Preparing for the Aftershock: Claims Against Bank Officers and Directors[1]

INTRODUCTION

The current financial crisis is unparalleled since the savings and loan crisis, when 1813 financial institutions failed.[2] Since 2008, there have been 181 bank failures, with projections indicating that many more bank failures are on the horizon.[3] Recent figures suggest that the current financial crisis may ultimately overshadow the experience twenty years ago.[4]

As an officer or director of a distressed financial institution, navigating through these troubled waters can be treacherous and, unfortunately, the risk of litigation is high. The officers and directors of a failing or a failed bank face scrutiny by one or more regulators, but the most likely threat of litigation is from the Federal Deposit Insurance Corporation ("FDIC"). When a federally insured bank is closed, the FDIC is appointed as conservator or receiver. The FDIC may then pursue a claim against directors or

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[2] Between 1985 and 1992, there were 794 bank failures and 1,019 savings and loan failures. *Recent Bank Failures and Regulatory Initiatives: Hearing Before the H. Comm. on Banking and Financial Services*, 106th Cong. (2000) (testimony of Donna Tanoue, Chairman, FDIC).

[3] In 2008, there were 25 bank failures, 140 in 2009, and 16 in 2010 to date.

[4] According to an article relying upon statistics from the MIT Center for Real Estate, commercial real estate has experienced a 39% decline in prices from the peak period two years ago, which is much higher than the 27% real estate decline from the prior savings and loan crisis of the late 1980's and early 1990's. Scott S. Powell and David Lowry, *Commercial Real Estate Crisis Threatens Recovery*, Atlanta Journal-Constitution, September 6, 2009, at A 17.

officers of the failed institutions in an effort to recoup losses to the bank. Of the financial institutions that failed in the period of 1985 – 1992, the FDIC initiated claims against the former officers and directors of 24% of those institutions.[5]

According to an FDIC Policy Statement, claims will not be brought against officers and directors "who fulfill their responsibilities, including the duties of loyalty and care, and who make reasonable business judgments on a fully informed basis and after proper deliberation."[6] In general, actions were brought against officers and directors during the savings and loan crisis where the FDIC believed that there was evidence of (i) dishonest conduct or abusive insider transactions, (ii) violations of internal policies, law or regulations that resulted in a safety or soundness violation, or (iii) failure to establish, monitor or follow proper underwriting procedures or heed warnings from regulators or advisors.[7]

In a replay of the earlier crisis, the FDIC has begun to investigate many of the failed banks and to make pre-litigation demands for payment of civil damages against officers and directors of some failed banks for losses incurred by the bank. There is no public source of information regarding the number of investigations or subpoenas that have been issued by the FDIC. It is also too early to determine how aggressive the FDIC will be in filing civil actions against officers and directors of failed banks. As noted in the FDIC Policy Statement, however, "the FDIC brings suits only where they are

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[5] Statement Concerning the Responsibilities of Bank Directors and Officers, FDIC Financial Institution Letter (FIL-87-92), Dec. 3, 1992. The Resolution Trust Corporation ("RTC") pursued claims against officers and directors in one-third of the number of institutions it handled. *Final Report of the Resolution Trust Corporation Professional Liability Section and Office of Investigations,* Apr. 1996.

[6] FDIC Financial Institution Letter (FIL-87-92), *supra* note 5.

believed to be sound on the merits and likely to be cost effective."[8] Some of these investigations will almost certainly lead to the filing of civil actions against former officers and directors.

The standard for bank director and officer liability is therefore coming to the fore again, after years of relative inactivity. In those instances in which the FDIC asserts claims for civil money damages against officers and directors of a failed bank, a threshold issue will be to determine the applicable standard that the FDIC must meet to establish liability. In the midst of the savings and loan crisis, the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA") was passed, which established gross negligence as a national minimum standard for officer and director liability. 12 U.S.C. § 1821(k).[9] This statute, however, permits the FDIC to pursue claims against officers and directors under a stricter standard for liability (simple negligence), if permissible under state law. For claims brought by the FDIC under 12 U.S.C. § 1821(k), therefore, the standard for liability of officers and directors may vary depending upon state law. Accordingly, analysis of the standard of liability under applicable state law is a critical first step in representing officers and directors of failed banks.

