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Responding to Capital Directives and Related Enforcement Actions by Banking Regulators

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This discussion is being provided to our clients and friends to analyze the challenges presented in this difficult economic environment when an FDIC-insured institution experiences a capital difficulty and is directed by the Banking Regulators[1] to restore the institution's capital adequacy.[2] In the past four years, the FDIC has closed approximately 400 insured institutions—as of January 1, 2012, the FDIC has indicated that there were over 800 banks on its "problem bank list." The difficulties experienced by many of these institutions are summarized in this analysis— and may provide useful guidance when attempting to resolve capital issues in the next few years.

In the typical current enforcement scenario, the national recession produced increased loan defaults and accompanying deterioration in asset valuation, which resulted in the Banking Regulators taking aggressive action to prevent a bank failure by demanding significantly increased levels of capital, loan loss reserves and improved risk management. This regulatory reaction has been implemented through the issuance of an enforcement order that contains: (a) a capital directive that raises a bank's capital level far above the capital level necessary to be deemed a "well-capitalized" institution; (b) a prompt corrective action order; and (c) a multitude of regulatory improvements intended to improve the ability of bank management and a board of directors to perform their management and oversight functions. Accompanying these directives is a designation that the bank is a "troubled" institution.[3]

[1] The term "Bank Regulators" includes the Federal Deposit Insurance Corporation (the "FDIC"), the Office of the Comptroller of the Currency (the "OCC") and the Board of Governors of the Federal Reserve System (the "FRB"). (While the emphasis in this analysis will be on the regulatory actions and responsibilities of the federal bank regulatory agencies, the same considerations will apply to the regulatory oversight and safety and soundness responsibilities of comparable state banking agencies.)

[2] In this memorandum the term "bank" will refer to an FDIC-insured depository institution, including commercial banks, savings associations and industrial loan companies.

[3] Section 32 of the Federal Deposit Insurance Act (the "FDI Act) requires troubled institutions to provide the FDIC with 30 days written notice prior to the appointment of any director or senior executive officer. As implemented by regulations issued by the Bank Regulators, a troubled institution is defined as one: (a) with a composite CAMELS rating of "4" or "5;" (b) subject to a

The combination of these regulatory actions has the effect of immediately imposing operational restrictions that, as a practical matter, impede the bank's ability to raise capital and restore operational stability.

This analysis examines from a practical perspective the issues presented to management and a board of directors of a bank and its holding company when the bank has been issued a capital directive and related enforcement orders (collectively, "capital-related orders")[4]. Among other things, the analysis identifies the various fiduciary and other legal obligations faced by stakeholders in a troubled bank, including its holding company, the boards of directors and management. In addition, this analysis describes the closing process typically followed by the FDIC should a bank fail, the potential liability of a board of directors and management following a failure, as well as reasonable steps that should be considered to defend against potential claims frequently made against former officers and directors by the FDIC.

A. The Issuance of a Capital Directive, Designation as a Troubled Institution and Other Enforcement Orders

(i) Current Enforcement Actions

Prior to the recession that commenced in late 2006, many banks were exceptionally profitable and received good or adequate CAMELS ratings.[5] Commencing in the period between 2007 to 2008, however, many banks experienced a sudden and unexpected downgrading of their CAMELS individual and composite ratings from a 1, 2 or 3 to a 4 or a 5. Accompanying one or several reports of examination that led up to the adverse CAMELS ratings were a series of cease and desist ("C&D") and related enforcement orders, which included a capital directive that required the bank to raise its capital level to 12% or 13% of Tier 1 capital, and a "prompt corrective action" order requiring the bank to restore its capital ratios to the "well-capitalized" category.

In addition to ordering a bank to increase capital, C&D orders issued prior to a potential failure almost always include a host of remedial actions required to be taken by a bank, including compliance plans and numerous special reporting requirements, such as: (a) reducing classified assets; (b) maintaining adequate allowances for loan and lease losses; (c) developing an asset/liability management plan; (d) retaining acceptable management; (e) correcting violations of law and eliminating unsafe and unsound practices; (f) reducing unsafe concentrations of credit; (g) developing a comprehensive loan policy; (h) developing an acceptable strategic plan; (i) developing an acceptable budget and profit plan; (j) reporting progress to the Bank Regulator on a quarterly or other periodic basis; and (k) similar corrective measures and reporting requirements.

