

BACK TO THE FUTURE: A NEW WAVE OF FDIC LITIGATION

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I. Introduction

“I gave you explicit instructions not to come here, but to go directly back to 1985.”¹ Given the current banking crisis, many may recollect a familiar scenario occurring twenty-five years ago. How this crisis will compare to the Savings and Loan meltdown of the 1980s is yet to be seen. At a minimum, courts will be confronted with similar litigation: suits brought by the FDIC, by shareholders, and of course, coverage issues related to any applicable Director & Officer (“D&O”) insurance policies.

This article compares the bank failures of today with those of the 1980s, and examines current litigation and coverage issues with which courts are dealing.

II. Bank and Thrift Failures

A. **How The Current Crisis Compares to the Savings and Loan Crisis**

NERA’s August 2010 report on bank litigation² notes that investor lawsuits involving failed and troubled banks have been a significant accompaniment of the current round of banking problems. In its most basic terms, a bank failure is the closing of a bank by a federal or state banking regulatory agency when it is unable to meet its obligations to depositors and others.³

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¹ Zemeckis, Robert. *Back to the Future*, Perf. Michael J. Fox, Christopher Lloyd, Amblin Entertainment, 1985.

² Paul Hinton, NERA Economic Consulting, Failed Bank Litigation: The Economics of Recent Bank Failures, Comparisons with the S&L Crisis, and implications for litigation against directors and officers, August 16, 2010, available at http://www.nera.com/nera-files/PUB_Failed_Bank_Litigation_0810.pdf (Last Visited November 1, 2010).

³ Federal Deposit Insurance Corporation, *When a Bank Fails – Facts for Depositors, Creditors, and Borrowers*, available at <http://www.fdic.gov/consumers/banking/facts/index.html> (Last visited November 1, 2010).

Kevin LaCroix of The D&O Diary has noted that unlike in the S&L crisis of the 1980s, “private litigation against D&Os has been widespread.”⁴ In 2008 and 2009, 240 securities class action lawsuits were filed against financial sector firms; 45 against depository firms.⁵

The D&O Diary reports that this trend may continue as bank failures continue this year, with 139 banks closing through October 22, 2010, nearly equal to the 140 banks that closed in all of 2009.⁶ Most of these closures are concentrated in 4 states, with Florida leading the way with 27 failed banks, then Georgia and Illinois with 16 failed banks each, and California with 10.⁷ The combined 69 banks failures in these four states alone represent just under 50% of all 2010 bank failures to date.⁸ These bank failures have largely been concentrated among smaller banks, with 116 of the 139 failures (83%) involving institutions with less than \$1 billion in assets, and 32 institutions (29%) with less than \$100 million in assets.⁹ This trend looks all too likely to continue among banks still in business, as one out of every ten banks in the United States is a “problem institution” according to the FDIC’s criteria, and this percentage does not include the 283 banks that failed between January 1, 2008 and September 1, 2010.¹⁰

⁴ Kevin LaCroix, The D&O Diary, *Commercial Banks: Closures, Lawsuits Continue to Mount*, October 25, 2010, available at <http://www.dandodiary.com/2010/10/articles/failed-banks/commercial-banks-closures-lawsuits-continue-to-mount> (Last visited November 1, 2010).

⁵ Id.

⁶ Id.

⁷ Id.

⁸ Id.

⁹ Id.

¹⁰ Kevin LaCroix, The D&O Diary, *FDIC: Banks Looking Up, But Number of Problem Banks Still Increasing*, September 1, 2010, available at <http://www.dandodiary.com/2010/09/articles/failed-banks/fdic-banks-looking-up-but-number-of-problem-banks-still-increasing> (Last visited November 1, 2010).

The current tally of 829 “problem banks” is the highest number since March 31, 1993, when there were 928 problem institutions.¹¹ Comparing the present situation to the Savings and Loan crisis of the 1980s, fewer banks have failed in the present crisis, but of the ones that have, “the losses incurred are larger than all but one year of losses during the S&L crisis of the 1980s due to the increased average size of banking and savings institutions.”¹²

B. FIRREA’s Passage and Effect on Litigation and Regulation

Following the S&L Crisis in the 1980s, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”). Among other things, this regulatory measure gave the FDIC new mandates and resources to pursue cases.¹³ In some of these cases, FIRREA may pre-empt otherwise governing state law in suits for breach of fiduciary duty.¹⁴ FIRREA’s ripple effect was felt in the years following its passage, when several states passed legislation establishing gross negligence or comparable conduct as the standard of liability for directors and officers of financial institutions.¹⁵

¹¹ Id.

¹² Kevin LaCroix, The D&O Diary, *NERA Releases Failed Bank Litigation Report*, August 25, 2010, available at <http://www.dandodiary.com/2010/08/articles/failed-banks/nera-releases-failed-bank-litigation-report/> (Last visited November 1, 2010).

¹³ Hinton, *supra*, available at http://www.nera.com/nera-files/PUB_Failed_Bank_Litigation_0810.pdf.

¹⁴ Id.

¹⁵ Id.