In most states, gross negligence remains the minimum standard for imposing liability upon bank officers and directors. Nevertheless, determining the standard for liability in a particular state may not be straightforward. Some states have a clear statutory provision or judicial decision setting the threshold to establish liability. More

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[7] *Id.*
[8] *Id.*

[9] Bank officers and directors may also be subject to claims for statutory violations and/or administrative actions under 12 U.S.C. § 1818, which imposes different standards than 12 U.S.C. § 1821(k).

often, the analysis is more complicated and requires reference to the applicable standard of care, the business judgment rule, each state's own legal idiosyncrasies, and perhaps other factors as well. This complexity creates potential pitfalls for practitioners, as well as opportunities for shaping the law, as the cases filed by the FDIC increase. The purpose of this article is to highlight the law in this area of some of the key states, so that practitioners may be consistent in their approach in the defense of bank directors and officers and avoid unnecessarily expanded liability.

FIRREA'S MINIMUM STANDARD OF LIABILITY: GROSS NEGLIGENCE

FIRREA sets a federally-mandated minimum threshold for liability in claims brought by the regulators against former bank officers and directors. Enacted in the midst of the savings and loan crisis, it 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 as conservator or receiver ... for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, as such terms are defined and determined under applicable State law. Nothing in this paragraph shall impair or affect any right of the Corporation under other applicable law.

12 U.S.C. § 1821(k).

Gross negligence is the baseline and liability may be imposed against bank directors or officers for conduct that equals or exceeds this level of culpability (intentional torts). "The federal statute . . . sets a 'gross negligence' floor which applies as a substitute for state standards that are more relaxed." *Atherton v. FDIC*, 519 U.S. 213, 216 (1997). The last sentence of § 1821(k), the savings clause, however, makes clear that states may impose a stricter standard of liability (one requiring less

culpability), such as simple negligence. "[S]tate law sets that standard of conduct as long as the state standard (such as simple negligence) is stricter than that of the federal statute." *Id.* Therefore, FIRREA requires initial reference to the state law to determine whether it has imposed a stricter threshold for liability.

STATE LAW THRESHOLDS FOR LIABILITY

In many states, gross negligence is the threshold for bank director and officer liability. The approach taken to reach this result, however, varies between states. In some, the approach is a direct one and the standard for liability is established by statute. In others, it involves the interplay between statute and case law. And in other states, the law may be unclear.

States with Statutory Gross Negligence Standards

Perhaps the clearest and most direct approach is those states that have statutes which expressly establish a gross negligence or higher standard. Florida and Texas, both states with growing numbers of bank failures, fall into this category.

Florida's statute, codified on July 1, 1987,[10] provides that:

> (1) A director is not personally liable for monetary damages to the corporation or any other person for any statement, vote, decision, or failure to act, regarding corporate management or policy, by a director, unless:
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> (a) The director breached or failed to perform his or her duties as a director; and
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> (b) The director's breach of, or failure to perform, those duties constitutes:

[10] Prior to 1987, the standard of liability for bank directors and officers in Florida was one of simple negligence. *See FDIC v. Stahl*, 89 F.3d 1510, 1516-18 (11th Cir. 1996). On July 1, 1987, the Florida legislature passed legislation "to afford corporate officers and directors greater protection from liability." *Id.* at 1516 n. 12. The statute governing the fiduciary duties of officers and directors is at Fla. Stat. § 607.0830.