A capital directive is the regulatory tool of choice employed by the Bank Regulators to order a bank to maintain a level of capital that is unique to that bank and reflects a level of capital deemed reasonable by the Bank Regulator. A capital directive is often the first step taken when a bank begins to experience losses, and is frequently included in a C&D order.[6] Unlike other statutory enforcement authorities that *theoretically* permit a bank to contest the underlying enforcement decision, judicial precedent supports the

formal enforcement action; or (c) informed in writing by the Banking Regulator that it is in troubled condition on the basis of the bank's most recent report of condition, report of examination, or other information available to the Bank Regulator.

[4] For purposes of discussion, the discussion that follows assumes that the bank has a holding company which may have outstanding trust preferred shares issued at the holding company level.

[5] The examination rating scheme utilized by the Bank Regulators utilizes the acronym "CAMELS," which stands for capital, assets, management, earnings, liquidity and sensitivity to risk. A Bank Regulator assigns a rating to each component of the CAMELS, as well as an overall composite rating, with a 1 constituting the highest or best rating and a 5 indicating the probable failure of the bank.

[6] 12 U.S.C. § 3907.

view that a bank has no right to an administrative review of the determination to issue a capital directive, and that any subsequent judicial review is limited as well.[7]

The prompt corrective action ("PCA") authority is the focal point utilized by the Bank Regulators to exercise increasing degrees of control over a capital-deficient institution as its capital deteriorates, as well as to alert the board and management that urgent attention must be taken to avoid a failure scenario.[8] This is accomplished because the capital levels articulated in the PCA regulations impose significant limits on a bank's operational flexibility as follows:

Adequately Capitalized—Limitations on acceptance or renewal of brokered deposits.[9]

Undercapitalized—(a) drafting of a capital restoration plan; (b) imposition of guaranty obligations on a holding company; (c) asset growth restrictions; and (d) prior approval required for acquisitions, branching and new lines of business.

Substantially Undercapitalized—(a) mandatory sale of capital stock; (b) restricted transactions with affiliates; (c) restrictions on rates of interest paid on deposits; (d) additional restrictions on growth; (e) restrictions on bank activities; (f) requirements to improve management; (g) prohibiting deposits from correspondent banks; (h) requiring prior approval of capital distributions by a holding company; (i) requiring divestiture; and (j) limits on executive compensation.

Critically Undercapitalized—(a) limiting or prohibiting payment on subordinated debt; and (b) appointment of a receiver or conservator upon failure to remedy critically undercapitalized status.[10]

In addition to the foregoing, accompanying the statutory restrictions required as a bank's capital deteriorates are a host of related regulatory restrictions and limitations typically contained in a C&D order. As noted above, the Bank Regulators possess extraordinarily broad authority to require remedial action for banks under Section 8 of the FDI Act.[11] Because the FDI Act provides numerous remedial alternatives to the Banking Regulators to cure a perceived regulatory problem, a C&D enforcement order frequently contains a multitude of remedial risk management and other requirements—which in the aggregate diverts personnel and economic resources available to a bank to resolve its primary concern—namely capital inadequacy.[12] (Moreover, these additional remedial tasks may act as a further disincentive on the part of potential investors to provide capital because of the difficulty involved in having a C&D order removed by a Bank Regulator.)

[7] The result of this grant of agency discretion has resulted in the Banking Regulators using capital directives with increased frequency. (Although by itself the issuance of a capital directive does not impose operational restrictions on a bank, the use of a capital directive in combination with a prompt corrective action order exacerbates the difficulty of restoring a bank to capital adequacy because the level of capital currently required by a capital directive generally is well above the minimum capital level required by a prompt corrective action order, thereby acting as a disincentive for investors to provide new capital to the bank.)

[8] Section 38 of the FDI Act.

[9] The import of brokered deposits cannot be overemphasized because the brokered deposit regulations oftentimes create a liquidity crisis that, if not closely monitored, independently may cause the failure of the bank.

