

Troubled Banks Mean Trouble for Bank Directors

By Michael A. Kus and Marsha J. Greco*

Introduction

Historically, it has been considered a great honor to be a member of the board of directors of a bank. With the ever increasing number of banks designated as being in a “troubled condition,” the role of bank director has become a much more challenging job, fraught with risks of increasing scope and severity.

According to an article on CNNMoney.com dated May 20, 2010, the number of banks on the FDIC’s list of troubled banks climbed to 775 during the first quarter of 2010.¹ While the economy in Michigan has been in recession for a longer period of time than experienced in most of the rest of the United States, relatively few Michigan banks have been closed and placed in receivership.

However, as the economic correction continues, banks, even those who are not in a “troubled condition,” are faced with escalating challenges, and those entrusted with the responsibility to steer the banks through those challenges are under increased pressure.

Standard of Care for Directors’ Duties

Under the Michigan Banking Code of 1999, a director of a bank:

[S]hall discharge the duties of his or her position in good faith and with that degree of diligence, care, and skill that an ordinarily prudent person would exercise under similar circumstances in a like position. In discharging his or her duties, a director or an officer, when acting in good faith, may rely upon the opinion of legal counsel for the bank, upon the report of an independent appraiser selected with reasonable care by the board or by an officer of the bank, or upon financial statements of the bank certified to him or her to be correct by an officer of the bank, or as stated in a written report by an independent public or certified public accountant

or firm of accountants to reflect fairly the financial condition of the bank.²

Under the federal Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”), a director or officers of an insured depository institution may be held liable to the FDIC for money damages for “gross negligence, including any similar conduct that demonstrates a greater disregard for a duty of care (than gross negligence) including intentional tortuous conduct, as such terms are defined and determined under applicable State law.”³ In *Atherton v FDIC*, 519 US 213 (1997), the United States Supreme Court construed FIRREA’s requirements and held that state law sets the standard of conduct to which bank directors are held “as long as the state standard (such as simple negligence) is stricter than that of the federal statute.”⁴ Thus, in Michigan, bank directors are held to the standards enumerated in the Michigan statute quoted above.

A director’s responsibilities include:

1. The duty of loyalty and good faith to avoid putting personal interest ahead of the interests of the bank;
2. The duty of care and prudence by ensuring the bank is operating according to safety and soundness guidelines of state and federal banking regulators;
3. The duty to remain informed by monitoring and taking an active role to ensure appropriate management and operation in the affairs of the bank; and
4. The duty of inquiry, which requires a bank director to stay informed about activities of the bank.

Potential for Liability

Possibly the greatest area of concern for director liability is the need to ensure that the bank complies with all of the safety and soundness regulations and regulatory guidelines. The subject matter that is encompassed in the term “safety and soundness” is expansive.

Section 39 of the Federal Deposit Insurance Act requires each federal banking agen-

cy (collectively, the “agencies”) to establish certain safety and soundness standards by regulation or by guidelines for all insured depository institutions. Under section 39, the agencies must establish three types of standards: (1) operational and managerial standards; (2) compensation standards; and (3) such standards relating to asset quality, earnings, and stock valuation as they determine to be appropriate.⁵

Appendix A to Part 364 of the Federal Deposit Insurance Corporation (“FDIC”) regulations identifies the areas that the federal banking agencies consider to be within the scope of safety and soundness: 1) internal controls and information systems; 2) internal audit system; 3) loan documentation; 4) credit underwriting; 5) interest rate exposure; 6) asset growth and asset quality; 7) earnings; and 8) compensation, fees, and benefits. As with most things regulatory, while the list appears straightforward, the devil is in the details, and it is those details that can fell a bank—and its directors and officers along with it.

