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FDIC and Other Banking Agency Litigation Against Auditors, Law Firms, Appraisers and Other Outside Advisors

Latest Developments in Defending Agency Claims and Maximizing E&O Insurance Coverage

THURSDAY, AUGUST 7, 2014

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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FDIC Claims Against Third-Party Professionals

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Overview of Discussion

1. FDIC Investigations and Authority to Sue
2. Use of Administrative Enforcement Powers
3. Defense Strategies for Responding to FDIC Investigations
4. Governing Law / Available Defenses
5. Settling FDIC claims

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Typical FDIC Claims Against Third-Party Professionals

1. Professional negligence
2. Aiding and abetting breach of fiduciary duty
3. Breach of fiduciary duty
4. Fraud
5. Breach of contract

FDIC Investigations

Investigation intended to determine whether an FDIC lawsuit would be meritorious and cost-effective.

1. Informal measures: informal requests for information, interviews, law firm files (FDIC as former client)
2. Formal measures
   a. Subpoenas for bank documents or law firm work product and files and/or personal financial information
   b. Subpoenas for testimony
   c. Requests for law firm insurance policy

Statutes of Limitation

1. 3 years for tort claims and six years for breach-of-contract claims to file suit from the time a bank is closed.

2. If state law permits a longer time, the state statute of limitations is followed.

Source: 12 U.S.C. § 1821(d)(14)

Timing for FDIC to Obtain Authority to Sue

1. FDIC's performance goal is to make a decision to close or pursue 80% of professional liability claims within 18 months of an institution's failure.

2. The FDIC met this goal (ranging from 80% to 87%) in every year between 2008 and 2012.

Tolling Agreements

1. Historically, FDIC occasionally relied upon tolling agreements

2. District court decision in *NCUA v. Credit Suisse Securities, et al.*, Case No. 12-2648-JWL (D. Kan. 2013), has made the FDIC skittish about the enforceability of tolling agreements, but they are still used (albeit not as often as before)

Financial Crises – Then and Now

1. 1980s S&L Crisis
   a. Between 1986 and 1995, over 1,000 financial institutions failed at a cost of about $150 billion
   b. 205 attorney malpractice lawsuits (less than 10% of failed financial institutions) with recoveries of $500 million
   c. Global settlements with four of the Big Six accounting firms = $1 billion

See Managing the Crisis: Professional Liability Claims (Ch. 11); Timothy Curry & Lynn Shibut, "The Cost of the Savings & Loan Crisis: Truth and Consequences," FDIC Banking Review (2000)

2. 2008 Great Recession
   a. 465 financial institutions failed resulting in nearly $87 billion in losses to the DIF.
   b. The FDIC has authorized approximately 20 lawsuits for accounting malpractice, appraiser malpractice, and attorney malpractice claims.

See FDIC website (http://www.fdic.gov/bank/individual/failed/pls/index.html)

Trends in Recent FDIC Actions

1. D&O claims – so far the FDIC has authorized lawsuits against former D&Os associated with 33% (154 out of 465) of failed institutions, as compared to 24% of failed institutions in the S&L crisis. Another 28% of failed financial institutions are still pending decision, so the number is likely to climb.

2. Third-Party Professionals – so far the number of FDIC lawsuits against third-party professionals is small. FDIC has authorized relatively few lawsuits against attorneys (3.8% of cases reviewed), appraisers (2.6%), and accountants (1.7%).

TAKE-AWAY: the FDIC has not pursued third-party professionals at the same rate it did in the aftermath of the S&L crisis.