[10] 12 C.F.R. § 325 *et seq*. Currently, the FDIC takes the position that when a bank is deemed to be critically undercapitalized, if it does not resolve the capital impairment within 60 days, the FDIC will close the bank.

[11] 12 U.S.C. § 1811 *et seq*. *See*, The Banking Law Journal, *Responding to Proposed Enforcement Actions by the Federal Banking Agencies* (January 2005).

[12] For example, remedies available under the FDI Act's C&D authority include: (a) requiring reimbursement, restitution, indemnification or loss guarantees; (b) the imposition of growth restrictions; (c) requiring asset sales or other dispositions of problem assets; (d) requiring the rescission of contracts; and (e) requiring the employment of qualified management. Further, the general enforcement authority found in the FDI Act overlaps with specific remedial authority the Bank Regulators may individually possess under their separate enabling statutes (such as the National Banking Act or the Federal Reserve Act) or special purpose laws (such as the Sections 23A and 23B of the Federal Reserve Act or the Truth-in-Lending Act).

(ii) Ability of a Bank or Holding Company to Contest Capital-Related Orders

Although it is possible to contest the issuance of a PCA or C&D order, as a practical matter banks rarely challenge the issuance of capital-related orders. This is because the Bank Regulators' enforcement alternatives are so expansive (and potentially, overwhelming) that banks do not elect to contest administratively the issuance of a package of capital-related orders. (As noted above, capital directives are a purely discretionary determination by the Bank Regulators and hence are beyond administrative review.)

The inability to contest the issuance of capital-related orders places great strain on stakeholders of a bank and its holding company. This is because the failure to comply with such orders exposes parties to those orders—including management and directors—to potentially significant civil money penalties.[13] Notwithstanding the potential personal exposure to liability, other tactical and strategic considerations militate against direct opposition to the issuance of such orders. Among other things, this is because the capital restoration process requires obtaining the cooperation of the Bank Regulators, and hence banks prefer to avoid contesting the issuance of capital-related orders and prefer displaying a cooperative attitude at this stage in the process.[14]

(iii) Restoring Capital Adequacy—the Process

Because state and federal securities laws require that a bank or holding company take all reasonable steps to prevent a failure, the issuance of capital-related orders imposes obligations on a board and management to resolve the capital deficiency as well as the related enforcement orders contained in a C&D.[15]

For purposes of this discussion, such remedial actions might be segmented into the following tasks: (a) restructuring and recapitalization initiatives; (b) financial oversight activity; and (c) implementation of regulatory and risk management compliance requirements.

Each of these remedial actions is discussed immediately below:

Restructuring and Recapitalization Initiatives. A bank or its holding company must generally engage investment bankers or similar consultants to assist in restoring capital adequacy. Inherent in this process is the need to prepare detailed financial analyses of the bank's current operations, including asset valuations necessary for investors to determine whether providing new capital to the bank is supported by the available data. Options at this time include seeking new capital from the existing shareholder base, soliciting new capital from the market and identifying potential merger partners. Because the preparation of detailed financial information provided to third parties creates liability under the securities laws (*i.e.*, materiality obligations), care must be exercised.

During this period of time, it is not unusual for potential investors to request the opportunity to conduct due diligence on some or all of the operations of a bank, which requires the execution of appropriate

[13] The Banking Regulators may assess civil money penalties against a bank and its holding company and their respective officers and directors for the failure to comply with an enforcement order. For basic violations (i.e., regardless of fault), the Banking Regulators may assess a penalty in the amount of $5,500 for each day an alleged violation continues; for reckless violations that result in harm to the institution, the maximum penalty rises to $27,500 a day per officer and director; and for violations that indicate criminal or quasi-criminal activity, violations carry a punitive penalty as high as $1,100,000 per day for each officer and director of the institution and the insured depository institution itself.

[14] For example, because a capital plan is frequently required, a bank cannot proceed with a proposed capital restoration plan until it receives the approval of its Bank Regulator—which requires a degree of cooperation.