Both federal and state banking regulators have the power to remove “institution affiliated parties”⁶ from office, impose civil money penalties for certain actions (or failures to act in some instances), and even to have criminal charges brought against a director.⁷ If a bank fails and the FDIC is appointed receiver, former directors are almost always the subject of formal investigations by the FDIC and are frequently the target of civil litigation by the FDIC in an attempt to recover losses. Shareholders are also increasingly filing civil suits against former directors of failed institutions.⁸

Minimizing Liability

The potential for liability for a bank director most frequently arises from accusations that the directors or former directors failed to fulfill their duty to operate the bank in a safe and sound manner. There are a number of ways that directors can minimize the potential for personal liability for bank losses or the failure of a bank: 1) implement and monitor appropriate policies to clearly guide the operations of the bank; 2) be aware of “red flags” in management actions and in reports provided to monitor the bank’s operations; and 3) obtain and understand the bank’s Director’s and Officer’s Liability Insurance policy coverage.

Policy Implementation

To ensure the bank is operated in a safe and sound manner, directors must develop and adopt policies to guide the activities of the bank. The board is obligated to monitor the implementation and ongoing compliance with the policies once adopted. Directors are required to ensure that all significant activities of the bank are covered by clearly communicated written policies that can be readily understood by all employees to ensure the bank is operated in a safe and sound manner.⁹

Specific board policies should at a minimum cover: loans, including internal loan review procedures; investments; asset-liability and funds management; profit planning and budget; capital planning; internal controls; compliance activities; audit program; compensation; conflicts of interest; and code of ethics.¹⁰

Policy Monitoring

All policies should be monitored by the board to ensure that they conform to changes in laws and regulations, economic conditions, and the institution’s circumstances. Monitoring is accomplished largely by reports prepared by bank management and presented to the board. Management reports to the board should include, at a minimum: income and expenses of the bank; the bank’s capital position; lending and investments; past due and non-accrual loans; problem loans and workout strategies; allowances for loan and lease losses; concentrations of credit; liquidity/funding risk management; and interest rate risk management.¹¹ All such reports should include an analysis of the bank’s current and historic performance compared to peer institutions.

In addition, the board must be extremely vigilant when considering insider transactions, compliance programs, compensation programs, and any extraordinary situation that may impact the reputation, safety, or soundness of the bank.¹²

It is the board’s responsibility to ensure that bank management is operating the bank in a safe and sound manner. Directors must insist on receiving management reports from those high level managers within the bank on whose area of responsibility the report is being made. If senior management appears to be attempting to control the board’s access to officers of the bank, the board must inquire and demand that those officers who

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are responsible for a particular area be present at board meetings where relevant reports are presented and discussed.¹³

Be Aware of Red Flags

Red flags are signals that the bank is headed for, or perhaps is already in, a troubled condition. A bank's board of directors needs concise, accurate and timely management information reports to help it perform its fiduciary responsibilities. Directors must review the management information reports critically and with an eye toward "red flags," which may signal existing or potential problems. Some "red flags" for directors, may include:

- Bank net worth ratios that are less than "well capitalized," and how such ratios compare with those of its peers.
- Significant concentrations of credit and inconsistent business lending practices, including a significant and increased number of loans granted on an exception basis.
- Significant upward or downward trends in the percentage of Allowances for Loan and Lease Losses ("ALLL") to total loans and leases, and ALLL averages and percentages significantly different from the peer group's.
- Downward trends in risk ratings and/or increases in special mention or classified assets.
- Any planned or anticipated growth that is inconsistent with the bank's budget, strategic plan, or with the bank's ability to properly manage, as well as growth that is significantly greater than that of peer banks, even if the growth is projected in the bank's budget or strategic plan.
- Introduction of new products or activities in which the bank has little or no expertise or for which there are inadequate risk management controls.
- Failure to revise risk management policies as changes in applicable laws and regulations occur.

Some of the most serious red flags that require immediate action from the board of directors include:

- Signs of significant deviation by management or staff from policy or operational standards.
- Any indication that management is trying to control or inhibit communications from certain senior management

or internal audit staff to the board of directors, including unexplained or unexpected changes in external auditors or the audit program.

