

Defending Bank Officers and Directors in FDIC Litigation

by

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In the fallout from the financial crisis, the FDIC, as receiver, has authorized suits against 373 former directors and officers of 41 failed banks and has already filed 17 such suits. The authors discuss the obstacles to such claims and the availability of affirmative defenses after the Supreme Court's landmark O'Melveny & Myers decision.

In the three years since the onset of the financial crisis, the number of banks that have been closed is roughly half the number of financial institutions that failed after the savings and loan crisis of the late 1980s.¹ Although the number of problem institutions declined in the second and third quarters of 2011, there remain 844 institutions on the FDIC's "problem bank list," which indicates that bank closings will likely continue at a steady pace in the near term.² Whether the number of failed banks ultimately reaches the level of closings experienced in the post-savings and loan crisis remains to be seen.

The wave of litigation that has begun slowly and will continue in the wake of the bank closings also parallels the post-savings and loan crisis in many respects.³ Significant developments in the law during the last decade, however, may yield strikingly different results in the claims that flow from the current financial crisis.

When a federally insured bank is closed, the Federal Deposit Insurance Corporation ("FDIC") is appointed as conservator or receiver. The FDIC investigates every closed bank to determine whether there may be claims that can be pursued in an effort to recoup losses to the bank.⁴ The investigation of a closed bank by the FDIC typically takes 18 months

with the focus on an array of professionals who provided services to the bank, including accountants, lawyers, appraisers, and insurance brokers.

The most intense scrutiny of the FDIC investigation, however, is on the former directors or officers of the failed financial institution. As a result, for an officer or director of a distressed financial institution, the risk of claims brought by the FDIC would appear to be high. The FDIC has three to four years from the closing of a bank to bring claims against the former officers and directors.⁵ At this point, the FDIC has authorized suits to be brought against 373 former directors and officers of 41 failed banks, seeking damages of at least \$7.6 billion.⁶ To date, however, only 17 lawsuits have been filed by the FDIC against former bank officers and directors. With the approach of the three-year mark from the early bank closings, the pace of lawsuits filed against former bank officers and directors will undoubtedly increase.

FDIC Claims Against Bank Officers and Directors

According to its policy statement, the FDIC will only bring suit when there is a reasonable chance of establishing liability and the likelihood of recovery exceeds the cost of pursuing a claim.⁷ The current post-bank crisis litigation presents significant challenges to the FDIC in proving its case in court against the former officers and directors. Under the federal statute that governs these claims, the FDIC must demonstrate that the officer or director's conduct was grossly negligent, unless the applicable state law allows liability to be imposed based upon a stricter standard (*e.g.*, negligence).⁸ Simply stated,

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the FDIC must prove that the officers and directors made decisions that were in reckless disregard of the best interests of the bank. In each case, the FDIC also must prove that the actions of the officers and directors caused actual losses to the bank. In addition, the FDIC must rebut any affirmative defenses raised by the officers and directors to these claims.

The first professional liability action brought by the FDIC in the current financial crisis was filed on July 2, 2010, against officers of the mortgage subsidiary of IndyMac, one of the earliest and largest bank failures. Since then, the FDIC has filed suits against the former officers and directors of 16 other banks in Arizona, California, Kansas, Illinois, Georgia, North Carolina and Washington.⁹ The FDIC has asserted claims against these former officers and directors for negligence, gross negligence and breach of fiduciary duty.¹⁰ In most of these cases, the claims relate to loans that were made by the bank. The FDIC also generally claims that the business plan executed by the officers and directors of the bank involved undue risk, overly aggressive growth strategy, or unwarranted concentration in real-estate-based lending, particularly acquisition, development and construction.

The FDIC has espoused the policy of pursuing claims against outside bank directors only for conduct that rises to the level of gross negligence or worse.¹¹ And, indeed, not all of the directors of these banks have been caught in the net of litigation. In many cases, only the outside directors who served on the loan committee and bore some responsibility for approving the particular loans were joined as defendants. In one instance, the FDIC sued outside directors for failure to supervise an allegedly faulty loan approval process. Notwithstanding its stated policy, however, the FDIC has asserted claims of negligence against these outside directors.