[15] While beyond the scope of this memorandum, fiduciary obligations generally require a board of directors of a bank and a holding company to take all possible steps to solicit new capital. Further, the failure to demonstrate that a robust capital-raising process was undertaken could subsequently expose management and a board to shareholder suits.

confidentiality agreements and similar protections. (Concern can arise that potential investors may utilize this opportunity to better understand a bank's asset base in order to succeed in obtaining the bank's assets should the bank be closed by the FDIC.)

In addition to the foregoing, the Bank Regulators may require constant updates and information regarding progress being made to resolve the bank's capital concerns.[16]

Financial Oversight Activity. While a bank is attempting to raise additional capital, close monitoring of its financial condition and records is necessary in order to address several concerns.

In the case of the ongoing operations of the bank, the financial results of the bank must coincide with the financial condition as determined by the Bank Regulators. This means that loan workouts, loan loss reserves and similar financial matters must be carefully reviewed and reflected on a bank's financial statements, including Call Reports, in order to avoid regulatory criticism.

Similarly, the financial performance of a bank can adversely affect the status of its holding company, which then might be required to address disputes with disgruntled investors. For example, in capital-deficiency situations, a PCA order will often prohibit dividends to be made by a bank to its parent holding company—which may affect separate obligations such as the payment of contractually required dividends on trust preferred shares issued at the holding company level.

Implementation of Regulatory and Risk Management Compliance Requirements. Finally, a bank, its management and its board of directors will usually be required to respond to a host of remedial measures contained in an enforcement order—which diverts attention from capital-raising efforts. Significant expenses may be incurred to accomplish tasks that in a capital crisis may appear to be of secondary importance yet are given seemingly identical weight by the Bank Regulators.

These corrective measures can be numerous and complex in nature, Further, it is not unusual that a C&D order requires that a special board of directors oversight committee be created to review all remedial measures and regularly report to the Bank Regulator regarding progress being made.

(iv) Recommended Steps to be Taken by a Bank and/or its Holding Company

Although the issues confronted by a bank and a holding company are numerous, the following items are highlighted because of their proven usefulness to avoid liability should a bank be unable to restore itself to capital adequacy.

Assemble a Team. As noted above, there are three separate components that need to be addressed by a bank and its holding company upon the receipt of capital-related orders, and the creation of a cohesive team is a critical factor in both achieving success as well as demonstrating that fiduciary and corporate obligations were complied with as part of the process.

Team members should include lawyers experienced in the representation of banks that have received capital-related orders, including dealing with the Bank Regulators. In addition, regional or national investment banking firms and other bank consultants are likely to be required.

[16] Particularly in the case of a deteriorating real estate market in which additional reserves are constantly required to be made to a bank's allowance for loan and lease losses (ALLL), the restructuring and recapitalization process may include a series of additional write-downs that make investors leery of further investment.

It is also important to recognize that bank or holding company stakeholders may have different economic and legal positions that frequently require separate counsel. For example, a holding company may require legal counsel separate from attorneys providing advice to the bank itself, including advice such as: (a) the possibility of bankruptcy; (b) the obligation of the holding company to indemnify the failed bank's officers and directors; (c) securities law claims, including claims filed by the holding company's common and trust preferred shareholders; and (d) direct claims by the FDIC against the holding company, such as claims arising from capital maintenance agreements and other regulatory obligations. Similarly, individual directors may also require their own counsel to provide legal advice regarding compliance with their fiduciary duties.

Review Corporate Law Formalities. As is frequently the case, the articles and bylaws of a bank or its holding company may not reflect current legal protections available to officers and directors. For example, in the past few years many states have liberalized their corporate law indemnification procedures to make it easier to pay defense costs to officers and directors who are targeted for alleged improper action such a breach of fiduciary duty. Similarly, several states provide potentially valuable limits on liability for independent directors by authorizing standards of care that may be more beneficial than those that apply for a bank's officers.

It is therefore important to conduct a corporate review to determine whether these and similar protections might be available. In many cases, it is necessary to amend the articles of incorporation and bylaws to adopt these corporate protections. However, the ability to adopt such measures may be objected to by the Bank Regulators as time progresses and a bank becomes more likely to fail.