C. The FDIC's Dual Role for Troubled Financial Institutions

The FDIC's involvement in the process of handling troubled a financial institution contains two major roles: conservator and receiver.¹⁶ It draws its authority for both under 12 U.S.C. § 1821.

1. The FDIC as Conservator

Under 12 U.S.C. 1821(d)(2), the FDIC has authority as conservator to put the institution into sound and solvent condition. The FDIC operates the failed financial institution and has authority to sell assets or to merge the failed financial institution with other institutions.¹⁷ The FDIC as conservator/insurer is functionally and legally separate from the FDIC acting in its role as receiver, and has separate rights, duties, and obligations.¹⁸

2. The FDIC as Receiver

In addition to its role as an insurer, the FDIC also operates as a receiver of the troubled institution. The FDIC draws its duties as a receiver generally from 12 U.S.C. 1821(d)(2), which grants the FDIC successor authority to all rights, powers, and authorities of the failed institutions, and to issue administrative subpoenas to support any investigations. During the course of these investigations, relevant bank documents and testimony may be obtained through discovery.¹⁹ Additionally, these receivership powers are not enjoined.²⁰

¹⁶ Federal Deposit Insurance Corporation, *When a Bank Fails – Facts for Depositors, Creditors, and Borrowers*, available at <http://www.fdic.gov/consumers/banking/facts/index.html> (Last visited November 1, 2010).

¹⁷ Federal Deposit Insurance Corporation, *Resolutions Handbook, Chapter 7- The FDIC's Role as Receiver*, available at <http://www.fdic.gov/bank/historical/reshandbook/ch7recvr.pdf> (Last visited November 1, 2010).

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ 12 U.S.C. §1821(j).

The FDIC may also marshal the assets of the institution for the benefit of its creditors and investors, if at all possible.²¹ In cases where federal assistance has been supplied, the receiver may assign the corporate FDIC all causes of action which the failed entity has against the directors and officers.²²

III. Statutory Powers

To these ends, the FDIC is endowed with special statutory powers under 12 U.S.C. §1821. These include the powers to:

- Stay judicial action to which a depository institution is a party for 90 days if acting as receiver, or 45 days if acting as a conservator. 12 U.S.C. §1821(d)(12)
- Attach assets with no need to show irreparable injury. 12 U.S.C. §1821(d)(19)
- Repudiate contracts and leases to which the failed institution was a party if it was burdensome or would hinder administration of the failed depository institution's estate. 12 U.S.C. §1821(e)(1-12)
- Enforce contracts entered into by the depository institution notwithstanding provisions allowing for the other party to terminate, accelerate, or exercise default rights. 12 U.S.C. §1821(d)(13)
- Obtain Relief from injunctions and freezes. 12 U.S.C. §1821(d)(18-19)
- Obtain Exemption from liability for any criminal actions from the failed institutions, and from any penalties or fines (including for failure to pay taxes). 12 U.S.C. §1825(b)

Further, the FDIC also is subject to a unique statute of limitations in its role as receiver, allowing up to six years to file a contract claim and up to three years to begin a tort suit.²³

²¹ 12 U.S.C. §1821(k).

²² Id.

²³ 12 U.S.C. §1821(d)(14).

IV. Priority of Payments

In the event of a bank failure, the FDIC, as insurer of the bank's deposits, pays insurance to the depositors up to the insured limit (\$250,000).²⁴ This insurance covers the balance of each depositor's account, dollar-for-dollar up to the insurance limit, including principal and any accrued interest through the date of the insured bank's closing.²⁵ FDIC Insurance covers checking, NOW, savings, money market deposit accounts (MMDA), and time deposits such as certificates of deposit (CDs).²⁶ These funds are paid by the FDIC in its corporate capacity.

The FDIC pays for expenses and creditor claims from the funds recovered through selling the assets of the failed bank.²⁷ When the FDIC acts as receiver, these payments are issued pursuant to a statutory priority of payments.²⁸ From these liquidated funds, payments are first made to cover any receivership administrative expenses.²⁹ Next, any uninsured deposit claims are paid and third, secured creditors' claims are paid.³⁰ Subsequently, any remaining funds are distributed to any general unsecured claimants and finally to the shareholders.³¹

²⁴ Federal Deposit Insurance Corporation, *When a Bank Fails – Facts for Depositors, Creditors, and Borrowers*, available at <http://www.fdic.gov/consumers/banking/facts/index.html> (Last visited November 1, 2010).

²⁵ Id.

²⁶ Id.

²⁷ Federal Deposit Insurance Corporation, *When a Bank Fails – Facts for Depositors, Creditors, and Borrowers*, available at <http://www.fdic.gov/consumers/banking/facts/index.html> (Last visited November 1, 2010).

²⁸ Federal Deposit Insurance Corporation, *Resolutions Handbook, Chapter 7- The FDIC's Role as Receiver*, available at <http://www.fdic.gov/bank/historical/reshandbook/ch7recvr.pdf> (Last visited November 1, 2010).

²⁹ Id.

³⁰ Id.

³¹ FDIC Law 1000, Federal Deposit Insurance Act, Sec. 11(d), 12 U.S.C. §1815(e)(2)(C).

