

WHEN FDIC SUES DIRECTORS, AND WHEN IT WON'T

Hint: The potential payoff to FDIC has a lot to do with it

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In a previous blog, I mentioned the possibility of FDIC litigation against directors of failed banks. Based on the e-mails I have received, I have, obviously, grabbed the attention of a certain segment of the industry.

As many of you know, my checkered past includes being the first head of the division of FDIC that sued directors of failed banks. As a result of that, I certainly do not address this topic from an academic basis, but a real one. When I was suing failed banks' board members for the FDIC in the late 70s, I initiated litigation in virtually every circumstance. It was not very difficult to differentiate the guilty from the innocent, but more importantly, it was a question of not only who was culpable, but who had the financial resources. I suspect not much has changed.

[If you missed the earlier blog, read "What's your real liability as a director or officer?" by clicking on the link.]

Directors and the "standard of care"

In the last downturn, somewhere in the neighborhood of 25% to 50% of all closed bank cases involved litigation against the directors. Why not 100%? Why not 0%? The reality lies in the fact that FDIC has to consider the "standard of care" in the jurisdiction in which the bank lies, and the financial resources of the directors. In the old days, the standard of care was always "simple negligence," i.e., the directors had a duty to the bank, and if they breached that duty and that breach caused a loss, then under the garden-variety negligence theory, they could be held responsible.

In August 1989, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA"), which included a federal "gross negligence" standard of care applicable to bank directors and officers. This is a lesser standard than simple garden-variety negligence, but not quite as low a standard as "recklessness." The U.S. Supreme Court held that the federal standard of care of "gross negligence" will apply unless the specific state has a lesser standard. New York State, for example, applies a simple negligence standard, so in New York, FDIC could avail itself of a simple negligence standard when determining whether to bring a claim.

Most directors' liability claims will be based on loans that "never should have been made" had the directors been doing their job. Many directors will defend on the basis that they relied on management. The question then will be whether their alleged reliance was "reasonable." If they received criticism of management or the credit administration function of the bank, or anything dealing with lending long before the bank closed and did nothing about it, then, arguably, their reliance was not reasonable.

In any event, the first step in determining whether to sue directors is whether there has been a breach of the standard of care. To date, FDIC has brought no litigation against directors of failed banks since 2007. (This is primarily because the statute of limitations in most cases has not run out.) FDIC must determine whether there is a case to be made and whether there is culpability on the part of failed bank's directors.

Once that determination is made, then FDIC needs to determine whether it makes economic sense to bring the litigation. Yes, a federal government agency dealing with economic sense. Although you will never see that on the regulatory side, on the "resolution" side (which used to be known as the "liquidation" side), we do see it.

FDIC, as receiver and in its corporate capacity as an assignee of the claim against the directors from the receiver, is economically driven. If the failed bank's directors have D&O insurance that survives the closing, they will probably get sued. If the failed bank directors are individually well-heeled, they are an even better target. If they are all broke, there is not much sense in bringing litigation. After the bank has failed, there is no regulatory "point" to be made.

The bottom line of all this is, a concerned director needs to: (a) understand the standard of care, (b) assess his or her conduct in view of that standard of care, and (c) determine whether if the regulators pursue that director, there would be any recovery available.

About the Author

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