Reflect All Compliance Efforts in Writing. While it is usual and typical to engage in numerous oral and "off-the-record" conversations with the Bank Regulators, the legal reality is that only the official records of the bank or holding company are relevant should enforcement action be taken. Accordingly, a bank and its holding company should at all times record its reasonable efforts to respond to all regulatory orders, as well as investigations into all alternative means of resolving a capital deficiency. The existence of a written record may also be beneficial in regard to third-party claims. For example, if a holding company or bank board is forced to substantially dilute existing shareholders by agreeing to a change of control or a merger transaction, demonstrating the efforts of an investment banker retained to identify all possible sources of new capital may provide protection against subsequent lawsuits by existing shareholders.

Review the Bank's Record-Retention Policy. One of the most significant errors often made by a bank or a holding company is to fail to adopt a records policy that permits officers and directors to retain copies of materials that reflect the performance of their duties and compliance with their respective fiduciary obligations. For example, in practically every jurisdiction, board members as a matter of right may retain their own copies of board materials used by them to oversee the bank and management—whether in the form of paper copies or materials provided in electronic form.

It should be noted that this area is a particularly sensitive one in the view of the FDIC, and appropriate legal advice is strongly recommended to create a records retention policy that balances the various legal perspectives.

Review D&O Insurance Coverage. It is critical to the welfare of both a bank's and a holding company's officers and directors that coverage under director and officer liability policies is available and clearly understood. Further, at the earliest opportunity, efforts should be made to determine whether additional coverage is available.

It is also important to understand that the interpretation of coverage provided by directors and officers liability insurance is highly specialized and is not a matter of general contract law. In the minimum, it is very useful to engage legal counsel with experience in the complexities of managing the relationship between the insurer and the officers and directors covered under a liability policy. Among other things, the technical requirements of notice and coverage terms under a policy must be well understood and managed so as to avoid inadvertently losing the ability to make a claim should a bank fail.

B. The Failing Bank Scenario

(i) The FDIC's Bank Closing Process

Assuming that a bank failure cannot be avoided, the FDIC will schedule a proposed closing date—typically on a Friday afternoon—and coordinate under the various statutory provisions of the FDIA and related banking statutes to have itself appointed receiver of the bank.[17]

Having determined that a failure cannot be avoided, the FDIC will evaluate and select the "least cost alternative" for resolving the potential bank failure as required by the FDIA—which often means that a so-called "purchase and assumption" ("P&A") transaction will be attempted. Essentially, a P&A transaction is a sale and assumption of some or all of the assets and liabilities of a failed bank, with the assuming entity—usually another bank or holding company—immediately opening the failed bank on the next business day as a branch of the assuming bank or as a separate subsidiary of the holding company.

In a P&A transaction, the FDIC as receiver will retain all assets not agreed to be assumed by the successful bidder, and may share losses on a negotiated basis with the assuming bank or holding company. In addition, claims against the failed bank or related to assets transferred to the assuming entity will also be retained by the FDIC as receiver, including litigation, employment and similar matters.[18] In this manner, the receivership is able to "wash" the assets and liabilities of the failed institution through the receivership, thereby retaining in the receivership all adverse claims relating to transferred assets or liabilities.

To effectuate a P&A transaction—as well as to minimize the cost of a failure to the FDIC's Deposit Insurance Fund—the FDIC will develop a bid package in the weeks leading up to a bank failure and invite interested parties to bid on the failing bank. Qualified bidders—which usually include direct competitors of the failing bank—may be afforded the opportunity to perform some degree of on-site and/or offsite due diligence, and to submit competitive bids that permit the respective qualified bidders to specify the terms for a proposed P&A transaction, including the degree to which the FDIC would be required to provide financial assistance, including asset support and other types of indemnification.[19]

Following the conclusion of the bidding process—which typically is completed by the middle of the week in which the bank closing is scheduled—upon receipt of official notification that the bank has been closed and that the FDIC has been appointed as receiver, the FDIC and the successful bidder enter the closed bank

[17] Although the actual language of the provisions of the FDI Act indicates that there is some discretion by the primary bank regulator not to appoint the FDIC as conservator or receiver of a failing bank, that language is formalistic in deferring to a determination regarding the conservator or receiver; in fact, the FDIC possesses statutory authority under the FDI Act to cause its appointment as receiver should a primary bank regulator ever make an election to the contrary. (Recently a state bank regulator refused to close a bank, whereupon the FDIC utilized the alternative authority to seize and close the institution.)