While private litigants will compete with the FDIC for D&O insurance, there may be instances where private litigants may be able to proceed against insurance assets even when the FDIC may not.³² For example, in cases where regulatory exclusions preclude coverage for the FDIC's claim, but not an investor's claims, the shareholders may seek to pursue those claims.³³ However, all litigants, both FDIC and private, will face "a basic causation problem: distinguishing the effects of underwriting practices from the effects of a deteriorating economy... These cases will require careful case-by-case economic analysis."³⁴

V. **FDIC Opening Moves**

A. **Send Letters to D&Os to put Individuals and Their Carrier on Notice**

What remains to be seen is the extent of the FDIC's potential litigation against directors and officers of failed banks. The *IndyMac* litigation was the first D&O suit filed by the FDIC earlier this year, and reports in early October, 2010, indicate that the FDIC authorized lawsuits against more than 50 officers and directors of failed banks in order to attempt to recoup more than \$1 billion in losses stemming from the credit crisis.³⁵

First, the FDIC "subpoenas bank officials and workers, hoping to gather evidence to use in potential litigation"³⁶ Next, the FDIC issues civil demand letters to former directors and officers. Thus far, civil demand letters have been issued to directors and officers in several

³² LaCroix, NERA Releases Failed Bank Litigation Report, *supra*.

³³ *Id.*

³⁴ *Id.*

³⁵ Bloomberg News, *FDIC may seek \$1B from directors, officers of failed banks*, Available at <http://www.businessinsurance.com/apps/pbcs.dll/article?AID=/20101008/NEWS/101009938> (Last visited November 1, 2010).

³⁶ Kevin LaCroix, The D&O Diary, *Failed Banks: Will the FDIC's Next Steps Include Litigation?*, January 11, 2010, available at <http://www.dandodiary.com/2010/01/articles/failed-banks/failed-banks-will-the-fdics-next-steps-include-litigation> (Last visited November 1, 2010).

states, including Florida, California, Illinois, Texas, and Georgia.³⁷ One trigger for a demand letter arises in circumstances where the expiration date of the D&O insurance policy is approaching.³⁸ These letters may give notice to insurers, and offer the possibility for settlement without accruing the expenses of litigation.³⁹

Typically, the FDIC spends about a year conducting its investigation into failed banks before deciding whether it can pursue a claim against former directors and officers for “unsafe and unsound banking practices.”⁴⁰ It has been estimated that when the expected round of litigation begins, about half of all bank failures will see some director litigation.⁴¹

While directors are generally given the benefit of the Business Judgment Rule, which may provide immunity for discretionary business decisions made in good faith, this rule applies only to directors, and the presumption of this rule may be overcome if the plaintiff shows that the director breached any of the three fundamental duties that he/she owes to the corporation: 1) the duty of care, 2) fiduciary duty, or 3) duty of loyalty.⁴² In these cases, directors and officers may find themselves personally liable for monetary damages in any civil action brought by the FDIC

³⁷ Id.

³⁸ Id.

³⁹ Id.

⁴⁰ Id.

⁴¹ Id.

⁴² FDIC Law, Regulation, Related Acts, 5000- Statements of Policy, *Statement Concerning the Responsibilities of Bank Directors and Officers*, available at <http://www.fdic.gov/regulations/laws/rules/5000-3300.html#fdic5000statementct> (Last visited November 1, 2010).

for gross negligence or for conduct demonstrating a greater disregard for the officer's duty of care than gross negligence, including intentional tortious conduct.⁴³

B. Tolling Agreement

The FDIC conducts a thorough investigation of a failed financial institution prior to filing suit. Once suit is filed, litigation can be lengthy and expensive. The execution of a tolling agreement can allow the FDIC time to conclude its investigation without concern that applicable statutes of limitations may run. In addition, a tolling agreement will allow more time to negotiate any possible settlement.

C. Factors Considered by FDIC in Determining Whether to Bring Suit

Suits by the FDIC are not brought lightly. The suits against former directors and officers of failed banks are based on detailed investigations, and lawsuits are authorized only after rigorous review of the reason and causes for the bank's failure.⁴⁴ Ultimately, review by senior FDIC supervisory and legal staff must be completed, and final approval by the FDIC Board of Directors must be obtained, before a lawsuit is filed.⁴⁵

Perhaps predictably, in the end, most FDIC suits involve evidence falling into at least one of the following categories⁴⁶:

- Dishonest Conduct
- Failure of an institution to adhere to applicable laws and regulation
- Failure to establish proper underwriting policies

⁴³ 12 U.S.C. §1821(k).

⁴⁴ FDIC, *Statement Concerning the Responsibilities of Bank Directors and Officers*, *supra*, available at <http://www.fdic.gov/regulations/laws/rules/5000-3300.html#fdic5000statementct>.