1. A violation of the criminal law . . . .

2. A transaction from which the director derived an improper personal benefit, either directly or indirectly;

3. A circumstance under which the liability provisions of s.607.0834 [unlawful distributions statute] are applicable;

4. In a proceeding by or in the right of the corporation to procure a judgment in its favor or by or in the right of a shareholder, conscious disregard for the best interest of the corporation, or willful misconduct; or

5. In a proceeding by or in the right of someone other than the corporation or a shareholder, recklessness or an act or omission which was committed in bad faith or with malicious purpose or in a manner exhibiting wanton and willful disregard of human rights, safety, or property.

(2) For the purposes of this section, the term "recklessness" means the action, or omission to act, in conscious disregard of a risk:

(a) Known, or so obvious that it should have been known, to the director; and

(b) Known 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 action or omission.

Fla. Stat. § 607.0831.[11]

The focus on "conscious disregard," "willful misconduct," "recklessness" and "bad faith" in the Florida statute could be read to impose liability "only for acts constituting *more than* gross negligence." *FDIC v. Gonzalez-Gorrondona*, 833 F. Supp. 1545, 1556 (S.D. Fla. 1993) (emphasis added); *but see Fla. Software Sys., Inc. v. Columbia/HCA*

[11] While the plain language of Fla. Stat. §607.0831 does not discuss the conduct of corporate officers, courts interpreting these provisions have held that the statutes apply equally to officers. *See, e.g., F.D.I.C. v. Gonzalez-Gorrondona*, 833 F. Supp. 1545, 1557-58 (S.D. Fla. 1993).

Healthcare Corp., No. 97-2866-CIV-T-17B, 1999 WL 781812, at *3 (M.D. Fla. Sept. 16, 1999) (holding duty of care could be breached through gross negligence). To that extent it would be preempted by the minimum gross negligence standard under FIRREA. Whether pursuant to the statute or by default under FIRREA, Florida is one state with a clear gross negligence standard.

Texas is another statutory gross negligence state. Its Finance Code addresses the standard of liability for a bank's officers and directors, and provides:

> The provisions of the Texas Business Corporation Act regarding liability, defenses, and indemnification of a director, officer, agent, or employee of a corporation apply to Texas depository institutions and their agents. Except as limited by those provisions, a disinterested director, manager, managing participant, officer, or employee of a depository institution may not be held personally liable in an action seeking monetary damages arising from the conduct of the depository institution's affairs unless the damages resulted from the gross negligence or wilful or intentional misconduct of the person during the person's term of office or service with the institution.

Tex. Fin. Code § 31.006(a). Not surprisingly, given that the statute expressly requires "gross negligence or willful or intentional conduct," Texas courts have concluded that the state law threshold for liability for bank directors and officers is gross negligence. *See, e.g., FDIC v. Harrington*, 844 F. Supp. 300, 306 (N.D. Tex. 1994); *FDIC v. Henderson*, 849 F. Supp. 495, 497 (E.D. Tex. 1994), aff'd, 61 F.3d 421 (5th Cir. 1995).

States That Provide a Statutory Standard of Care and Apply the Business Judgment Rule

In many other states, the analysis is not so straightforward. The threshold for liability is also gross negligence, but rather than reaching this result through an express statutory mandate, it is a product of the interaction between the standard of care and the business judgment rule.

The interplay between the standard of care required of an officer or director and the application of the business judgment rule is one that has challenged lawyers and courts for years. On the one hand, there is the standard of care imposed by most states requiring directors and officers to exercise the care of an ordinarily prudent person under the circumstances. On the other hand, there is the business judgment rule, which is generally viewed as protecting directors and officers from personal liability for ordinary negligence. The result is a dichotomy or tension that one leading corporate treatise has summarized as follows:

> On the surface, at least, there is some tension between the business judgment rule, which absolves directors for all but gross negligence, and the duty most states impose on directors to exercise the care which an ordinarily prudent person would exercise under similar circumstances. To the extent these two rules can stand side-by-side, it is because courts do not push the rules to the logical limits of their broad language. When applying the duty of care, courts focus their inquiry on management's efforts in arriving at the decision rather than on the wisdom of the decision itself. When applying the business judgment rule, courts will not protect decisions where the directors' exercised little care in reaching the decision.