- Inability of management to provide timely and accurate financial, operational, and regulatory reports.
- Information in management reports that is inconsistent, or reports that are untimely, incomplete, or inaccurate.

The Office of the Comptroller of the Currency has published a guide "Detecting Red Flags in Board Reports—A Guide for Directors" that contains greater details about red flags of which directors should be aware and should be prepared to take proactive steps to address.¹⁴

If there is any doubt about how critical it is for directors to be aware of these red flags, a quick reading of a Material Loss Review, commissioned by the FDIC Office of Inspector General after a bank failure, is very instructive in how the FDIC views action or inaction by boards of directors as contributing factors to bank failures. The content of a Material Loss Review purports to show the progression of the decline of a bank and what a bank's senior management and board did, or did not do, to correct the course of the bank. Material Loss Reviews are published by the FDIC and are available online at: www.fdicig.gov.

Directors' Liability Insurance

If red flags appear that are not being addressed by bank management despite the efforts of the board, or if a director has any reason to believe that the bank is or soon will be in a troubled condition, a director should request and retain a copy of the bank's Director and Officer Liability Insurance policy ("D&O policies.") It is critical for a director to understand what type of insurance coverage is available should claims be made against the bank losses.

A disturbing trend is for D&O policies to contain something known as a "regulatory exclusion" that precludes coverage for actions brought by the FDIC, state regulators, and other regulatory agencies. Once a bank becomes "troubled," it is more difficult to obtain D&O coverage that does not contain the regulatory exclusion.¹⁵

Even if the bank's D&O policy does not contain a regulatory exclusion, some insurers will attempt to deny coverage for claims brought by the FDIC as receiver under some-

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thing called the “insured-versus-insured” exclusion. This exclusion basically “bars coverage for claims by one insured entity (i.e., the FDIC, which steps into the bank’s shoes upon being appointed receiver) against another (i.e., the officers and directors).”¹⁶

Worst Case Scenario

If, despite the board’s best efforts, the bank is closed and the FDIC is appointed receiver, former bank directors need to be prepared to receive a demand letter from the FDIC informing them that they may be subject to possible civil charges or that they may be the target of formal investigations via a “Notice of Investigation.” This process could result in subpoenas of personal financial records and other documents.¹⁷

There is concern that the FDIC is targeting individual former directors of failed institutions whom the FDIC believes have the financial means for recovery, rather than focusing on those persons whom the FDIC thinks are actually responsible for a failure.¹⁸ However, the FDIC maintains it is “looking at whether we have a meritorious and cost-effective claim.... How far we go will depend on the facts and circumstances in each case,” according to Richard Osterman, Deputy General Counsel at the FDIC.¹⁹

Potential for Civil Suit by the FDIC

In its Financial Institutions Letter 87-92, the FDIC issued a statement of policy concerning the Responsibilities of Bank Directors and Officers. The statement also includes a discussion of the procedures followed by the FDIC to institute civil lawsuits against former directors and officers and describes the nature of suits filed. Inside directors are at a higher risk of being sued by the FDIC than outside directors.²⁰

According to the policy statement, the FDIC will only institute a lawsuit against a former director after a review of factual circumstances surrounding the bank’s failure by senior FDIC supervisory and legal staff, and final approval is given by the FDIC Board of Directors or its designee. The factual circumstances are developed in part based on information provided by the former director in response to a Notice of Investigation and subpoena(s). In most cases, the FDIC attempts to alert proposed defendants in advance to allow them to respond to proposed charges informally and discuss possible settlement.²¹

