

DÉJÀ VU ALL OVER AGAIN: BANK OFFICERS AND DIRECTORS PREPARE FOR A REPLAY OF LITIGATION THAT FOLLOWED THE SAVINGS AND LOAN CRISIS



The current financial crisis is unparalleled since the savings and loan crisis, when 1,813 financial institutions failed.¹ There have been 123 bank failures to date in 2009, in addition to the 26 bank failures in 2008, with projections indicating that hundreds more bank failures may be on the horizon.² Recent figures suggest that the current financial crisis may ultimately overshadow the experience 20 years ago.³

In most instances, the failure of a bank is preceded by a variety of regulatory mandates, including heightened supervisory initiatives, such as a board resolution or a memorandum of understanding, as well as more substantive formal enforcement initiatives, such as a cease and desist order that mandates steps the bank must take to attain financial soundness and prompt corrective actions if the bank continues to fail to comply. In general, these directives impose additional requirements on the banks to raise capital and place restrictions on lending activity. As a director of a distressed bank, navigating through these troubled waters can be treacherous and, unfortunately, the risk of litigation is high.

The officers and directors of a failing or 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 officers of the failed financial institutions in an effort to recoup losses to the bank. Of the financial institutions that failed in the period between 1985 and 1992, the FDIC initiated claims against the former officers and directors of 24 percent of those institutions.⁴

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.”⁵ In general, actions were brought against officers



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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.⁶

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 believed to be sound on the merits and likely to be cost effective.” Accordingly, in order to determine the ability of an individual to respond to a claim, if successful, it is routine for the FDIC to seek personal financial information from the officers and directors as part of the investigation. In addition, the FDIC typically sends its demand for payment of civil damages directly to the D&O insurance carrier to provide the requisite notice under the policy to trigger insurance coverage as a potential source of recovery if liability is established.

A further source of litigation risk for officers and directors of banks or holding companies are shareholder lawsuits. The number of shareholder class actions filed against financial institutions in 2008 was at an all-time high, accounting for 54 percent of the market cap of all such lawsuits filed against S&P 500 companies.⁷ This is the highest percentage of any business sector, by a wide margin, in the past eight years. Moreover, financial institutions were defendants in 67 percent of the shareholder class action filings in the first half of 2009.⁸ The shareholder plaintiffs typically allege that the company’s stock price was inflated by falsely disclosed financial reports that overestimated the value of real-estate-backed assets, and that once the truth was revealed, it caused the stock price to fall to the shareholders’ detriment.

With the heightened risk of litigation in the financial sector, there are certain steps that counsel for bank officers and directors may take to prepare for claims or litigation that may follow. Meeting with the board members and reviewing the examination reports



and other documents available while the bank remains open will provide insight into the specific issues that confront the board of directors and management. It is important that documents pertaining to the bank are preserved and counsel may give guidance on specific document preservation procedures.

In this environment, it is especially important for bank officers and directors to have a clear understanding of the scope and potential limitations of their D&O insurance policies. There are a variety of clauses that may impact the availability of insurance coverage in these cases. In the wake of the savings and loan crisis, insurance carriers began to include regulatory exclusions in D&O policies, in an effort to reduce exposure to claims for civil damages and/or penalties sought by the regulators.⁹ Bank directors and officers will want to know whether their policy contains such limitations and have sought legal counsel regarding the practical impact of the limitations. Other provisions of the insurance policy may require that certain action be taken to afford coverage. For example, many policies require that the insureds furnish a “Notice of Circumstances” under the policy, which is typically prepared by counsel and provides a description of potential claims that may be brought against the insureds. Such notices may provide coverage under the policy that the directors and officers otherwise would not have. Accordingly, directors and officers should seek counsel to consider whether a Notice of Circumstances is warranted.

The waves of litigation from the financial crisis will undoubtedly continue. Counsel for bank officers and directors can take steps now to prepare for claims or litigation that may follow, including (i) gaining an understanding of the particular issues confronting the bank, through a review of the examination reports and other documents available while the bank remains open; (ii) a review of the D&O policies; and (iii) the preparation of a Notice of Circumstances. There may be other steps that are also appropriate at this juncture, depending upon the particular facts and circumstances of the bank.

Endnotes

¹ Between 1988 and 1992, there were 794 bank failures and 1,019 savings and loan failures. *Testimony of Donna Tanoue, FDIC Chairman, On Recent Bank Failures and Regulatory Initiatives, Before The Committee on Banking and Financial Services, U.S. House Of Representatives, February 8, 2000.*

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- ² The FDIC announced on August 27, 2009, that the number of financial institutions on the “Problem List” had increased from 305 to 416 by the second quarter of 2009. See *FDIC Quarterly Banking Profile, Second Quarter 2009*, June 30, 2009.
- ³ According to a recent article relying upon statistics from the MIT Center for Real Estate, commercial real estate has experienced a 39 percent decline in prices from the peak period two years ago, which is much higher than the 27 percent real estate decline from the prior savings and loan crisis of the late 1980s and early 1990s. “Commercial Real Estate Crisis Threatens Recovery,” *Atlanta Journal-Constitution*, September 15, 2009.
- ⁴ *FDIC Financial Institution Letter (FIL-87-92)*, December 3, 1992.
- ⁵ *Id.*
- ⁶ *Id.*
- ⁷ *Cornerstone Research, Securities Class Action Filing, 2008: A Year in Review.*
- ⁸ *Cornerstone Research, Securities Class Action Filings, 2009 Mid-Year Assessment.*
- ⁹ The terms of these “regulatory exclusions” vary between policies and the specific terms of the policy should be reviewed carefully.

ABOUT THE AUTHORS



Mary C. Gill, Mark C. Kanaly and Robert R. Long are partners in the firm’s Atlanta office and are part of its dedicated Officers & Directors of Distressed Financial Institutions team, a cross-disciplinary group that contains members with substantial experience in representing the financial services sector on transactional and regulatory issues as well as in matters involving bank officers and directors in regulatory, securities, and other corporate governance disputes. The team has recently advised more than 20 distressed banks and represents well over 100 bank officers and directors in regulatory and shareholder matters, including in over 30 claims by the FDIC brought after bank failures.

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