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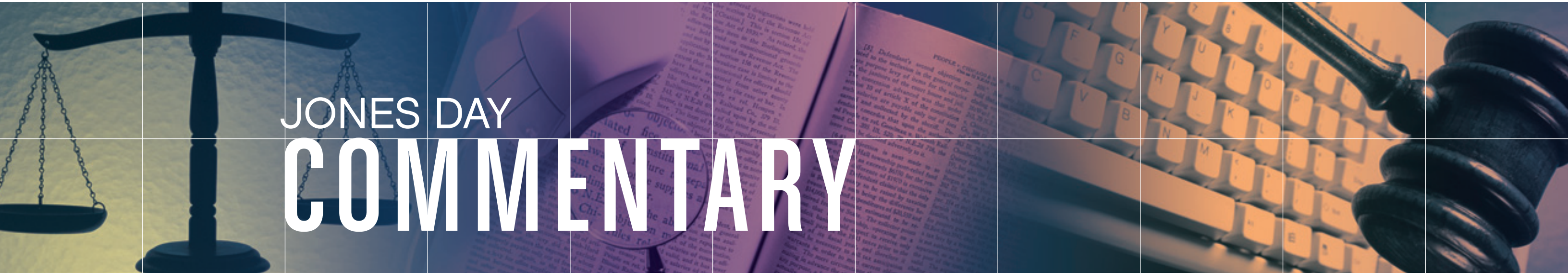

FDIC FAILED BANK DIRECTOR AND OFFICER CLAIMS – RECENT COURT DECISIONS BETTER DEFINE THE LANDSCAPE

Since the current cycle of bank failures began in 2008, the FDIC has authorized suits for director and officer ("D&O") liability against 427 individuals in connection with 49 failed banks. Through February 9, 2012, the FDIC has filed 22 lawsuits against former officers and directors of failed banks, most of which were instituted within the past year.

Recently, United States District Courts in Atlanta and Chicago have issued important opinions governing the manner in which these lawsuits should be handled. In *FDIC v. Steven Skow, et al.*, a case which arose from the failure of Integrity Bank, Alpharetta, Georgia ("*Integrity*"), on August 29, 2008,[1] and *FDIC v. John M. Saphir, et al.*, a case arising out of the failure of Heritage Community Bank, Glenwood, Illinois ("*Heritage*"), on February 27, 2009,[2] the courts define the legal grounds on which the FDIC's bank failure claims against D&Os may be litigated, especially in the early motion stage.

The *Integrity* and *Heritage* cases are based on a familiar set of FDIC allegations and claims in failed bank D&O lawsuits: the alleged pursuit by directors and officers of failed banks of an unsustainable growth strategy concentrated on lending for allegedly high-risk and speculative real estate ventures, which resulted in substantial losses when the real estate market collapsed and the bank failed. In these and other lawsuits, the FDIC has asserted claims for (i) breach of fiduciary duty, (ii) ordinary negligence under state law, and (iii) gross negligence under the

1 FDIC, as receiver of Integrity Bank v. Skow, et. al., Civil Action No. 1:11-CV-0111-SCJ (N.D. Ga. Feb. 27, 2012) (Jones, J.). *See also* Jones Day analysis of this failure and resolution.
2 *FDIC, as receiver of Heritage Community Bank v. Saphir*, 2011 WL 3876918, No. 10 C 7009 (N.D. Ill. Sept. 1, 2011) (Pallmeyer, J.). *See also* Jones Day analysis of this failure and resolution.

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federal Financial Institutions Reform Recovery and Enforcement Act of 1989 ("FIRREA").

The director and officer defendants in these recent cases filed dispositive Rule 12 motions seeking dismissal of all claims. In *Integrity*, the FDIC also moved to strike a number of the defendants' affirmative defenses. In both *Integrity* and *Heritage*, the courts allowed some of the FDIC's claims to survive dismissal at the pleadings stage, while other claims and certain affirmative defenses did not.

CLAIMS BASED ON ORDINARY NEGLIGENCE SHOULD NOT SURVIVE THE BUSINESS JUDGMENT RULE

The defendants in *Integrity* and *Heritage* argued that the business judgment rule barred claims for ordinary negligence. The *Integrity* Court addressed the substance of this argument.

Under Georgia corporate law, as noted by the Integrity Bank defendants and the court, the business judgment rule "affords an officer the presumption that he or she acted in good faith, and absolves the officer of personal liability unless it is established that he or she engaged in fraud, bad faith or an abuse of discretion."[3] Thus, "allegations amounting to mere negligence, carelessness or 'lackadaisical performance' are insufficient as a matter of law."[4] Finding this principle determinative, the court held that claims against directors and officers for ordinary negligence, as well as claims for breach of fiduciary duty based on ordinary negligence, are precluded by the business judgment rule under Georgia law.[5]

By precluding claims based on ordinary negligence, the *Integrity* ruling confirms that the FDIC should be held to the higher standard of gross negligence when attempting to prove liability against failed bank directors and officers. We believe this is an appropriate decision that should be helpful to directors and officers of other failed banks, especially in jurisdictions with bank corporate laws similar to Georgia's. This ruling should enable more productive discussions with the FDIC before it files a failed bank D&O lawsuit, discourage similar claims by the FDIC, and support defendants' motions to dismiss claims based on ordinary negligence.

