**Liability Risks for Directors and Officers of Financial Institutions**
The Coming Wave of FDIC Litigation

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Now more than at any time since the savings and loan (S&L) crisis in the 1980s, directors and officers of financial institutions must be aware of liability risks related to performance of their duties.

All indications point toward the Federal Deposit Insurance Corporation (FDIC) digging in for a litigation campaign against bank directors and officers of the same size and scope as the S&L crisis. On Nov. 1, 2010, the FDIC filed its second lawsuit against officers of a failed bank, Heritage Community Bank in Illinois, following the FDIC's first such suit in July 2010 against former officers of IndyMac Bank. On Jan. 14, 2011, the FDIC filed two more suits against former officers of Integrity Bank of Alpharetta, Ga., and of 1st Centennial Bank in California.

These suits are at the leading edge of a building wave of litigation against bank directors and officers. In addition to the four suits identified above, the FDIC has authorized suits against numerous other officers and directors of failed banks. In total, as of the end of February 2011, the FDIC has authorized suits against 130 officers and directors, seeking total damages of over $2.5 billion.

The FDIC has hired a substantial number of lawyers for the specific purpose of litigating FDIC claims against directors and officers of failed financial institutions. The agency recently reported to Congress that its "professional liability activities are expected to increase substantially" moving forward. A former senior FDIC official was quoted as saying that about half of the failed banks will see some form of litigation against its directors and officers.

**What the FDIC Is Doing Now**

Over the last twelve to eighteen months, counsel for the FDIC has been contacting a substantial number of former directors and officers of failed financial institutions, often with some form of demand letter, tolling agreement, or both. (In a tolling agreement, the potential director/officer target of the lawsuit agrees that the statute of limitations can be extended against that person while the FDIC considers how to proceed. In most instances, the targeted director/officer agrees to tolling in hopes that the FDIC ultimately will opt not to file the lawsuit.)

Recent litigation has involved the first failed banks of 2007 and early 2008. For the most part, the FDIC appears to be targeting the institutions chronologically, addressing the earliest failures first and continuing down the list while staying within the statute of limitations (tolling agreements among other factors can change that order). For example, the failure of IndyMac Bank in California occurred July 11, 2008, and the FDIC's lawsuit against former officers at IndyMac was filed on July 10, 2010, almost two years to the date. The IndyMac complaint asserted 68 causes of action against former officers.

Unlike a securities class action, which has stringent statutory and case law pleading requirements for securities fraud claims, FDIC complaints typically assert negligence and breaches of duty of care, which are not as easily subject to dismissal before discovery. Because the FDIC has authorized a large number of additional suits, it is a near certainty that similar litigation involving more recent bank failures will begin to build in the next 12 to 24 months.

The FDIC follows a consistent process for assessing potential claims when an FDIC-insured financial institution fails.

First, the FDIC attorneys in its professional liability group open an investigation to identify potential claims against directors, officers, and carriers, as well as independent accountants, attorneys, appraisers, or anyone else who provided professional advice to the failed bank. These investigations are separate from the material loss reviews conducted by the FDIC Office of Inspector General.

Because the FDIC is typically a receiver of the failed bank, it has access to all of the bank's internal documents. FDIC investigators also have the power to subpoena bank officials and others as a means of gathering additional evidence.

Findings from the investigation are sent to the senior FDIC supervisory and legal staff for review, and litigation recommendations are made to the FDIC board of directors or designee for final approval.

**What Is on the FDIC's Radar**

The FDIC reports that contributing factors leading to bank failures include material loss reviews during each period described, inadequate policies and controls, overly aggressive business strategies, and lack of oversight (particularly with regard to underwriting) – all similar underlying factors in the savings and loan crisis 20-25 years ago. From the few demand letters that are publicly available, such as the one sent to BankUnited in Florida, the FDIC's claims also appear to track those asserted during the savings and loan crisis. The FDIC is more likely to pursue cases where the underlying factors for bank failure are alleged to go beyond just the economy and other market-wide effects, such as:

1) Uninformed or inattentive boards, with the primary factors being lack of knowledge or inattention to lending policies, failing to adequately reserve for loan losses, and general risk management controls over lending practices

2) Operational weaknesses, such as understaffing appraisal departments

3) Overly aggressive activity such as rapid and unprepared growth, inappropriate lending, or over-concentration of assets in certain products (for instance, in BankUnited, Option ARM products)

4) Dishonest conduct by officers or directors

5) Approval or condonation of abusive transactions with insiders

While the FDIC has a pecuniary interest in maximizing total recovery and therefore will focus many of its resources on larger bank failure cases, smaller-scale cases are unlikely to be ignored. During the savings and loan crisis, the average recovery by the FDIC was around $2 million, with most of the D&O lawsuits involving banks with less than $1 billion in assets. The FDIC has said it will pursue any case it deems cost-effective to do so. Therefore, one can expect the FDIC to bring a large number of cases even where potential recoveries are not significantly greater than expected costs of litigation.

**Other Potential Litigation Threats**

In addition, for those companies, institutions, and individuals subject to Securities and Exchange Commission (SEC) jurisdiction, the SEC represents a separate and independent litigation threat from the FDIC and other government agencies. SEC jurisdiction exists for public companies or those having something to do with the sale or transfer of securities (which is often broadly defined, expanding SEC jurisdiction). About one-quarter of banks that have failed in recent years are publicly held. Even in non-public banks, or sales under exemption, there may be significant exposure to litigation due to disclosure requirements of the securities laws and broad-based shareholder groups.

Assuming recent budget issues are resolved, other developments would indicate that the SEC and other government agencies, as well as private plaintiffs, are likely to become increasingly more involved in these issues in the coming months. The Dodd Frank Act, while only applicable to reporting companies, is a broad whistle-blower provision currently in force. Because of the Dodd Frank Act, the SEC and many plaintiff's lawyers are reporting a sizable spike in the number of whistle-blowers going to the SEC and plaintiff's firms. The provision requires the SEC to award between ten and thirty percent of all recoveries over $1 million to whistle-blowers who satisfy certain requirements (such as being the original source of the information and other provisions similar to the federal False Claims Act).

The Fraud Enforcement Recovery Act and federal health care legislation also amended the False Claims Act (FCA), bolstering the FCA following a period where its reach was scaled back by the courts. These amendments generally make it easier for whistle-blowers to assert misuse of government funds under the FCA, increasing the potential litigation threat to members of the financial services industry. Some bank directors and officers also may face criminal investigations.

**Preparing to Defend Potential Claims**

In sum, the wave of coming FDIC litigation focused at directors and officers is preparing to hit shore. In preparation for this approaching wave, bank directors and officers should be careful to keep well-documented records of their oversight and preparation and consideration of alternatives in decision-making. An additional prudent measure is conducting a review of director and officer insurance policies to ensure appropriate coverage for claims from regulators, shareholders, and vendors. In the event a claim is initiated, directors and officers should immediately provide appropriate notification to carriers. If the FDIC or other authorities come knocking, these policies may be one of the only things standing between individual bank directors and officers and potentially significant personal liability.