3A William M. Fletcher, Fletcher Cyclopedia of the Law of Corporations § 1036 (2002). Put more simply, even if the standard of care is simple negligence, the business judgment rule limits personal liability to instances of gross negligence or intentional misconduct.

Georgia and California are two good examples of this approach. Georgia, which currently leads the nation in the number of bank failures, sets the standard of conduct for bank directors and officers as follows:

> Directors and officers of a bank or trust company shall discharge the duties of their respective positions in good faith and with that diligence, care, and skill which ordinarily prudent men would exercise under similar circumstances in like positions. In discharging his duties, a director or

> officer, when acting in good faith, shall be entitled to rely upon information, opinions, reports, or statements, including financial statements and other financial data . . . . A director or officer who so performs his duties shall have no liability by reason of being or having been a director or officer of the bank or trust company

O.C.G.A. § 7-1-490. This "ordinarily prudent men" standard, on its face, sounds like simple negligence.

But Georgia, like most states, also honors the business judgment rule. "The business judgment rule protects directors and officers from liability when they make good faith business decisions in an informed and deliberate manner. The presumption is that they have acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Unless this presumption is rebutted, they cannot be held personally liable for managerial decisions. However, officers may be held liable where they engage in fraud, bad faith, or an abuse of discretion." *TSG Water Resources, Inc. v. D'Alba & Donovan*, 260 F. App'x. 191, 197 (11th Cir. 2007), *cert. denied*, 128 S. Ct. 2969 (2008) (internal punctuation and citations omitted). *See also Medserv Corp. v. Nemnom*, No. 1:95-cv-0462, 1997 U.S. Dist. LEXIS 18246, at *10-11 (N.D. Ga. September 23, 1997) ("It has been held that an action for breach of fiduciary duty by a corporate officer requires a showing of more than mere negligence or careless performance of his duties. Georgia follows the business judgment rule. This protects officers and directors from liability when they made good faith business decisions in an informed and deliberate manner.") (citations omitted).

As a result, simple negligence is not enough to establish personal liability. *See, e.g., Brock Built, LLC v. Blake*, 300 Ga. App. 816, 686 S.E. 2d 425 (2009) (granting summary judgment where plaintiff had only alleged negligent or carelessness in the

performance of the officers' duties); *RTC v. Artley,* No. CV492-20, slip op. at 11-12 (S.D. Ga. 1993) (denying judgment on pleadings for bank officers and directors because evidence of self-dealing rebutted the protection of business judgment rule) (unpublished decision on file with authors). The plaintiff has the burden to plead facts that rise to the level of gross negligence or more. Georgia does not impose a stricter standard of liability than gross negligence and FIRREA therefore imposes gross negligence as the applicable standard by default.[12]

California, another jurisdiction with a growing number of bank failures, follows a similar pattern. Like Georgia, California imposes a statutory standard of care on directors:

> A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinary prudent person in a like position would use under similar circumstances.

Cal. Corp. Code §309(a). Like Georgia, the statutory standard sounds very much like simple negligence.

But also like Georgia, California's business judgment rule protects directors and officers from personal liability for simple negligence. *Lee v. Interinsurance Exch.*, 57 Cal. Rptr. 2d 748 (Cal. Ct. App. 1997). California's business judgment rule "requires

[12] While this issue is beyond the purview of this article, the business judgment rule is considered a rebuttable presumption in some states, while other states recognize it as a defense. *See FDIC. v. Harrington*, 844 F. Supp. 300 (N.D. Tex. 1994) (dismissing negligence and breach of fiduciary duty claims because bank directors were entitled to the presumption of the business judgment rule). This characterization of the business judgment rule as a rebuttable presumption in favor of the defendant, rather than an affirmative defense that must be pleaded and proven by the defendant, is important as it stands in contrast to the holdings of courts in other jurisdictions that have required directors and officers to show they were *not* negligent before the court would apply the business judgment rule.