DEFENDANTS SHOULD CONSIDER FILING A MOTION FOR JUDGMENT ON THE PLEADINGS, NOT JUST A MOTION TO DISMISS FOR FAILURE TO STATE A CLAIM

The directors and officers in *Heritage* also moved to dismiss the FDIC's ordinary negligence claims based on the business judgment rule.[6] The *Heritage* court declined to address the merits of the defendants' argument, however, concluding that the business judgment rule was an affirmative defense which had yet to be raised because the defendants had not answered the complaint.[7] Accordingly, the court reasoned, the effect of the affirmative defense on the FDIC's claims was more appropriately considered on a motion for judgment on the pleadings.[8]

Integrity reached a different conclusion, citing Eleventh Circuit authority that subjects a complaint to dismissal under Rule 12(b)(6) when the allegations, on their face, show that an affirmative defense bars recovery.[9] Given these differing judicial viewpoints, former directors and officers may wish to consider filing both a motion for judgment on the pleadings and a motion under Rule 12(b)(6) when arguing that the

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3 *Skow* at 16 (quoting *Brock Built, LLC v. Blake*, 300 Ga. App. 816, 821–822, 686 S.E.2d 425, 430–431 (2009)). Georgia, like a number of other states, follows the Model Business Corporation Act.
4 *Id.*
5 *Id.* at 18.
6 *Saphir*, 2011 WL 3876918, at *1.
7 *Id.* at *5.
8 *Id.* The *Heritage* court did, however, dismiss the FDIC's negligence claims on grounds that they were duplicative of the FDIC's breach of fiduciary duty claims. *Id.* at *9.
9 *Skow* at 18 (citing *Cottone v. Jenne*, 326 F.3d 1352, 1357 (11th Cir. 2003)).

business judgment rule, or any other affirmative defense, precludes the FDIC's claims.

EXCULPATORY PROVISIONS IN A BANK'S ARTICLES OF INCORPORATION MAY NOT BAR CLAIMS FOR GROSS NEGLIGENCE BROUGHT BY THE FDIC

In addition to relying on Georgia's business judgment rule, the Integrity Bank defendants argued that exculpatory provisions in the bank's articles of incorporation precluded claims for breach of the duty of care and gross negligence under FIRREA.[10] Like many states, Georgia allows companies in their articles of incorporation to limit or exculpate directors from liability for the breach of the duty of care, including gross negligence. In a typical derivative lawsuit brought by a corporation's shareholders against its directors, defenses based on these exculpatory provisions are common and often effective. Even so, the FDIC argued that the exculpatory provision in the bank's articles of incorporation had no effect because the lawsuit was not a derivative action and the FDIC, as receiver, was acting not as a shareholder, but as successor to the bank.[11] The Court in *Integrity* agreed with the FDIC.

At the outset, the *Integrity* Court noted that the express purpose of FIRREA "was to improve the FDIC's ability to recover federal funds spent to rescue failed banks" and that FIRREA "preempts state laws to the extent that those laws insulate bank directors from personal liability for gross negligence in an action brought by the FDIC."[12] The court also held that the exculpatory provisions did not preclude state law fiduciary duty claims for the breach of the duty of care based on gross negligence.[13] The reason, according to the court, is that the "FDIC [is] primarily serving as an instrument of the banking industry" when it becomes a receiver for a failed bank, not as the bank's shareholder or as the corporation per se.[14] The *Integrity* decision then proceeded to analyze the allegations in the complaint, in the light most favorable to the FDIC, and determined that they sufficiently stated a claim for gross negligence.[15]

The *Integrity* decision on the issue of gross negligence and exculpatory provisions presents the biggest downside to D&Os. If other courts adopt this approach, it will be difficult for defendants to eliminate claims of gross negligence at the early stage of litigation through motions to dismiss or for judgment on the pleadings. In future cases, however, defendants may be well-advised to raise exculpatory provisions as a defense, if only to preserve the issue for appeal. Defendants also should make every effort to show the FDIC during its investigation stage and any court in the event a complaint is filed, how the FDIC's allegations do not factually support a claim for gross negligence in their particular situation.