Cases most often result when a former director engaged in dishonest conduct or approved or condoned abusive transactions with insiders, or where a director failed to ensure the bank adhered to applicable laws and regulations, its own policies or an agreement with a supervisory authority, or otherwise engaged in an unsafe or unsound practice.²² By far, the majority of cases involve allegations that former directors failed to establish proper loan underwriting policies and monitor adherence to those policies, approved loans they knew or had reason to know were improperly underwritten, or failed to heed warnings from regulators or professional advisors about the situation.²³ Perhaps the most troubling aspect of the current FDIC pursuit of former directors is that many allegations against former directors do not relate to activities that are unique to a particular bank. For example, the FDIC will take the position that generally poor economic conditions in a particular geographic area that contribute to a bank’s decline are somehow attributable to actions, or inactions, of a bank’s directors. Thus, it seems likely that some version of “guilt by association” (e.g., that a bank happens to be located in a geographic area that is economically stressed—a condition for which an individual director cannot personally be responsible) may cause even the most diligent bank directors to find themselves defending against claims by both regulators and shareholders.²⁴

As an example, the Material Loss Review of Citizens State Bank, New Baltimore, Michigan states: “[t]he bank’s financial deterioration was exacerbated by the depressed economic conditions, deteriorating automobile industry, and high unemployment rates prevalent in the Detroit metropolitan area.”²⁵ While seemingly aware of the role extraordinary economic conditions played in the bank’s failure, conditions that are clearly beyond the control of a bank’s directors, the MLR nevertheless placed the cause of the bank’s failure squarely on the board and management of the bank.²⁶

Defenses to Civil Suits; Business Judgment Rule

In the face of a formidable opponent such as the FDIC, what defenses are available to directors who find themselves under investigation or a defendant in a civil suit brought by the FDIC? The “business judgment rule”

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is the first and foremost legal argument as a defense to such a suit.

A former director who is being targeted by the FDIC is entitled to rely on the “business judgment rule” to protect himself or herself from personal liability, assuming the director acted prudently and impartially under the circumstances.²⁷

The United States District Court for the Western District of Michigan had the occasion to review the current state of the business judgment rule in the 2008 unreported case, *Virginia M Damon Trust v Mackinaw Fin Corp.* In its discussion of the business judgment rule, the court noted that:

The business judgment rule “is a presumption that in making a business decision the directors of a corporation acted on an informed basis and in the honest belief that the action was taken in the best interests of the company.” *Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 747 (Del. Ch. 2005) (internal ellipses and quotations omitted). Where, however, the directors’ “methodologies and procedures are restricted in scope, so shallow in execution, or otherwise so *pro forma* or halfhearted as to constitute a pretext or a sham, then inquiry into their acts is not shielded by the business judgment rule.” *Resolution Trust Co. v. Rahn*, 854 F.Supp. 480, 489 (W.D. Mich. 1994). Moreover, “[g]ood faith alone will not excuse [directors] when there is a lack of the proper care, attention, and circumspection in the affairs of the corporation, which is exacted of them as trustees.” *City of Grand Rapids v. F & M Foods, Inc.*, No. 271773, 2007 Mich. App. LEXIS 926, 2007 WL 914667, at *4 (Mich. App. Mar. 27, 2007).²⁸

If a bank director stays informed and acts under a good-faith belief that the decision is in the best interests of the bank, the business judgment rule may provide a substantial basis of a defense to claims of negligence.

The Best Defense is A Good Offense

As strong a defense as the business judgment rule is, the best defense is a good offense. Taking certain actions at the first sign of red flags is the best way a director can protect himself or herself from personal liability. Directors should consider consulting competent counsel of their own when red flags begin to appear. While the bank may have competent

counsel who gives sound legal advice to the bank and the board of directors during difficult times and prior to a bank failure, it is important for directors to be sure they take appropriate steps to protect themselves from liability in the event the bank fails. Directors need to know the scope and coverage of the D&O policy. Directors also need to organize business records with an eye toward establishing a defense to potential litigation. Directors should also understand what the requirements are for the particular D&O policy applicable to their role as a bank director. Failure to follow the required notice procedures and other directives contained in the D&O policy may result in a director being denied coverage.

Copies of the board minutes, loan committee minutes, board reports, resolutions, or corrective action plans are extremely useful as evidence that a director acted according to the required standard of care. It is critical to obtain the advice of counsel in the organizing of business records because these documents are highly sensitive and subject to confidential or restricted treatment under federal and state law. Extreme care must be taken when dealing with such records so as to avoid any allegation that a director improperly removed official bank records from bank property.