directors to perform their duties in good faith and as an ordinarily prudent person in a like circumstance would." *FDIC v. Castetter,* 184 F.3d 1040, 1043 (9th Cir. 1999). If bank directors meet requirements of California's business judgment rule, they are entitled to immunity from personal liability for acts taken by directors and officers in good faith and in the absence of a conflict of interest. *Berg & Berg Enters., LLC v. Boyle*, 100 Cal. Rptr. 3d 875 (Cal. Ct. App. 2009).[13]

As a result, regardless of the standard of care, simple negligence is not enough to establish personal liability. *Lee,* 57 Cal. Rptr. 2d 798. As the 9th Circuit explained in *Castetter*, involving a suit brought by the FDIC against bank directors under FIRREA:

> [T]he FDIC has misapprehended the structure of the California business judgment rule: it would impose liability for negligence in obtaining and acting upon information provided by independent consultants. Plainly, the statute specifically allows directors acting in good faith to rely upon such information without liability for doing so. Of course, the directors must establish they acted in good faith and make a prima facie showing of a reasonable investigation in order to rely on the defense. However, if they have done so without rebuttal, and if they relied on the type of information identified in § 309(b), they are entitled to immunity from claims of ordinary negligence.

Castetter, 184 F.3d at 1045.

And because there is no liability for "ordinary negligence" for a director's ultimate business decision, California's business judgment rule necessarily holds directors to a "gross negligence" standard. *Katz v. Chevron Corp.*, 27 Cal. Rptr. 2d 681, 689 (Cal. Ct.

[13] However, under Cal. Corp. Code §309(a), directors still have a duty of "reasonable inquiry" necessary to trigger the business judgment rule, such that "directors may not close their eyes to what is going on about them in corporate business, and must in appropriate circumstances make such reasonable inquiry as an ordinary prudent person under similar circumstances." *Gaillard v. Natomas Co.*, 256 Cal. Rptr. 702, 711 (Cal. Ct. App.1989).

App. 1994) ("[U]nder the business judgment rule[,] director liability is predicated upon concepts of gross negligence."). This is the default position under FIRREA as well.

Jurisdictions with Other Standards

While some states, like Florida and Texas, have statutes expressly establishing gross negligence standards, and others, like Georgia and California, have established the same standard by application of the business judgment rule, these are not the only approaches, and practitioners need to be prepared for further differences still. For example, at least one state, Colorado, does arguably impose a simple negligence standard. *See FDIC v. Stahl*, 89 F.3d 1510, 1516 (11th Cir. 1996) .

There is also at least one jurisdiction, the District of Columbia, that takes a hybrid approach. As the federal district court explained:

> [E]ven though courts frequently speak as if simple and gross negligence were subject to simple and distinct classification and application, in truth there is no exact standard as to what conduct constitutes negligence or gross negligence in a given situation:
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> ...
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> The degree of care required depends upon the subject to which it is applied, and each case is to be determined in view of all of the circumstances.

Washington Bancorporation v. Said, 812 F. Supp. 1256, 1265 (D.D.C. 1993). The Court therefore developed its own flexible approach, holding that a gross negligence standard applied for "routine" transactions, and the "reasonable investigation" prong of the business judgment rule, while a simple negligence standard may apply to transactions in which a bank might be unfamiliar. *Id.* at 1265-1266.

CONCLUSION

Litigation from the current financial crisis is undoubtedly on the horizon. Counsel for bank officers and directors can take steps now to prepare for claims or litigation that may follow. Two critical steps are identifying the applicable standard of liability for officers and directors and assessing how clearly this has been established in your jurisdiction. The anticipated wave of litigation will create opportunities to make or clarify existing law. It is vitally important that counsel be thorough in analyzing and applying the body of law that exists in their state, or in developing that law, to counteract any attempt to expand liability for bank officers and directors beyond gross negligence.