⁴⁵ *Id.*

⁴⁶ *Id.*

- Where the board failed to heed warnings from regulators or professional advisors.⁴⁷

The FDIC has primary litigation authority for its civil professional liability claims.⁴⁸

While the FDIC does not “bring” any criminal actions *per se*, as this responsibility lies with the United States Department of Justice (“DOJ”), the FDIC does devote its resources on the criminal side to supporting the DOJ’s bank fraud prosecutions. Factors that are considered by the FDIC in deciding whether to bring its own civil claim, or encouraging the DOJ to bring a criminal prosecution in a particular matter, include:

- The seriousness of the alleged conduct under investigation
- Any applicable statutes of limitations and whether they have lapsed, especially for civil claims, where such statutes generally are for shorter periods of time than their criminal counterparts.
- Recovery sources (liability insurance is available as a recovery source only in civil cases)
- Whether the homestead or other property exemptions apply to defendant’s assets; protecting the property from being seized by creditors in a civil case, but preempted when DOJ enforces criminal restitution/forfeiture orders under federal law.

A critical distinction in evaluating whether to bring an action against a director is between inside directors (who are generally officers of the institution) and outside directors (who usually have no connection to the bank other than a directorship and perhaps being a small shareholder).⁴⁹ The most common suits brought against outside directors either involve insider

⁴⁷ *Id.*; see also Hinton, *supra*, available at http://www.nera.com/nera-files/PUB_Failed_Bank_Litigation_0810.pdf.

⁴⁸ 12 U.S.C. § 1819(a).

⁴⁹ FDIC, *Statement Concerning the Responsibilities of Bank Directors and Officers*, *supra*, available at <http://www.fdic.gov/regulations/laws/rules/5000-3300.html#fdic5000statementct>.

abuse or situations where the directors failed to heed warnings from regulators, accountants, attorneys or others that there was a significant problem in the bank which required correction.⁵⁰

III. Litigating with the FDIC

A. Suing D&Os of Failed Financial Institutions

The role of the FDIC in litigation can be either as the plaintiff, as we have seen with *IndyMac*, or as an intervenor in suits brought by shareholders. While the FDIC continues to investigate failed banks, they are being confronted with suits filed by shareholders. Thus, several issues can arise for the FDIC.

B. FDIC as Plaintiff

The FDIC conducts a comprehensive investigation of every failed financial institution. As noted above, the FDIC has statutory authority to issue administrative subpoenas to obtain documents and testimony in the course of its investigation.⁵¹ Given its subpoena powers and the resources available to the FDIC, these claims can be thoroughly evaluated prior to the filing of suit, allowing only meritorious suits to be filed. Additionally, the FDIC will only pursue those professional liability claims where there is a likelihood of recovery. Typically, insurance proceeds are the most likely source of recovery for any judgment or settlement.

The *IndyMac* litigation, for example, was filed in the Central District of California on July 2, 2010, against former directors and officers of the failed bank.⁵² The complaint was over 300 pages in length, and demonstrates the comprehensive analysis conducted by the FDIC prior to the filing of a director and officer liability suit. In addition to D&O suits, the FDIC (through

⁵⁰ Id.

⁵¹ See 12 U.S.C. § 1818(n) and § 1821(d)(2)(I).

⁵² *FDIC v. Van Dellen, et al.*, U.S. District Court, C.D. Cal., Case No. SACV 10-004915.

its Professional Liability Group) has filed a significant number of mortgage malpractice and mortgage fraud suits against title insurance companies, mortgage companies, and closing agents. These will likely provide a significant source of recovery for the FDIC.

Pre-suit settlement negotiations with the FDIC continue. While these out of court resolutions are preferable, given the number of demand letters sent to former directors and officers of failed banks, and the recent news regarding the authorization to file lawsuits by the FDIC, we will likely see more litigation filed by the FDIC.⁵³

C. FDIC as Intervenor

Shareholders of certain financial institutions have filed suit against former directors and officers of their respective banks. When the FDIC becomes aware of these suits, it typically files a motion to intervene, asserting that the claims are derivative and thus belong exclusively to the FDIC, as receiver. These motions may also include a request to stay the action brought by the shareholders.

1. Derivative Claims

Pursuant to FIRREA, the FDIC, as receiver of the failed financial institution, succeeds to “all rights, titles powers, and privileges of the insured depository institution, and of any stockholder . . . of such institution with respect to the institution and the assets of the

⁵³ Bloomberg News, *FDIC may seek \$1B from directors, officers of failed banks*, available at <http://www.businessinsurance.com/apps/pbcs.dll/article?AID=/20101008/NEWS/101009938> (Last visited November 1, 2010).

institution.”⁵⁴ FIRREA grants the FDIC ownership over all shareholder derivative claims against a bank’s officers.⁵⁵

FIRREA does not prohibit a shareholder from pursuing non-derivative claims against solvent third-parties.⁵⁶ The issue that courts must decide, then, is whether the claims asserted by the shareholders are derivative claims, belonging exclusively to the FDIC, or whether the claims are direct claims, which can be asserted by the individual shareholder(s).

A derivative claim is one “in which the right claimed by the shareholder is one the corporation could itself have enforced in court.”⁵⁷ Thus, an action is derivative if it seeks damages arising from an injury to the corporation.⁵⁸ Typical claims include: allegations of corporate mismanagement; failure to comply with banking regulations and industry standards; general loss of value to bank stock/diminution of the value of shares of stock; and deficient lending practices. Essentially, these are acts by the bank officers that injure all shareholders in the same way, and would typically be considered derivative claims.