Conclusion

Implementing appropriate policies, monitoring adherence to those policies, being aware of red flags, and taking appropriate action to address those red flags are all important steps to minimizing director liability. Understanding the type and extent of any insurance coverage for actions taken as a director is also an important element in managing director liability.

For current and former bank directors, the risk of personal liability for losses incurred by a failed bank is very real. While there is no way to eliminate the risk of being targeted by regulators or shareholders for such losses, there are several effective steps directors can take to minimize that risk.

NOTES

1. http://money.cnn.com/2010/05/20/news/companies/fdic_list/index.htm.
2. MCL 487.13504(1).
3. 12 USC 1821(k).
4. *Atherton v FDIC*, 519 U.S. 213, 216 (1997).
5. Appendix A to 12 CFR Part 364 is available at: <http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=f>

f956618654606baae12cdc005d99835&rgn=div9&view=text&node=12:4.0.1.2.48.0.3.3.32&idno=12?

6. "Institution affiliated parties" include 1) any director, officer, employee, or controlling stockholder (other than a bank holding company) of, or agent for, an insured depository institution; (2) any other person who has filed or is required to file a change-in-control notice with the appropriate Federal banking agency; (3) any shareholder (other than a bank holding company), consultant, joint venture partner, and any other person as determined by the appropriate Federal banking agency (by regulation or case-by-case) who participates in the conduct of the affairs of an insured depository institution . . . which caused or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the insured depository institution. 12 USC 1813(u).

7. 12 USC 1818(e) – (i).

8.. "Distressed Debt and other Woes: What Bank Directors Should be Doing...Now", Bank Director Magazine – 4th Quarter 2008 available at www.bankdirector.com.

9. FDIC Pocket Guide for Directors, available at: <http://www.fdic.gov/regulations/resources/directors/index.html>.

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.*

14. The guide is available online at: http://www.occ.treas.gov/RF_Book.pdf.

15. Chris Rafferty, "How Changes in Community Banking are Affecting Directors and Officers Liability Insurance", Smart Business Indianapolis, June 2010, available at: http://www.sbnonline.com/Local/Article/19879/74/228/How_changes_in_community_banking_are_affecting_directors_and_officers_liability_insurance.aspx. Mr. Rafferty is Vice President of the Financial Services Group at Aon Risk Services.

16. "FDIC Poised to Sue Former Directors and Officers of Failed Banks." GreenbertTraurig Financial Institutions/ D&O Litigation update, January 5, 2010, available at: www.gtlaw.com. See also William G. Passanante and Raymond A. Mascia Jr, "When the FDIC Comes Calling: Protecting D&O Coverage for a Failed Bank's Directors And Officers," *AKO Financial Services Alert*, December, 2009, and "D&O Liability Policies – Regulatory Exclusion," Latham & Watkins, LLP Client Alert, July 21, 2008.

17. Joe Adler, "First the Failures, Then the Lawsuits," *American Banker*, Tuesday, July 13, 2010.

18. *Id.*

19. *Id.*

20. FDIC Statement Concerning the Responsibilities of Bank Directors and Officers, FDIC Financial Institution Letter (FIL-87-92) December 3, 1992.

21. *Id.*

22. *Id.*

23. *Id.*

24. Posting of Kevin M. LaCroix to "The D & O Diary," www.dandodiary.com. Mr. LaCroix is an attorney and a partner with OakBridge Insurance Services, in Beachwood, Ohio. OakBridge is an insurance intermediary focused exclusively on management liability issues.

25. Office of Material Loss Reviews Report No. MLR-10-042, July 2010.

26. *Id.*

27. Thomas P. Vartanian, "The Retribution Phase of the Financial Meltdown", *American Banker*, June 1, 2010.

28. No. 2:03-CV-135, 2008 US Dist LEXIS 23 at *28 (WD Mich Jan 2, 2008).



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