In each of the pending lawsuits, the former officer and director defendants have moved to dismiss the negligence claims on the grounds that FIRREA requires, at a minimum, a showing of gross negligence.¹² Thus, the threshold issue in these cases is whether claims of ordinary negligence will lie against the former officers and directors under the applicable state law. Based upon well-established state law principles and decisions from the post-savings and loan litigation, courts should readily determine that the FDIC claims for negligence

should be dismissed. In most states, directors are not subject to liability for negligence, either by statute or the application of the business judgment rule, which is generally viewed as protecting directors and officers from personal liability for ordinary negligence. Accordingly, in cases arising from the savings and loan crisis, courts rejected claims of negligence brought by the FDIC against bank officers and directors. For example, in a 1999 decision applying California law, the Ninth Circuit Court of Appeals held that directors are immune from claims of ordinary negligence brought by the FDIC when they have acted in good faith and on an informed basis.¹³ Similarly, in the first court decision rendered in the recent wave of litigation, a federal court in California followed the same reasoning and held that the former directors of a credit union could not be held liable for negligence, which allegedly caused the failure of the institution.¹⁴

Although each case will be governed by the applicable state law governing the particular bank, the similarities in state law should lead to comparable results in most cases. Unless the state law governing the bank permits officers and directors to be held liable for ordinary negligence, the courts should dismiss the FDIC's negligence claims. The rulings in these initial cases will have a profound effect on the director and officer litigation that will continue in the years to come.¹⁵

The Availability of Affirmative Defenses to FDIC Claims

The FDIC will also confront a variety of affirmative defenses raised by the former officers and directors in these cases. Many of these defenses were rejected by courts in the post-savings and loan crisis litigation. The most common ground for striking affirmative defenses was the so-called "no duty" rule. A ruling by the United States Supreme Court near the end of the savings and loan litigation, however, has reopened the door to these defenses. As a result, there is a renewed viability to many of these affirmative defenses, which will level the playing field for officers and directors defending against FDIC claims.

The "no duty" rule was based upon "federal common law" and precluded former officers and directors from asserting certain defenses against the federally appointed receiver. The policy behind the "no duty" rule was "that any affirmative defense

calling into question the pre-or post-bank closing action of the FDIC are [*sic*] insufficient as a matter of law because the FDIC owes no duty to the officers and directors of a failed bank, either in its pre-failure regulation of a bank or in its post-failure liquidation of the same.”¹⁶ Based upon this reasoning, the Resolution Trust Corporation (“RTC”), which served as receiver for many closed savings and loans, and the FDIC consistently relied on the “no duty” argument to block former officers and directors from asserting a variety of affirmative defenses to the receiver’s claims, including failure to mitigate damages, contributory or comparative negligence, estoppel, and waiver. Prior to 1994, the RTC and the FDIC were generally successful in striking these defenses. As a result of the widespread acceptance by the courts of the “no duty” rule, bank officers and directors were handicapped in defending these lawsuits in the late 1980s and early 1990s.

The litigation landscape was significantly altered near the end of the savings and loan litigation through a decision by the United States Supreme Court. As a result, former officers and directors of failed banks who face FDIC claims today may have an array of defenses that were not previously available.

In the 1994 landmark decision, *O’Melveny & Myers v. FDIC*,¹⁷ the Supreme Court rejected the premise of “federal common law,” which afforded the FDIC unique protection from defenses. In doing so, the Supreme Court ruling swept away the basis for the “no duty” argument that had been applied by courts to reject an array of affirmative defenses raised by bank officers and directors to the FDIC claims. In *O’Melveny & Myers*, the FDIC sued the former lawyers of a failed savings and loan institution. In their defense, the lawyers relied upon a defense that imputed the fraud of the former officers of the savings and loan to the institution itself and, as a result, to the FDIC, which as receiver stepped into the shoes of the institution. The FDIC argued

that public policy and federal common law barred the application of this defense against the FDIC. Calling the FDIC’s premise “plainly wrong,” the Supreme Court unequivocally rejected the principle that there was a federal body of common law that afforded special defenses to the receiver. The Court held that neither federal policy, nor FIRREA itself, created a federal rule to protect the FDIC. Instead, “any defense good against the original party is good against the receiver.”¹⁸

Thus, the FDIC’s previously successful argument that a federal “no duty” rule trumps otherwise available state law defenses is no longer available. Moreover, because *O’Melveny & Myers* undermines the rationale upon which the prior pro-FDIC case law was based, these earlier decisions are no longer binding, nor should they be persuasive to courts in the current litigation environment. In a number of decisions, courts have relied upon *O’Melveny & Myers* to reject the FDIC’s “no duty” argument and afford the director defendants state law defenses that would have been denied them previously.¹⁹ These decisions should pave the way for courts to allow the officer and directors’ affirmative defenses to proceed on the merits, rather than stripping them of these arguments as a matter of federal policy.