Howard v. Haddad is one instance where the court found that the injury to the individual shareholder was a direct claim. The plaintiff in *Howard* alleged that two bank officers induced him to purchase a large block of shares in the bank without disclosing the precarious financial

⁵⁴ 12 U.S.C. §1821(d)(2)(A)(i).

⁵⁵ *Lubin v. Skow*, 2010 WL 235 4141, 2 (C.A. 11 (Ga.)); *Pareto v. FDIC*, 139 F.3d 696, (9th Cir. 1998); *In re Fed. Home Loan Mortgage Corp. Deriv. Litig.*, 643 F. Supp.2d 790 (E.D. Va. 2009); *Pareto v. FDIC*, 139 F.3d 696, 700 (9th Cir, 1998) (“Plainly [section 1821(d)(2)(A)(i)] vests all rights and powers of a stockholder of a bank to bring a derivative action in the FDIC”).

⁵⁶ *Id.*; *FDIC v. Jenkins*, 888 F.2d 1537 (11th Cir. 1989).

⁵⁷ *Howard v. Haddad*, 916 F.2d 167, 169 (4th Cir. 1991) quoting *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 529, 104 S.Ct. 831, 835, 78 L.Ed.2d 645 (1984).

⁵⁸ *Id.*

condition of the institution.⁵⁹ The FDIC argued that, as liquidator of the Bank, it owned all causes of action for harm done to the bank arising out of mismanagement of or breach of duties to the bank.⁶⁰ The court found that the claims were premised on the diminution in the value of the stock, and were thus derivative claims belonging to the FDIC. On appeal, the FDIC argued that even if the plaintiff's claims were not derivative, it should have "absolute priority" over such claims because the plaintiff sought recovery from the same assets that the FDIC would look to for payment in order to maximize recovery for the insolvent bank's creditors and shareholders.

The Fourth Circuit held that the plaintiff asserted claims premised on the alleged misrepresentations of the bank officers that were intended to induce the plaintiff to purchase stock in the bank. As such, those claims were direct, non-derivative claims. The Court noted that the measure of damages for Howard's claims would be the difference between what he paid for the stock and what it was worth on the day he paid for it. The damages, then, were not merely a diminution in the value of the stock.

A recent ruling on this issue, *Lubin v. Skow, supra*, discusses the distinction between a direct claim and a derivative claim. The bankruptcy trustee for a holding company sought to impose liability on the officers of both the holding company and its failed subsidiary bank. The trustee sought damages for breach of fiduciary duties and for negligence, asserting mismanagement and risky lending practices. The FDIC intervened.

⁵⁹ The complaint initially included RICO claims against the officers for an alleged pattern of corporate mismanagement which led to a steep decline in the value of the bank's stock. Once the FDIC intervened asserting that derivative claims belonged to the FDIC, plaintiff amended his complaint to eliminate the RICO claims.

⁶⁰ *Id.*

Applying Georgia law, the Court stated that a direct claim is distinguishable from a derivative claim if the shareholder is “injured in a way which is different from the other shareholders or independently of the corporation.”⁶¹ The Court held that the alleged harm to the holding company stemmed from the bank officers’ management of bank assets, which was inseparable from the harm done to the bank. As such, the claim was derivative.

2. Is the FDIC a Super-plaintiff?

Some recently-filed motions to intervene by the FDIC also include a request to stay the attendant shareholder litigation. The FDIC argues that permitting plaintiffs to pursue their claims contravenes the statutory mandate that the FDIC maximize the return on failed banks: “The priority scheme of congress would be turned on its head if shareholders such as these Plaintiffs could receive a disproportionate share of the assets available to satisfy claims against [the bank’s] former directors and officers.”⁶² This argument is based upon *Gaff v. FDIC*, 919 F.2d 384 (6th Cir. 1990), which stayed the litigation of the individual shareholder pending resolution of claims by the FDIC. The *Gaff* court explained:

[T]he policies underlying the national bank insurance system and the Bankruptcy Code permit us to create a priority for the FDIC and prevent a race to the courthouse between the FDIC and Gaff [individual shareholder]. The alleged wrongs of the officers in mismanaging the Bank hurt the Bank as a whole including its general creditors and depositors. The injury was not limited to the plaintiff stockholder, but also injured the ‘entire community of interests of the corporation.’ Any collection that the FDIC makes might eventually inure to the benefit of Gaff because it will enlarge the potential estate of the Bank. Moreover, if the officers and

⁶¹ *Lubin, supra* at 3, quoting *Grace Bros. v. Farley Indus. Inc.*, 450 S.E.2d 814, 816 (Ga. 1994).

