claims, but may be long for breaches of fiduciary duties. For example, California law provides only a two-year limitations period for negligence claims, but a four-year limitations period for breaches of fiduciary duties.[38] Especially in banking cases, a key issue is not necessarily the applicable limitations period, but rather the time a claim accrues to start the limitations period. In general, under the discovery rule, a limitations period will begin to run once a claim is discovered. However, when a majority of directors of a corporation are alleged to have committed a wrongful act against the corporation, the doctrine of adverse domination allows the limitation period to be tolled until the alleged wrongdoers no longer control the corporation.[39] For example, in the banking context, the statute of limitations for a claim against the directors for negligently approving bad loans may not begin to run until the bank fails and the directors no longer control the bank. Under Financial Institution Reform, Recovery, and Enforcement Act ("FIRREA"), claims asserted by the FDIC as receiver of a failed bank against the bank's former directors and officers are further tolled for the longer of three years from the time of the bank's failure for tort claims (or six years for contract claims), or the period applicable under state law.[40] Thus, even though claims against a director or officer may be subject to a relatively short limitations period, those claims may not accrue (and the period may not begin to run) until years after the underlying action occurred.

LESSON #5 – BY LAW, BANKING REGULATORS ARE "SUPER-PLAINTIFFS" AND COMMON DEFENSES MAY BE UNAVAILABLE AGAINST THEM.

Banking regulators are armed with a variety of powers that give them an immense advantage in claims against directors and officers. As discussed above, FIRREA sets a minimum limitations period for claims that have not yet expired at the time of the bank's closing of three years for tort claims and six years for contract claims.[41] As receiver, the FDIC enjoys a number of other powers typically not afforded to plaintiffs. For example, the FDIC, as receiver, has a broad power to issue subpoenas for the "purposes of carrying out any power, authority, or duty with respect to an insured depository institution (including determining any claim against the institution, and determining and realizing upon any asset of any person in the course of collecting money due the institution)."[42] The FDIC routinely subpoenas personal financial information from directors and officers to determine if litigation is financially worthwhile. Further, FIRREA sets a ceiling on the standard of liability that the FDIC must prove to prevail against directors and officers. Specifically, FIRREA provides that "[a] director or officer of an insured depository institution may be held personally liable for monetary damages in any civil action by, on behalf of, or at the request or direction of the [FDIC] . . . acting based upon a suit, claim, or cause of action . . . for gross negligence. . . ."[43] In other words, even in states that require a standard of liability higher than gross negligence to prevail on a claim against a director or officer (for example, Florida, which requires a showing of recklessness[44]), the FDIC, as receiver, need only show gross negligence.

Discovery in litigation against the FDIC is also complicated by the fact that courts distinguish between the FDIC in its regulatory, corporate capacity, and the FDIC as receiver for a failed bank. This distinction can

[35] Delaware Code § 145.

[36] *Id.*

[37] 12 C.F.R. § 359.1.

[38] *FDIC v McSweeney*, 976 F.2d 532, 534, 538 (9th Cir. 1992).

[39] *See, e.g.*, *FDIC v. Bird*, 516 F. Supp. 647, 651 (D.P.R. 1981); *Clark v. Milam*, 872 F. Supp. 307 (S.D. W. Va. 1994); *RTC v. Farmer*, 865 F. Supp. 1143, 1154 n.11 (E.D. Pa. 1994).

[40] 12 U.S.C. § 1821(d)(14).

[41] *Id.*

[42] *Id.* at § 1821(d)(2)(I)(i).

[43] *Id.* at § 1821(k)(3).

[44] Fla. Stat. § 607.0831.

present hurdles. For example, if a defendant director or officer seeks documents pertaining to regulatory warnings asserted by the FDIC, it may be unclear if these documents could be found in the files of the FDIC in its corporate capacity, the FDIC in its capacity as receiver (i.e., the bank's files), or both. Potentially duplicative productions can dramatically increase the time and costs of the resulting document review. Even more fundamentally, despite having served as officers and directors, it is often the defendants playing catch-up during discovery, since the FDIC as receiver obtains bank documents at closing, well before the start of discovery. As a result, the defendants are forced to carefully craft discovery requests in efforts to obtain relevant documents, while the FDIC rarely needs to do the same.

In addition, common defenses that might prevail against other plaintiffs are unlikely to succeed against banking regulators. For example, often when a bank fails, the defendant directors and officers will point to the poor economy as a superseding cause of the failure of the loans. This defense has been generally unsuccessful against banking regulators. In order to prevail, the defendant directors and officers would have to show that the economic downturn was a highly improbable and extraordinary event that was not reasonably foreseeable. However, major economic downturns, while not common, have occurred many times in the past and thus are probably not unforeseeable events. Further, regulatory warnings, such as reports of examination, may also show that the bank had notice of a declining market prior to failure. Defendant directors and officers may also raise as a defense the regulators' comparative negligence in failing to identify poor policies or loans during examinations. This has also been generally unavailing against banking regulators. For example, many federal courts have found that the FDIC as regulator owes no legal duty to the directors and officers of a bank to conduct regulatory examination in any particular manner.[45]

LESSON #6 – D&O INSURANCE IS A LAST LINE OF DEFENSE, NOT A COMPREHENSIVE SHIELD AGAINST LIABILITY.