Conclusion

The wave of FDIC litigation against former officers and directors of banks will continue to build over the next few years. Not all officers and directors will face claims by the FDIC. For those who do, the burden of proof on the FDIC to establish liability is high. Moreover, as a result of significant court decisions from the earlier savings and loan litigation, former bank officers and directors who face FDIC claims today have access to affirmative defenses that may bar or otherwise limit the receiver’s claims against them. Bank directors and officers of distressed financial institutions may wish to seek counsel who can advise them and take steps now to prepare for potential FDIC claims.

Notes

¹ Between 1988 and 1992, there were 794 bank failures and 1,019 savings and loan failures. *Speeches and Testimony, Recent Bank Failures and Regulatory Initiatives, Before The Committee on Banking and Financial Services, U.S. House Of Representatives, Testimony of Donna Tanoue, FDIC Chairman*, (February 8, 2000), <http://www.fdic.gov/news/news/speeches/archives/2000/sp-08Feb00.html>.

² FDIC Quarterly Banking Profile, Third Quarter 2011, <http://www2.fdic.gov/qbp/2011sep/qbp.pdf>.

³ The FDIC asserted professional liability claims against the former officers and directors of 24% of the banks that failed as a result of the savings and loan crisis from the late 1980s. Many of these claims were resolved, however, without litigation being filed by the FDIC.

⁴ In an earlier article, the authors provided a full discussion of the FDIC investigation process, see Gill et al., *Claims Against Bank Officers and Directors Arising from the Financial Crisis*, 26 Rev. Bank. & Finan. Serv. 69 (July 2010).

⁵ In some instances, the FDIC will seek to enter into tolling agreements with the former directors and officers in an effort to resolve the claims without filing a lawsuit and to afford the parties more time to do so.

⁶ <http://www.fdic.gov/bank/individual/failed/pls/>.

⁷ FDIC, *The FDIC and RTC Experience: Managing the Crisis*, 266 (1998).

⁸ Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”), 12 U.S.C. § 1821(k).

⁹ *FDIC v. Van Dellen*, No. 2:10-cv-04915-DSF-SH (C.D. Cal., July 2, 2010); *FDIC v. Saphir*, No. 1:10-cv-07009 (N.D. Ill., Nov. 1, 2010); *FDIC v. Appleton*, No. 2:11-cv-00476-DDP-PLA (C.D. Cal., Jan. 14, 2011); *FDIC v. Skow*, No. 1:11-cv-0111 (N.D. Ga., Jan. 14, 2011); *FDIC v. Stark*, No. 3:11-cv-03060-JBM-BGC (C.D. Ill., Mar. 1, 2011); *FDIC v. Killinger*, No. 2:11-cv-000459 (W.D. Wash., Mar. 16, 2011); *FDIC v. Spangler*, No. 10-cv-4288

(N.D. Ill., May 5, 2011); *FDIC v. Perry*, No. 11-cv-5561-ODW-MRWx (C.D. Cal., July 6, 2011); *FDIC v. Briscoe*, No. 1:2011-cv-002303 (N.D. Ga., July 14, 2011); *FDIC v. Cuttle*, No. 2:11-cv-13442-BAF (E.D. Mich., Aug. 8, 2011); *FDIC v. McCaffree*, No. 2:11-cv-02447-JARKGS (D. Kan., Aug. 9, 2011); *FDIC v. Willetts*, No. 7:11-cv-00165-BO (E.D.N.C., Aug. 10, 2011); *FDIC v. Bryan, et al.*, No. 1:11-cv-02790-JEC (N.D. Ga., Aug. 22, 2011); *FDIC v. Gary A. Dorris and Phillip A. Lamb*, No. 11-cv-01652-GMS (D. Ariz., Aug. 23, 2011); *FDIC v. Blackwell*, No. 11-cv-03423 (N.D. Ga., Oct. 7, 2011); *FDIC v. Mahajan*, No. 1:11-cv-07590 (N.D. Ill., Oct. 25, 2011); *FDIC v. Johnson, et al.*, No. 3:11-cv-05953 (W.D. Wash., Nov. 18, 2011).

