

SUITS AND ORDERS

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No, this is not an article about ordering suits from Jos. A. Bank. Rather, this article will briefly discuss the growing whirlwind concerning lawsuits against officers and directors of failed banks and officer and director liabilities imposed by regulatory orders. In addition, this article implores directors and officers to review their D&O insurance coverage.

Directors owe two basic fiduciary duties to their institution and its shareholders: the duty of loyalty and the duty of care.

The duty of loyalty means that directors must put the interests of the institution and its shareholders before their own. They may not use their corporate position to gain an unfair personal profit and advantage. If a director of an institution has a financial or personal interest in a transaction in which the institution proposes to engage, the director should disclose to all decision-makers the nature of that interest and all related material facts and abstain from any discussion or vote on the transaction in question.

To help avoid conflict of interest problems, all companies including depository institutions and their holding companies should adopt and disseminate clear conflict of interest statements and/or clear ethical guidelines, which are signed by directors annually and directors should receive periodic training about federal and state regulations dealing with conflicts of interest.

Directors have a duty to exercise "the degree of care . . . which an ordinary prudent and diligent person would exercise under similar circumstances." The term "prudent" and "diligent" refer to different characteristics. Prudence involves the basic attributes of common sense, practice, wisdom and informed judgment. Diligence requires effort and attention. Directors must maintain an awareness of corporate developments, monitor corporate affairs and policies, and investigate events and developments when circumstances should warrant a reasonable director of the need to so do.

Federal bank regulators are gearing up to sue officers and directors of failed banks and impose civil money penalties on officers and directors of non-failed banks for breaches of duty of care and loyalty. In a recent case¹, the FDIC sued directors of Heritage Community Bank for failure to properly manage and supervise Heritage and its commercial real estate lending program.

We learn from the

- establish and enforce lending policies, including limits on CRE concentrations and limits on speculative and/or high-loan to value CRE projects.;

¹ *FDIC v. Saphir, et. al.*, U.S.N.D.Ill (Nov. 2010).

- establish sufficient reserves for loan losses and to maintain adequate capital consistent with the inherent risk in the bank's CRE lending program;
- insure that the bank had sufficient and capable personnel to undertake and administer the CRE lending program;
- comply with regulatory standards regarding its CRE lending program;
- correct deficiencies identified in reports of examination performed by state and federal bank examiners;
- avoid being over-exposed to CRE risk without having sufficient ALLL reserves to cushion against that risk; and
- avoid deficiencies (e.g., excessive LTV ratios, deficient or incomplete appraisals, inaccurate credit ratings under Heritage's loan policy that failed to take into account the risks attendant to projects, a borrower or guarantor with excessive liabilities or who otherwise lack the financial wherewithal to service the loan, insufficient proof of pre-sales and/or necessary market demand and insufficient collateral).

The FDIC has indicated that there will be many additional lawsuits filed against directors of failed institutions. The FDIC also announced that criminal investigations will be undertaken in many cases.

It is important for directors in this environment to: (1) supervise other directors as well as the institution's officers; (2) establish internal compliance programs; (3) be sure loan officers are appropriately documenting loans and taking sufficient collateral for loans; and (4) respond to warnings or criticisms from regulators, auditors and others.

Regulatory enforcement actions are on the rise. On Friday, February 11, 2011, an article in the *American Banker* indicated that for the second year in a row, enforcement actions set a record, jumping 21% last year to 2,724, an increase industry representatives attributed to a persistently heightened focus on capital and safety and soundness standards in the wake of the financial crisis.

Unlike 2009, there were more informal actions issued by the regulators while there was an 8% drop in formal regulatory actions. Nonetheless, there has been an explosive issuance of regulatory orders over the last few years.

When meeting with a bank board that is being asked to sign a regulatory order, the two prominent questions posed by directors are: (1) should I resign, and (2) what is my personal liability by signing the order?

My standard answers to these questions are: (1) unless you are convinced that the other directors and management will not be serious about complying with the order, we do not recommend that directors resign and (2) to the extent that the directors and management work feverishly to comply with the mandates of the order, director liability, by signing the order, will

be minimal (however, director actions leading up to the order may already result in liability on the directors).

It is an easy segway at that point to advise the officers and directors that a thorough review of their D&O insurance policy is a must. Unfortunately, such a review should have occurred prior to the time that the bank became "troubled." In fact, all banks, troubled or not, should have their legal counsel and insurance consultant thoroughly review their D&O policies.

We recommend that a broker (as opposed to an agent) be retained for consultation about D&O coverage, particularly one with expertise in D&O insurance. We are seeing a lot of policies put in place with a primary coverage, excess coverage and Side A coverage. These three coverages sit on top of each other. Side A protects the individual directors and officers for claims where the primary and excess insured companies cannot indemnify the Ds&Os in scenarios such as insolvency and derivative actions. All banks should consider purchasing Side A coverage.

In addition, there are coverage enhancements that should be investigated, including, without limitation, (a) being sure the holding company is a named insured, (b) negotiating defense costs carved-back to the regulatory exclusion, (c) limit definition of application to filings for just the past twelve months, (d) up-date definition of claim to include informal investigations, (e), investigate costs sublimit, (f) limiting the imputation of knowledge (severability), (g) updating the definition of Company to include debtor in possession, (h) insured versus insured-carve-backs for creditor committee, bankruptcy trustee, whistleblower or old board members, (i) limit when insurance carrier can cancel policy and (j) limit the threshold of the conduct exclusion (fraud and personal profit) to the "final adjudication" standard.

D&O insurance cannot protect directors and officers against all of the liabilities to which they are subject — in particular, those attributable to conflicts of interest, self-dealing, fraud or dishonesty. This hardly a surprising conclusion. Only the directors' own good faith and diligence can offer complete protection. Nevertheless, now is the time for officers and directors that have not done so recently to re-review the bank's D&O insurance coverage.