⁶² Motion to Intervene of the Federal Deposit Insur. Corp. as Receiver of Heritage Community Bank, N.D. Ill., No. 09-7979; see also *Patel v. Patel*, N.D. Ga, No. 09-CV-3684, Federal Deposit Insurance Corp. as Receiver of Haven Trust Bank’s Memorandum in Support of Its Motion to Intervene, Stay Proceedings, and Extend Time for filing Pleadings in Intervention. (“[N]ot continuing the stay will result in prejudice to the [FDIC] by continuing to diminish potential sources of recovery.”)

directors have money after the FDIC collects, then Gaff may proceed with his action.⁶³

The Eleventh Circuit took a different view. In *FDIC v. Jenkins*, the Court found that the statute did not require the court to grant the FDIC a priority over other claimants, stating: “We are not convinced Congress considered collections against parties such as the bank-related defendants in this case as a necessary part of the recovery to the deposit insurance fund. Any such priority over third-party lawsuits will have to come from Congress, not this Court.”⁶⁴ The FDIC’s argument that it should have an “absolute priority” to the bank’s assets also proved futile in the *Howard* case. (“We cannot see why the fact of liquidation should somehow act to deprive Howard of these causes of action.”)⁶⁵

Congressional intent appears to favor this argument. “Giving the FDIC an absolute priority would undermine fraud enforcement [and] would be potentially unfair to private plaintiffs who were innocent victims of wrongdoing.”⁶⁶ Congress explicitly rejected including a provision in the bill that gave claims priority to the FDIC.⁶⁷

Bankruptcy case law also exists which would support the argument that the FDIC is not entitled to an absolute priority. In *In re CHS Electronics, Inc.*, the former shareholders of a corporation filed a motion in the bankruptcy court seeking authorization to use the proceeds of

⁶³ *Id.* at 394. The *Gaff* Court believed that “[t]he receiver here is not just any receiver but an agency of the federal government charged with the important task of insuring bank deposits in order to guarantee the health of the national banking system.” *Gaff* at 391. The Court then looked to the law of corporate dissolutions and bankruptcy and found that corporate dissolution law shifts the risk of failure as much as possible to the stockholders, and that allowing the FDIC priority over the individual shareholders was analogous to the principle of equitable subordination in bankruptcy. *Id.*

⁶⁴ *FDIC v. Jenkins*, 888 F.2d 1537, 1546 (11th Cir. 1989).

⁶⁵ *Howard* at 170.

⁶⁶ 135 Cong. Rec. H4989 (daily ed. Aug. 3, 1989).

⁶⁷ *Jenkins*, 888 F.2d at 1538.

the D&O policy to fund a proposed class action settlement arising from securities fraud. The bankruptcy trustee objected arguing that the insurance proceeds should be preserved in order to satisfy the potential claims it may assert against the directors and officers. The court noted that the trustee's position was consistent with the policy of maximizing the bankruptcy estate, but held that "[s]imply because [the Trustee] is a trustee in bankruptcy does not arm him with super-plaintiff powers in causes of action between third parties."⁶⁸

There is case law supporting both the position of the FDIC and of other claimants seeking recovery from the bank's assets, namely the insurance policy. Which line of cases will be followed by the courts currently evaluating the issue is yet to be seen.

3. Claims Against Officers of a Holding Company

Some recent litigation involves suits brought by shareholders of holding companies, or by the bankruptcy trustee of a holding company. Under FIRREA, the FDIC succeeds only to the rights of the Bank.⁶⁹ "[W]here the Trustee is suing to vindicate the rights of the Holding Company against its own officers, FIRREA is not invoked."⁷⁰

Holding company suits can create what are referred to as "double derivative" claims. In a double derivate action the shareholder "of a holding company seeks to enforce a right belonging to the subsidiary...the power to bring suit flows directly from the injured subsidiary." *Brown v. Tenney*, 125 Ill. 2d 348, 532 N.E.2d 230 (1988).

The most recent guidance we have on this issue is again the Eleventh Circuit holding in *Lubin v. Skow*, *supra*. There, the alleged harm to the holding company stemmed from the bank

⁶⁸ *In re CHS Electronics, Inc.* 261 B.R. 538, 544 (Bankr.S.D.Fla. 2001).

⁶⁹ *Lubin*, *supra*.

⁷⁰ *Id.* at 9.

officers' management of bank assets — essentially, the bank officers' decisions to extend unreasonable risky and unlawful loans that ultimately interfered with the proper management and profitable operation of the bank. The court noted that the complaint did allege a unique harm to the holding company — the inability to pay \$34 million of debt. However, it was the bank's insolvency which precluded the holding company from repaying the \$34 million and forced it into bankruptcy. The Court found that the holding company's harm, and its ultimate bankruptcy, were derivative of the harm to the bank. The Court confirmed the district court's dismissal of the complaint as to the individuals in their capacity as officers of the bank.

The Court conducted a different analysis for the defendants as officers of the holding company. The Court noted that the individuals, as officers of the holding company, owed a fiduciary duty to the shareholders of the holding company. While the complaint failed to sufficiently plead a breach of fiduciary duty, the Court left the door open to the possibility that a shareholder of a holding company could maintain a cause of action for “breach of fiduciary duties to the Holding Company.” The Court stated: “We express no opinion about whether [officers of the holding company] might have breached their duties as Holding Company officers by failing to inform the Holding Company board about bank mismanagement or by failing to influence the Holding Company (as sole shareholder of the Bank) to respond to this mismanagement by changing the Bank management.”⁷¹

IV. D&O Insurance Policy Issues in Actions by Regulatory Agencies

A. Insurance Policies: The Most Likely Source of Recovery

Before commencing lengthy and costly litigation against the directors and officers of a troubled or failed banking institution, the FDIC and other agencies will naturally want to know if

⁷¹ *Ludin, supra* at 5.

there will be available and recoverable assets, including insurance proceeds under any applicable D&O policies. As the FDIC, in particular, is gearing up to attempt to recoup losses arising from the recent bank crisis, the question of whether there is valid, collectible insurance becomes paramount.