[18] The powers and authorities of the FDIC as receiver are formidable and generally are viewed as exceeding the powers exercisable by a bankruptcy trustee. See Section 1821 *et seq.* of the FDI Act.

[19] In the last three years, the FDIC has primarily employed so-called "loss-share" agreements, which are a form of P&A transaction. In a loss-share arrangement, the acquiring bank assumes the obligation to manage all of the assets of the failed bank, with the FDIC providing a negotiated guaranty against loss.

and take control of the operations of the failed institution. Although an exhaustive discussion of the FDIC's closing procedures is beyond the scope of this communication, closing procedures generally include: (a) assuming physical and legal ownership and control of all components of the failed bank's assets, liabilities and operations; (b) closing out all deposit and lending transactions as of the day of the closing; (c) inventorying physical assets; (d) creating a closing balance sheet that will become the basis for the P&A transaction; and (e) other receivership functions.[20]

Finally, the FDIC executes the P&A agreement with the successful bidder and commences the process of transferring the operations of the failed bank to the new owner.

(ii) Contesting a Bank Closing

Although there are instances in which the closing of a bank may be viewed by stakeholders as unfair or perhaps illegal, there are no modern instances in which a bank closing has been reversed or enjoined. This is because the FDIC's bank closing process reflects a public policy that critically undercapitalized banks should be resolved as quickly as possible.

Accordingly, notwithstanding the perceived unfairness of the situation, it is a fool's errand to seriously consider legal steps to convince a court to halt or to reverse a bank failure. Rather, it is more useful for officers and directors to focus on the goal of preventing a failure from actually taking place by restoring capital adequacy. Stated another way, the only reasonable course of action upon the receipt of capital-related orders is to devote all resources and best efforts to restore the bank to capital adequacy in a manner that is satisfactory to the Bank Regulators (and to demonstrate that such efforts are being made).

C. Claims Made Against Former Officers and Directors by the FDIC Following a Bank Failure

In its role as receiver of a failed bank, the FDIC's authority under the FDIA authorizes it to stand in the shoes of the bank, the bank's former shareholders and its officers and directors. Because the FDIC as the operator of the Deposit Insurance Fund has a fiduciary duty to minimize its losses as a result of a bank failure, it regularly initiates an investigation into the reasons for the failure. Specifically, the FDIC conducts an investigation to determine whether grounds exist to allege misfeasance or malfeasance against insiders at the failed bank, as well as other persons or entities involved in the management of the bank such as independent (i.e., outside) directors. In the case of a bank holding company, the FDIC may make claims against the holding company for the failure of the holding company to support the capital needs of the failed bank, as well as to claim ownership of assets such as net operating losses.

The post-closing period can be very difficult for former bank insiders because the FDIC possesses investigative authority that includes subpoena authority to depose former officers and directors, as well as to require insiders to disgorge records and documents that are owned by the bank and which are not records personally maintained by the particular officer or director.

(i) The Investigation of a Failure by the FDIC

The single most important change that occurs following a bank failure is that the former officers and directors no longer constitute management and the board, but rather, become the targets of investigation by the FDIC. This is because the FDIC as insurer and the receiver of a failed bank or thrift is statutorily required

[20] Detailed descriptions of numerous tasks performed by the FDIC immediately prior to a bank closing, during the weekend immediately following, and thereafter are set forth in several receivership and liquidation manuals employed by the FDIC to standardize as much as possible the bank closing process.

to investigate why the failure occurred. (Moreover, as noted above, the FDIC in its role as the receiver of the failed institution has a fiduciary duty to the Deposit Insurance Fund and to the depositors and other creditors of the failed institution to recover assets to minimize losses.)

