

Whatâ€™s your real liability as a director or officer?

Recently I have been receiving many questions from community bankers that deal with their liability as bank directors and officers. Since my checkered past includes suing bank directors for the FDIC when their banks failed, defending directors since I left the FDIC 25 years ago, and, in all likelihood, serving as an expert witness for directors in the future, I suppose they picked me as a likely candidate to be able to respond.

Directors and officers liability emanates from three sources primarily: the shareholders, the receiver or its assignee in a failed bank situation, or the regulators in an open bank situation.

I will spare all of you the recitation of your duties and responsibilities and simply focus in this discussion on potential sources of liability and what I believe to be realistically and practically the greatest concern.

Starting with the first source of potential financial liability noted above, the shareholders, it is appropriate to analyze what the real exposure of a director or officer is to the shareholders. As a practical matter, it is typically zero. "How can that be?" you say, "shareholders sue corporate and bank holding company directors and officers fairly regularly, it seems." Now you may find this hard to believe, but there are actually lawyers who look over various securities and other filings just to determine who they can sue. That is the bad news. On a liability front, however, virtually all community bank and bank holding companies have directors and officers insurance. D&O insurance does a nice job of protecting you as a director or officer from any personal liability in connection with a shareholder's suit. So I view that as a very, very minimum exposure in the real world for a director or officer.

The second source of liability, the receiver or its assignee in a failed bank case, for those whose banks fail, is a very real financial exposure. The reality, however, even if my prediction of 500 to 750 bank failures before this is all over occurs, that will still be less than 20% of the banks currently operating in the industry. Of that 20% that fail, I predict that probably only about half of those will see some type of litigation from the FDIC. Typically the way that works is the bank fails and the FDIC as receiver steps into the shoes of the bank. The receiver then sells certain assets and has certain liabilities assumed by an assuming bank, and sells certain assets to the FDIC in its corporate capacity, including the claim against the directors. As noted, I do not believe that in every failed bank situation the directors will be sued. When I was suing bank directors in connection with failed banks in the late seventies, I do not recall a bank failure where I did not sue the directors. In the late eighties and early nineties, however, with the last rash of bank failures, I think the litigation rate was somewhere in the 50% range. So if you are looking at exposure as a director, you do have exposure if your bank fails. That would be 20% of the industry, and possibly half of those, or a few hundred, would have exposure to the FDIC in a failed bank situation.

The real exposure of the directors and officers is to civil money penalties while the bank is still open. The regulators are getting much more aggressive with respect to civil money penalties. Civil money penalties can range anywhere from a very small amount, up to approximately \$1.2 million a day (although I have never seen a penalty of that size against a domestic bank or director). Most of the penalties range from \$5,000 to about \$250,000, and are against individual directors and officers. The penalty can be assessed (with the right to due process, i.e. a hearing) for "any violation of law, rule or regulation." That is a pretty broad standard. Civil money penalties are usually assessed, for example, for a new bank that fails to follow its business plan, a bank that commits a legal lending limit violation that causes loss, a repeated and consistent failure to comply with a Cease and Desist Order (or now the new Consent Order), or other somewhat egregious acts. The bad thing about civil money penalties is that they are brought against the directors and officers individually. The process is initiated with a "15-day" letter. The 15-day letter from the regulator informs the director or officer that the regulators intend to bring a civil money penalty action unless the director or officer talks them out of it. The 15-day letter is generally followed by a response and a period of negotiation. There is also an opportunity for a hearing.

The issue with liability, however, is that the typical language of a D&O policy excludes civil money penalties from coverage. That is not true for all D&O policies, but for many of them it is. For some D&O policies, the bank has even purchased a civil money penalty endorsement, which purports to specifically include coverage for civil money penalties.

Unfortunately, and not to get hyper-technical, but the problem with civil money penalties is Part 359 of the FDIC Regulations. This particular regulation prohibits the bank from providing insurance policies that cover civil penalties. If the bank has provided such an insurance policy, then under this section, the FDIC can prohibit the insurer from paying coverage for a civil penalty. The bank is prohibited from indemnifying, or providing insurance to indemnify, a director officer or other institution-affiliated policy from a civil money penalty assessed against the individual personally.

A way around this is for the directors and officers to either pay their portion of a CMP endorsement on the policy, or pay their portion of the coverage for the bank policy that deals with civil money penalties, or obtain their own policy. If anyone would like any further information on how to do this, please email me and I will send it to you.

About the Author

Jeff Gerrish is chairman of the board of Gerrish McCreary Smith Consultants, LLC, and a member of the Memphis-based law firm of Gerrish McCreary Smith, PC, Attorneys. He is a frequent contributor to ABA Banking Journal and ABA Bank Directors Briefing, and frequently speaks at ABA events and telephone briefings.

Gerrish formerly served as Regional Counsel for the Memphis Regional Office of the FDIC, with responsibility for all legal matters, including cease-and-desist and other enforcement actions. Before coming to Memphis, Gerrish was with the FDIC Liquidation Division in Washington, D.C. where he had nationwide responsibility for litigation against directors of failed banks.

Gerrish can be reached at jgerrish@gerrish.com, and the firm's website, www.gerrish.com