Generally speaking, D&O insurance is designed to protect directors and officers from personal liability for actions taken in their roles as directors and officers. As a practical matter, D&O policies and their proceeds are often one of the few remaining assets of a failed banking institution. As such, the FDIC and other regulators will look to the D&O policies for recovery whenever possible.⁷² Whether there is coverage under such D&O policies will be an important issue, then, for both insurers and regulators.

Given the spate of securities litigation against directors and officers of troubled companies and institutions in recent years, for example, many current D&O policies already may be stretched at or near their coverage limits. Moreover, many troubled institutions have already faced sharply reduced coverage and/or markedly expanded exclusions in light of increased shareholder suit activity coupled with the prospect of increased regulatory actions. As a result, many current D&O policies may, in fact, offer substantially stripped-down coverage compared to prior, healthier times in the industry. While available coverage limits will have an obvious impact on the amount of proceeds available to the FDIC or other agencies, also of critical importance is the presence and enforceability of policy exclusions, including insured-versus-insured exclusions, regulatory exclusions, and fraud or dishonesty exclusions, all of which may serve as a bar to coverage entirely.

⁷² D&O policies typically do not provide coverage for civil penalties awarded in administrative proceedings or criminal fines. This discussion, therefore, focuses instead on civil litigation brought by regulators seeking money judgments.

B. Exclusions

In evaluating the likely impact of the expected wave of litigation against directors and officers of banking institutions by the FDIC and other regulatory agencies resulting from the recent banking crisis, the results of the last great round of similar lawsuits, stemming from the S&L failures of the 1980s, may be instructive.

1. Insured versus Insured (“IvI”) Exclusion

The Insured versus Insured exclusion excludes coverage for claims made by or on behalf of an insured person or entity against another insured. Most of the cases arising from the S&L crisis of the 1980s which addressed the impact of IvI exclusions in D&O policies found that the IvI exclusion did not bar coverage for lawsuits brought by the FSLIC or FDIC as receiver of the troubled institution. In reaching this conclusion, courts examined the question of whether the FSLIC or FDIC, in their role as receivers “standing in the shoes” of the insured institutions, were therefore “insureds” under the policies. In finding that an IvI exclusion did not prevent coverage for suits brought by the FSLIC or FDIC as receivers, most courts relied on the public policy behind the IvI exclusion, which is to prevent collusion between the insured institution and its directors and officers. This risk of collusion, most courts reasoned, would not be present where the FSLIC or FDIC was seeking to recover as receiver. Accordingly, these courts refused to enforce the IvI exclusion in FSLIC or FDIC litigation.

While most courts refused to apply the IvI exclusion to regulatory actions, some courts during the aftermath of the S&L crisis, however, were not persuaded by such policy arguments, and instead focused on the role of regulatory agencies in stepping into the shoes of the insured. These courts, therefore, extended the reach of the IvI exclusion to include the barring of suits brought by the FSLIC, FDIC, and similar regulatory agencies.

In *Powell v. American Cas. Co.*, 772 F. Supp. 1188 (W.D. Okla., 1991), for example, the FDIC sued certain directors and officers of a banking institution, based on alleged negligence by the directors and officers in extending loans. The directors and officers then brought an action against the insurer seeking coverage under the bank's D&O policies, which contained IvI exclusions. First, the Powell court held that the IvI exclusion was not against public policy, and clearly applied to actions filed by the FDIC. Because the FDIC stands in the shoes of the insured institution in prosecuting claims, the court concluded that the FDIC would be considered an “insured” for coverage purposes, and the IvI exclusion would preclude such coverage.

Similarly, the court in *Gary v. American Cas. Co.*, 753 F.Supp 1547 (W.D. Okla., 1990), found that IvI exclusions do not violate public policy and were enforceable to preclude D&O claims by the FDIC. In *Gary*, insured directors and officers brought suit against the insurer seeking coverage under the bank’s D&O policy. The FDIC, having brought claims against the directors and officers, intervened. The D&O policy at issue contained an IvI exclusion that excluded from coverage claims brought by any director, officer, or the insured entity. Reasoning that the FDIC’s claims were “claims of the financial institution which [the FDIC] acquired after failure of such institution by succession or purchase and are thus asserted in the capacity of assignee of the failed financial institution,”⁷³ the court concluded that the FDIC had therefore filed claims on behalf of an insured and would be barred from pursuing them by the IvI exclusion.