The FDIC's investigative process typically has three stages. The first occurs as of the date of closing and immediately thereafter, and includes taking control of all property and documents belonging to the failed bank, including materials that address the potential liability of directors and management. Following a short period of time that involves on-site inquiries, the FDIC next conducts a forensic inquiry regarding losses at the failed bank—which in the current failure environment has taken as long as two years. At the end of that period, staff at the FDIC and its local counsel evaluate all data that has been assembled, and tentatively identify individuals to target who are associated with the failed institution—which almost invariably includes some or all senior officers and directors of the failed bank.

Finally, the FDIC sends to individuals who have been targeted a demand letter that notifies them that the FDIC may hold them liable for the failure, and includes an extensive list of theories of liability—which essentially are alternative formulations of breaches of the standard of care owed by the targeted individuals. Accompanying the demand letter is an investigative subpoena that requests documents related to the failed institution, as well as detailed personal financial information of the targeted officer or director. If necessary, the FDIC may elect to take depositions to gather additional information, including making inquiries of deponents regarding individual loan transactions and other matters that might support the FDIC's liability analysis.

At the conclusion of this process, the FDIC considers the evidence it has obtained and determines whether to initiate litigation against targeted individuals or attempt to settle alleged claims based upon available funds, such as an officers and directors liability policy. Targeted individuals are always notified on the FDIC's decision to sue prior to the filing of the complaint, and will have an opportunity to negotiate a settlement of the case. [21]

(ii) The Standard of Liability Required for Officers and Directors to be Found Liable for Damages

While the FDIC conducts its investigations on a national basis, it is important to note that the FDIC is bound by state law standards of liability as a result of an important Supreme Court decision. In the case of *Atherton v. FDIC*, 519 U.S. 213 (1996), the FDIC alleged that it was entitled to a national standard of liability when recovering against officers and directors of failed institutions. Specifically, the FDIC claimed that a provision that was included in the FDI Act set a national standard of mere negligence.[22]

The Supreme Court disagreed, and determined that state law controlled the establishment of the duties owed by officers and directors of banking institutions, subject to a significant qualification. Specifically, the Court interpreted Section 11(k) of the FDI Act as setting gross negligence as the minimum ceiling for liability—with each state being empowered to set a stricter standard such as mere negligence. Stated another way, the Court recognized a partial preemption of state law by which state law could set a liability level that was higher than the federal standard (i.e., mere negligence), but the federal standard would trump a state law standard should the local standard exceed gross negligence.

[21] While the amount claimed by the FDIC as its loss is usually staggering, claims are usually settled for a much lesser amount. It should also be noted that the FDIC engages in an economic analysis to determine whether alleged claims should be pursued based upon the likelihood that assets would be available to pay a judgment or settlement.

[22] Approximately 40 state jurisdictions have adopted gross negligence as the standard of liability that is required to be shown in order to recover from officers and directors. (Several states differentiate between officers and directors by applying a gross negligence standard to outside directors and a negligence standard to inside directors and officers.)

Following *Atherton*, numerous states adopted special rules establishing liability limitations for officers and directors—and in the majority of instances those standards require a showing of gross negligence or intentional conduct. Accordingly, in order to establish liability, the FDIC must conform to the state law duty owed by officers and directors to an institution, as well as the standard for judging whether a breach of that duty creates liability for the members of the board or management.[23]

(iii) Steps to Be Taken Following a Bank Failure

Although prudent action taken when a bank remains open also effectively addresses concerns that arise following a failure, several items are noteworthy, as follows:

Holding Company Concerns. Following a bank failure, the solvency of the holding company becomes an issue, and a bankruptcy frequently follows. Because a holding company is not subject to the special bank receivership rules governing the failed bank subsidiary, the holding company must consider securities law claims, including claims filed by the holding company's shareholders, as well as direct claims by the FDIC against the holding company, such as claims arising from capital maintenance agreements and similar regulatory obligations.