AFFIRMATIVE DEFENSES BASED ON THE PRE-RECEIVERSHIP CONDUCT OF THE FDIC IN ITS CORPORATE REGULATORY CAPACITY MAY NOT SUCCEED

The Integrity Bank defendants raised a number of other affirmative defenses, including estoppel, based on the FDIC's conduct before the bank failed. Specifically, the defendants argued that the FDIC's "lax oversight" and "arbitrary" regulatory constraints contributed to the bank's failure and that the FDIC neglected or refused to take appropriate steps to mitigate its damages.[16] The court, however, rejected these arguments, holding that affirmative defenses based on the FDIC's pre-receivership regulatory conduct in its corporate capacity must be stricken.[17]

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10 *Id.* at 6.
11 *Id.* at 9.
12 *Id.* at 7 (citing *Atherton v. FDIC*, 519 U.S. 213, 227–229 (1997)).
13 *Id.* at 12.
14 *Id.* at 11 (citing *FDIC v. Harrison*, 735 F.2d 408, 413 (1984)).
15 *Id.* at 13.
16 *Id.* at 25.
17 *Id.* at 26.

The court reasoned that the "FDIC has the authority to serve in two separate and legally distinct capacities: (1) in its corporate capacity as an insurer of deposits and regulator of member banks [Corporate FDIC] and (2) in its receivership capacity as a receiver of failed banks [Receiver FDIC]."[18] Corporate FDIC was not a party to the lawsuit, which was brought by the FDIC in its capacity as receiver. The court looked to federal appellate authority recognizing this distinction and holding that Receiver FDIC cannot be liable for wrongs committed by Corporate FDIC.[19] On the basis of this authority, the court ruled that affirmative defenses against Corporate FDIC had no bearing on Receiver FDIC's claims.[20] The court, however, did not strike affirmative defenses based on the post-receivership conduct of the FDIC in its capacity as receiver.[21]

Accordingly, defendants should focus any reasonable estoppel-type defense on the conduct of Receiver FDIC to the extent possible. Defendants should still raise these affirmative defenses, even as to Corporate FDIC, to preserve this issue for appeal at least until appellate courts definitively resolve the issue.

CAUSATION ARGUMENTS BASED ON THE PRE-RECEIVERSHIP CONDUCT OF THE FDIC IN ITS CORPORATE CAPACITY REMAIN OPEN ISSUES

The Integrity Bank defendants also raised a causation "defense," arguing that Corporate FDIC's pre-receivership conduct in tacitly approving the bank's business plans and then abruptly downgrading its assets contributed to the bank's failure.[22] Noting that causation is not technically an affirmative defense, but rather an essential element of the FDIC's claims, the court found this to be a murkier question of law than that posed by the FDIC's motion to strike certain affirmative defenses.[23] Hence, the court determined that the issue warranted additional briefing either at the summary judgment stage or before trial.[24]

In passing on this issue, and thus denying the FDIC's motion to strike, the court also refused to address the FDIC's argument that the defendants should have impleaded Corporate FDIC if they intended to contend that its pre-receivership conduct caused the bank's failure. Because this issue remains unsettled, and given the FDIC's position, defendants will need to consider whether to implead Corporate FDIC when arguing that the FDIC helped cause the bank's failure. More importantly, banks and their boards of directors should periodically review their business plans, asset and concentration levels, staffing and experience levels, and risk tolerances to manage their risks, maintain good regulatory relations, and prevent these sorts of claims from shareholders, as well as regulatory enforcement actions while their banks are operating and potential claims by the FDIC, as receiver, if their banks fail.

CONCLUSION

Failed bank director and officer liability will become more defined as additional rulings are rendered in the other pending FDIC cases and upon appellate review. For now, however, the *Integrity* and *Heritage* cases have helped inform the strategy of former directors and officers facing potential FDIC claims or actual litigation. More importantly, the *Integrity* decision appropriately set the bar higher for FDIC claims based on ordinary negligence, at least in jurisdictions with law similar to Georgia, whose corporate law, like many states, is based on the Model Business Corporation Act. *Integrity*'s precedent is also significant because Georgia has had 77 bank failures from 2007 through March 9, 2012, more than any other state, making it an important battleground for failed bank litigation.

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18 *Id.* at 25 (citing *Harrison*, 735 F.2d at 412).
19 *Id.*
20 *Id.* at 26.
21 *Id.* at 30.
22 *Id.* at 30.
23 *Id.* at 31.
24 *Id.*

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Joseph E. Finley
Atlanta
1.404.581.8409
jfinley@jonesday.com

Jonathan Leiken
Cleveland/New York
1.216.586.7744/1.212.901.7256
jleiken@jonesday.com

Chip MacDonald
Atlanta
1.404.581.8622
cmacdonald@jonesday.com

Michael J. McConnell
Atlanta
1.404.581.8526
mmcconnell@jonesday.com

David F. Adler
Cleveland
1.216.586.1344
dfadler@jonesday.com

Geoffrey J. Ritts
Cleveland
1.216.586.7065
gjritts@jonesday.com

Walter W. Davis
Atlanta
1.404.581.8517
wwdavis@jonesday.com

Jayant W. Tambe
New York
1.212.326.3604
jtambe@jonesday.com

N. Scott Fletcher
Houston
1.832.239.3846
sfletcher@jonesday.com

Patricia J. Villareal
Dallas
1.214.969.2973
pjvillareal@jonesday.com

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