A handful of other courts reached similar conclusions. See, e.g., *Mt. Hawley Ins. Co. v FSLIC*, 695 F.Supp 469 (C.D. Cal., 1987) (FSLIC essentially became the bank for purposes relevant to the D&O policy; accordingly, there was no coverage, since the D&O policy was

⁷³ Id. at 1555

designed to protect directors and officers from losses arising out of third party claims, not from claims made against them brought by the institution itself); *National Union Fire Ins. Co. v. Resolution Trust Co.*, 1992 US Dist. Lexis 14914 (S.D. Tex, 1992) (Resolution Trust Corporation, as receiver for a savings bank, had filed suit on behalf of the bank itself, not for the benefit of its shareholders, creditors, or other noninsured parties; thus, claim was precluded by the IvI exclusion).

In response to litigation addressing the IvI exclusion which arose in the aftermath of the S&L crisis, D&O policies have evolved, and now typically include a “carve back” provision excepting claims by receivers, liquidators and bankruptcy trustees from the IvI exclusion. Ultimately, the language of the policy must be examined to evaluate whether the IvI exclusion is applicable.

2. Regulatory Exclusion

While a limited number of courts gave effect to IvI exclusions in the context of suits brought by regulatory agencies, in response to the S&L crisis, insurers sought greater protection through an additional, more specific exclusion. As a result, insurers created a regulatory exclusion, often crafted specifically to exclude from coverage proceedings brought by the FDIC and other agencies. Courts in many Circuits have almost universally upheld the validity of these regulatory exclusions.⁷⁴ See, e.g., *FDIC v. Am. Cas. Co. of Reading PA*, 975 F2d 677 (10th Cir. 1992) (power of FDIC to assert rights of shareholders and depositors did not invalidate

⁷⁴ Although this article primarily addresses suits by regulatory agencies, an interesting corollary is the ability of shareholders to bring a claim against the directors and officers of an institution where the FDIC or other agency is barred from doing so by a regulatory exclusion in a D&O policy. Under state law, a shareholder would need to seek permission from the institution – or the agency standing in the institution’s shoes – to bring such a suit. Whether the FDIC, for example, precluded from bringing such a suit itself, may nonetheless grant permission to a shareholder to bring such a suit, presents an interesting scenario.

regulatory exclusion, which barred coverage for suit by regulatory agency); see also *Am. Cas. Co. v. Baker*, 22 F2d 880 (9th Cir. 1994); *Am. Cas. Co. of Reading PA v. FDIC*, 944 F2d 455 (8th Cir. 1991); *FDIC v. Am. Cas. Co.*, 998 F2d 404 (7th Cir. 1993); *Am. Cas. Co. v. FDIC*, 39 F3d 633 (6th Cir. 1994); *FDIC v. Connor*, 973 F2d 1236 (5th Cir. 1992); *FDIC v. Am. Cas. Co.*, 995 F2d 471 (4th Cir. 1993).

Despite the almost universal acceptance and enforcement of regulatory exclusions, D&O Insurers, however, may still have reason to proceed with caution. At least one court dealing with a case arising from the recent banking crisis has found that even though, under the terms of the applicable D&O policy, the coverage period ended upon an insured bank being placed into receivership, the policy had not been terminated; thus, the receivers could continue to submit claims for occurrences before the bank went into receivership.⁷⁵

3. Fraud / Dishonesty Exclusion

Many D&O policies also include exclusions against claims arising from the fraud or dishonesty of the directors and officers of the insured institution. Typically, however, this exclusion will only apply upon a final adjudication of such fraud or dishonesty, so at the outset of a lawsuit against insured officers and directors by the FDIC, the ability of an insurer to rely upon a fraud/dishonesty exclusion would be uncertain.

4. Notice Issues

Another issue that may arise in the context of FDIC litigation is the question of when the director or officer received notice of a claim or a potential claim, and when the insurer received sufficient notice under the policy. Typically, the FDIC sends notice to the affected directors and officers prior to filing a lawsuit. As D&O policies are typically claims-made policies, the timing

⁷⁵ *Columbian Fin. Corp. v. BancInsure Inc.*, No. 08-2642-CM, 2009 WL 4508576 (D. Kan. Nov. 30, 2009).

of notice to the insurer is an important issue, since depending on when the insurer is actually notified of a claim, a party seeking coverage may be covered under a different policy for a different period, which may contain different limits and exclusions, or may have no coverage available at all. Even where there might otherwise be coverage, therefore, the timing of notice to the insurer may play a critical role.

C. Coverage Disputes

Litigation, including the filing of suits by the FDIC, is more likely to occur when there is a potential for recovery -- that is, the existence of insurance policies. Regulatory exclusions in D&O policies have been generally found valid and enforceable. Knowing this, even where applicable D&O policies may contain valid IvI, regulatory, and/or fraud/dishonesty exclusions, what the FDIC ultimately may be seeking is to force an insurer to confront the possibility of a costly coverage dispute.

V. Conclusion

We find ourselves once again confronted with significant numbers of failed financial institutions. The FDIC has filed suit in a number of mortgage malpractice and mortgage fraud cases, and is currently conducting investigations into numerous failed banks. The three-year limitation period gives the FDIC significant time to conduct its investigation. In the interim, however, shareholders are filing their own suits. Given the typically limited sources of recovery — generally a D&O policy — the FDIC may be forced to act more quickly. Stay tuned.