Liability Insurance Coverage. Following a bank failure, officers and directors must verify that the insurer has been properly placed on notice of potential FDIC claims, and that the insurer accepts coverage—or at least issues a reservation of rights notice that permits the payment of defense costs. Further, former directors and management must also understand the role of the insurer in the FDIC investigative process. For example, it is necessary to distinguish between policies that require an insurer to provide a defense (which places the insurer in the position to actively participate in defending claims brought by the FDIC), versus a duty to pay defense costs that obligates an insurer to reimburse for legal costs (but counsel is retained directly by the targeted officers and directors). Similarly, it is important that the rights of the insurer be understood when participating in settlement negotiations with the FDIC, including the ability of the insurer to directly engage the FDIC in discussions.

Investigative Subpoenas. The FDIC typically issues investigative subpoenas that are directed at targeted officers and directors. These subpoenas are extraordinarily broad in scope, and seek records held by the recipient, as well as detailed financial records of the individual. It should be noted that these subpoenas are not self-enforcing, which means that to enforce the subpoena in regard to objectionable requests, the FDIC is required to seek enforcement by a federal district court.

The task of complying with an investigative subpoena requires care to ensure that the FDIC is not allowed to engage in a fishing expedition in order to identify deep pockets that justify proceeding with litigation. However, if settlement negotiations appear to be advisable, the FDIC will generally insist that some financial information be provided prior to discussions taking place. Should a strategic decision be made that some financial information will be provided, care must be exercised so that inadvertent misstatements are not included in any financial disclosures—particularly since federal criminal laws apply to false statements made to the FDIC.[24]

[23] Among other things, state law also determines the nomenclature to be used for applying any duties and standards that are created. For example, many states employ the "business judgment rule" as a means to evaluate conduct.

[24] It should be noted that FDIC subpoenas requesting bank documents also include electronic communications such as emails, which means that personal computers used by outside directors must be accessed and emails and documents provided to the FDIC for bank-related materials. (The assistance of forensic computer experts experienced in retrieving emails is recommended for this task.)

Transfers of Assets by Officers and Directors. The FDI Act contains a very punitive provision that the FDIC views as authorizing it to negate any personal transfers of assets held by former officers and directors of a failed institution. Because the FDIC conducts an investigation that includes identifying asset transfers through the use of public records, caution and sensitivity when electing to engage in personal financial planning by targeted individuals is warranted.

Assembling Bank-Related Documents. Following a failure, if officers and directors do not have personal copies of documents used in the performance of their duties, a high priority should be placed on assembling appropriate documentation. As noted above, immediately after a failure, the FDIC will prohibit officers and directors from having access to documents necessary to respond to charges that might be brought against them.

Accordingly, it is very useful if counsel obtains copies of bank records pertinent to the performance of management's and a board's responsibilities during the time the bank was open and operating. Copies of records that may prove to be valuable include: (a) board packets and minutes; (b) loan committee minutes; (c) regulatory correspondence and compliance records; (d) copies of pertinent liability policies; and (e) formal and informal communications with state and federal banking regulators.

It should be emphasized that the retention of records is deemed a highly sensitive issue by the FDIC, and it is strongly recommended that experienced counsel be consulted in regard to bank-related records. For example, while the FDIC takes the legal position that most bank documents concerning customers' personal financial information cannot be retained by former officers and directors, the FDIC has been reasonable in negotiating the use and retention of bank records that directly impact the potential liability of targeted individuals.

As noted above, this discussion is intended to provide a general overview of legal issues that arise following the receipt of capital-related orders, but should not be viewed as an exhaustive treatment of the topic. Each potential bank impairment situation presents potentially unique concerns, and should be analyzed by experienced counsel.

Providing legal advice in the context of a capital deficiency requires counsel accustomed to working within this area, because the administrative process following the issuance of capital-related orders is so opaque. Among other things, utilizing experienced counsel who understand the process when communicating with the Bank Regulators, including the FDIC, may assist in minimizing inaccurate communications and maximizing possible alternatives.

We trust that this analysis is instructive regarding the issues to be confronted by boards of directors and management. Please note, however, that the analysis provided is general in nature and should be used as a starting point when considering alternatives to be implemented.

Of course, we are available to discuss any questions that might arise.

If you have questions, please contact the Pillsbury attorney with whom you regularly work or the author:

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