D&O insurance is an important safety measure in protecting directors and officers in potential litigation, but should not be viewed as the primary shield against liability. As an initial matter, directors and officers should insist that their corporation maintains D&O insurance with sufficient limits of liability. While there is no formula for determining what amount of liability is "sufficient," most D&O insurance policies are "wasting" policies, meaning that defense costs are drawn down from the policy limits. It would be prudent to ensure that there is coverage sufficient to pay the legal costs of a protracted litigation with room to spare. Failure to do so could expose director and officer defendants to personal liability for remaining defense costs, settlements, and/or judgments. If the corporation's current policy limits are insufficient, excess policies can be purchased to increase the aggregate coverage amount (typically with the same terms as the underlying primary policy).

Directors and officers should also ask for a copy of the policy and review its terms. There are many traps in the policy terms that could preclude coverage. For example, directors and officers should be aware of the notice requirements when a claim is made or threatened. Most D&O insurance policies are "claims made and reported" policies, meaning that a claim must be made against an insured and written notice of the claim must be given to the insurer during the policy period to trigger coverage. Thus, to ensure coverage, it is essential to notify the insurer as soon as a potential claim is known. The policy terms will typically set forth the requirements for the notice. While a detailed and lengthy notice may not be necessary, it is critical that the insured directors and officers follow the terms carefully and file the notice within the policy period. Even after the policy period has run, there may be a reporting "tail" that allows additional claims to be made for a short period of time. The policy may further provide the corporation with an option to purchase additional time to discover and report claims based on wrongful acts that occurred prior to the expiration of the policy.

The policy may also contain a number of exclusions that could block coverage under certain circumstances. For example, many policies contain a "prior acts" exclusion, which precludes claims for events or transactions that occurred prior to a specific date. Policies with this exclusion may also include a provision that considers multiple wrongful acts arising out of the same or related facts to constitute a single claim. This exclusion can arise in claims based on systemic wrongdoings, when a portion of the alleged wrongful acts occurred before the prior acts date and a portion after. In such a situation, the insurer may decline coverage, and litigation may be necessary to determine if the claims were in fact related under the policy. If the acts are deemed related, they will be considered to have first occurred when the first wrongful act occurred.

[45] *First State Bank v. United States*, 599 F.2d 558, 566 (3d Cir. 1979), *cert. denied*, 444 U.S. 1013 (1980); *FDIC v. Butcher*, 660 F. Supp. 1274, 1281-82 (E.D. Tenn. 1987).

Certain exclusions are of particular interest to directors and officers of banks and other financial institutions. The insured versus insured exclusion, for example, typically precludes coverage for claims brought by an insured person (or the corporation) against any other insured person (or the corporation). This exclusion can arise in bank-failure cases when the FDIC or other regulator, as receiver of the failed bank, sues the former bank directors and officers. Courts are split as to whether the FDIC "steps into the shoes" of the bank to become an "insured" for purposes of the exclusion. The majority rule makes an exception for the FDIC, noting that the FDIC files professional liability suits in a variety of capacities, and the insured versus insured exclusion does not exclude coverage for FDIC claims when the FDIC sues as subrogee, or on behalf of shareholders or creditors of a failed bank.[46]

Another exclusion that arises in bank-failure cases is the regulatory exclusion. This exclusion precludes coverage for suits brought by governmental, quasi-governmental, or self-regulating agency. Sometimes it will name specific regulatory agencies, such as the FDIC or state level regulators. While it is conceivable that this exclusion could be challenged on public policy grounds (i.e., the exclusion prevents banking regulators from recovering in claims against directors and officers who have committed wrongful acts), it is unlikely that coverage would be available under a policy with the exclusion in litigation initiated by a regulatory agency.

LESSON #7 – INDEPENDENT COUNSEL CAN BETTER REPRESENT THE INTERESTS OF DIRECTORS AND OFFICERS WHEN LITIGATION IS ANTICIPATED.

As mentioned above, most D&O insurance policies are wasting policies, meaning that the counsel retained to defend the insured directors and officers against a claim is paid by the insurer. This situation can be problematic because instances may arise where the insurer and defendants have differing interests regarding how to handle the litigation. For example, the defendants may want to settle the claims early through payment of the policy proceeds to avoid individual exposure, but the insurer might disagree.

Independent counsel, paid out of pocket rather than from the insurance proceeds, can be especially useful during litigation. Independent counsel can monitor counsel hired by the insurer in order to keep litigation costs low and preserve the policy limits. Additionally, independent counsel can be instrumental in advocating a settlement within policy limits in order to protect the defendants from becoming personally liable.

Finally, if the insurer refuses to settle the case within policy limits after a plaintiff makes a policy limits demand, independent counsel can help the directors and officers settle the claim without the consent of the insurer. In such agreements – known alternatively as *Coblentz*, *Damron*, or *Miller-Shugart* agreements – the defendant director and officers assign to the plaintiffs any claims they may have against the insurer for refusing the defend them under the policy.[47] This may benefit the directors and officers by allowing them to exit the litigation early, and letting the insurer and plaintiff, rather than the directors and officers, expend resources litigating coverage under the policy.

CONCLUSION

Litigation from the recent banking crisis has taught hard-earned lessons – some common sense and some counter-intuitive – into how current directors and officers can limit their future liability. These seven lessons scratch the surface and there is much more that can be gleaned from this hard experience. ■

[46] *See, e.g., FDIC v. Zaborac*, 773 F. Supp. 137, 144 (C.D. Ill. 1991).

[47] *Coblentz v. Am. Sur. Co. of N.Y.*, 416 F.2d 1059 (5th Cir. 1969); *Damron v Sledge*, 460 P.2d 997 (Ariz. 1969); *Miller v Shugart*, 316 N.W.2d 729 (Minn. 1982).