Understanding and Reducing Liability Risks for Bank Directors

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Now is a good time for bank directors to assess their liability exposure and take steps to minimize it. The worst of the 2008-09 crisis is behind us but the number of problem institutions (those rated as either a 4 or 5) remains elevated when compared to historical standards. Given the unpredictability of economic downturns and the attendant bank failures, directors should use the current lull to optimize their insurance coverage and otherwise better protect themselves. This article assesses some of the current risks faced by bank directors and suggests ways to mitigate those risks.

The risk of a director of a failed bank being sued by the FDIC remains high. FDIC seizures of banks have declined but the number of lawsuits filed by the FDIC against bank management has increased. The FDIC filed 2 lawsuits in 2010, 16 in 2011 and 4 so far in 2012. That represents lawsuits against less than 5% failed banks. However, the FDIC has authorized (but not yet filed) lawsuits against 49 failed institutions and 427 officers and directors of those institutions. By comparison, during the savings and loan crisis of the 1980s, the FDIC filed suits related to approximately 24% of all bank failures. Thus, based simply on historical averages and the FDIC's incentive to avoid statutes of limitations, there should be substantially more FDIC litigation against the directors of failed banks in the next two years.

The FDIC can sue directors under a variety of theories. Dishonest conduct, insider transactions or violations of bank policies, law or regulations can give rise to a claim. The FDIC may pursue claims if it finds indications that directors and officers pursued high risk, high growth lending strategies or ignored warnings related to risk issues, problem loan strategies and/or aggressive sales tactics. In addition, other conduct can be the basis of FDIC claims including such obvious actions such as misappropriation of bank assets or opportunities, commingling assets, and failing to disclose conflicts of interest. Using these guidelines, the FDIC has pursued a variety of claims against officers and directors including gross negligence claims, simple negligence claims (when authorized by state law) and breach of fiduciary duty claims.

The FDIC typically conducts extensive investigations in order to weigh the costs of pursuing gross negligence claims against the likelihood of success. These investigations contribute to the long lag time between bank receivership and the filing of suits against directors and officers. In addition, the difficulty of compiling evidence of such extreme conduct accounts for the relatively low rates of suits against directors and officers of failed banks.

As a practical matter, the FDIC generally does not pursue claims based on regulatory violations if the bank's D&O policy excludes regulatory violations because the insurance carrier will refuse coverage of such claims. On the other hand, if the FDIC believes the director has sufficient personal net worth, the FDIC may sue anyway.

Regulators seem to be aggressively pursuing administrative remedies, particularly civil money penalties (CMPs), against officers and directors of open banks. CMPs can vary widely but are usually between $5,000 and $250,000. CMPs are assessed against directors and officers for regulatory violations, including failure to follow a bank's business plan, lending limit violations and failure to comply with cease and desist orders. These penalties represent the most likely risk to directors' and officers' personal assets because they usually are not covered under D&O policies. They are also painful from a reputation perspective.

Some D&O policies purported to cover CMPs in some fashion. However, FDIC regulations prohibit banks from indemnifying directors and officers for CMPs. Some carriers offered separate CMP endorsements to their D&O policies for banks which endorsements are invoiced separately and paid directly by the directors and officers. However, this practice has been criticized by the FDIC. The FDIC argues that no policy written in the name of the bank can have an endorsement providing CMP coverage for individual officers and directors regardless of who pays the premium. In fact, the FDIC has begun to review director and officer liability policies during their examinations to specifically review whether the D&O policy contains a CMP endorsement. If the

FDIC finds a CMP endorsement, it may issue a citation and order that the endorsement be deleted. Of course, the FDIC is also reviewing the D&O policies to determine the liability limits if the bank goes into receivership and whether the policy has a regulatory violation exclusion.

Given the FDIC's hostility to CMP coverage, most carriers likely will no longer offer a CMP endorsement as part of the renewal process. Banks should seek coverage for defense costs related to CMPs, paying particular attention to the definition of the term "claim" so that initial notifications of the FDIC's intent to seek CMPs can be defended out of court by regulatory counsel at the insurance company's cost. Such defense cost coverage should be permissible under FDIC regulation but would still leave directors personally liable for any actual CMPs assessed. FDIC regulation does not prohibit directors from independently purchasing their own liability insurance policies, although such policies are largely unavailable.

There are several specific steps directors can take to reduce their liability exposure:

- ***Be informed.*** Read all applicable enforcement actions and be familiar with bank policies and the bank's business plan as filed with regulators.
- ***Ask questions!*** Read the board package, ask tough questions and be sure those questions are reflected in the board minutes.
- ***Show up and have attendance recorded in the minutes.*** Frequent absences can be evidence of negligence.
- ***Obtain expert legal, accounting or other advisory services on key votes,*** policy changes and public disclosure issues. Verbal input can be cost-effective and valuable if recorded in the board minutes.
- ***The board should review its D&O insurance coverage annually*** with a specialist in bank insurance who understands the changing regulatory environment Start the review process at least 90-120 days before the renewal date.

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