¹⁰ In one of the cases, the spouses of the former officers were also sued for alleged fraudulent conveyance of assets. *FDIC v. Killinger*, *supra* note 9.

¹¹ *Managing the Crisis*, *supra* note 7, at 275.

¹² The difference between negligence and gross negligence could be significant. Gross negligence requires a showing of reckless conduct in disregard of the best interests of the bank. Ordinary negligence may be established by showing a failure to act with ordinary care.

¹³ *FDIC v. Castetter*, 184 F.3d 1040 (9th Cir. 1999).

¹⁴ *National Credit Union Administration v. Siravo*, No. 2:10-cv-01597-GW-MAN (C.D. Cal.), Mar. 3, 2010.

¹⁵ Further, under either a simple negligence or gross negligence standard, the FDIC must prove that the conduct was the actual cause of loss to the bank. For example, the FDIC will have to demonstrate that the officers and directors’ conduct caused the loss, rather than other intervening factors such as the unprecedented collapse of the real estate markets. See, e.g., *Resolution Trust Corp. v. Youngblood*, 807 F. Supp. 765, 773 (N.D. Ga. 1992) (“It should be noted that the RTC must still establish that the defendants’ conduct was the proximate cause of the injury claimed in order to prevail at all; . . .”).

¹⁶ *FDIC v. Schreiner*, 892 F. Supp. 848, 853 (W.D. Tex. 1995).

¹⁷ 512 U.S. 79 (1994).

¹⁸ *O'Melveny & Myers*, 512 U.S. at 86 (quoting *FDIC v. O'Melveny & Myers*, 969 F.2d 744, 751 (9th Cir. 1992)).

¹⁹ *See, e.g., RTC v. Mass. Mut. Life Ins. Co.*, 93 F. Supp. 2d 300, 306 (W.D.N.Y. 2000) (permitting the defense to assert the affirmative defenses of contributory negligence and failure to mitigate damages against the FDIC/RTC); *FDIC v. Ornstein*, 73 F. Supp. 2d 277, 282 (E.D.N.Y. 1999) (concluding that *O'Melveny & Myers* completely undermined the “no duty” rule and freed defendants to assert state law affirmative defenses, such as failure to mitigate damages, against the FDIC); *FDIC v. Gladstone*, 44 F. Supp. 2d 81, 89 (D. Mass. 1999); *FDIC v. Haines*, 3 F. Supp. 2d 155 (D. Conn. 1997); *RTC v. Liebert*, 871 F. Supp. 370 (C.D. Cal. 1994). A few courts have reached contrary results and held that *O'Melveny & Myers* should be limited to its facts. *See, e.g., FDIC v. Healey*, 991 F. Supp. 53 (D. Conn. 1998); *see also Grant Thornton, LLP v. FDIC*, 535 F. Supp. 2d 676 (S.D. W.Va. 2007); *FDIC v. Raffa*, 935 F. Supp. 119 (D. Conn. 1995). These decisions are based upon the rationale that it is inappropriate to second-guess the conduct of federal banking agencies. *See generally, Healey*, 991 F. Supp. at 58-63. This reasoning, however, directly contradicts *O'Melveny & Myers*, which rejects the notion of federal common law used as a shield for affirmative defenses that would otherwise be available. In a recent decision, *FDIC v. Van Dellen*, the Central District of California granted a motion by the FDIC for partial judgment on the pleadings with respect to certain defenses raised by the former officers of IndyMac. *Mem. (in Chambers) Order Granting in Part & Den. in Part Pl.'s Mot. for Partial J. on the Pleadings, FDIC v. Van Dellen*, No. 2:10-04915-DSF-SH (C.D. Cal., Sept. 27, 2011), ECF No. 75. In applying the holding of *O'Melveny & Myers*, the court recognized that “any defense good against the original party is good against the receiver.” *Id.* at 6 (quoting *O'Melveny & Myers*, 512 U.S. at 87). The court limited the availability of these defenses, however, to those defenses that would have been applicable to the bank itself. As a result, the affirmative defenses of failure to mitigate damages, unclean hands and ratification were unavailable “to the extent they are

based on the FDIC’s post-receivership conduct in managing IndyMac, or its pre-receivership conduct as a regulator because the defenses could not have been asserted against IndyMac.” *Id.*