Possible Reasons for FDIC's Greater Reluctance to Pursue Third-Party Professionals

1. Loss-causing events were simply not those in which law firms' work was central (or even important).
2. Fewer obvious targets because attorneys who represent financial institutions may be less likely to serve as directors.
3. Availability of more developed affirmative defenses such as *in pari delicto*.
4. Better loss prevention practices by law firms

Risk Factors in FDIC Claims Against Third-Party Professionals

1. Conflicts of interest and/or self-dealing
2. Significant potential damages (but see exemplar appraiser cases)
3. Available pool of money for recovery

Examples of FDIC Claims Against Third-Party Professionals – Attorneys

1. Attorneys (8 completed matters as of 9/30/13)
   a. *FDIC v. Icard, Merrill, Cullis, Timm, Furen & Ginsburg, P.A., et al.* (M.D. Fla. Dec. 2011): $4 million lawsuit against law firm and firm partner for legal malpractice arising out of the firm's representation of multiple parties in a single loan transaction by the failed First Priority Bank of Bradenton, Florida. Case tried to $1.2 million verdict. Currently on appeal.
   b. *FDIC v. Mahajan, et al.* (N.D. Ill. Oct. 2011): $125 million lawsuit against both D&Os, law firm partner (who was also a director of the bank), and his law firm. The law firm was alleged to have aided and abetted reckless lending and unlawful dividends by Mutual Bank of Harvey, IL and having a conflict of interest in the underlying loan transactions. Currently in discovery.
   c. *FDIC v. Smith, Welch & Brittain LLP, et al.* (N.D. Ga. Feb. 2011): $6 million lawsuit against law firm and partner who represented bank in certain loan transactions. Case settled for $1.8 million.
   d. *FDIC v. Nason Yeager Gerson White & Lioce, P.A., et al.* (M.D. Fla. Mar. 2013): $31 million lawsuit against law firm that allegedly turned a "blind eye" to a "slew of glaring red flags" in connection with loans that violated legal lending limits and manipulated the bank's accounting. Pending tentative settlement.

Examples of FDIC Claims Against Third-Party Professionals – Accountants/Auditors

1. Accountants / Auditors (3 completed matters as of 9/30/13)

   - *FDIC v. PWC LLP and Crowe Horwath LLP* (M.D. Ala. Oct. 2012): $1 billion lawsuit against Colonial Bank's external and internal auditors related to failure to discovery massive mortgage banking fraud by the bank's largest mortgage banking customer. This is the first FDIC case against auditors brought since the Great Recession. Currently starting discovery.

Examples of FDIC Claims Against Third-Party Professionals – Appraisers

1. Appraisers (8 completed matters as of 9/30/13)
   a. *FDIC v. Heyward* (C.D. Cal. May 2012) – lawsuit against appraiser for $2.2 million appraisal related to $1.5 million mortgage refinance by BankUnited. Case settled in July 2013 for $300,000.
   b. *FDIC v. VRG Appraisels, Inc., et al.* (M.D. Fla. Aug. 2012): lawsuit against appraiser related to $734,000 appraisal for Colonial Bank loan. Case settled in April 2014 for $137,500.

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FDIC Administrative Enforcement Powers

1. Removal & Prohibition / Suspension
2. Civil Money Penalties
3. Cease and Desist Powers

Definition of Institution-Affiliated Party

4) Any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in

   a) Any violation of any law or regulation;

   b) Any breach of fiduciary duty; or

   c) Any unsafe or unsound practice,

   which caused or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the insured depository institution.

Source: 12 U.S.C. § 1813u

Application of IAP Status to Third-Party Professionals

1. *Cavallari v. O.C.C.*, 57 F.3d 137 (2d Cir. 1995)
   - "[A]s Cavallari himself admitted in a deposition, his advice on the exchange of guaranties was a 'business opinion' concerning the transaction's soundness rather than a legal opinion on any aspect of the transaction."
2. *Grant Thornton, LLP v. O.C.C.*, 514 F.3d 1328 (D.C. Cir. 2008)
   - The court further held that the relevant legislative history "distinguishes between an attorney who provides a bank advice or services in good faith and an attorney who also knowingly participates in other activities which result in serious misconduct, saying the former is not a target for enforcement action." Id. at 1334 (internal quotation marks omitted).
3. Legislative history
   - Good-faith advice as to a transaction's legality does not result in liability for an attorney. See H.R. Rep. No. 54, 101st Cong., 1st Sess. (1989), pt. 1 at 467.

Burden of Proof for R&P

1. Kim v. OTS, 40 F.3d 1050 (9th Cir. 1994)
   - Prohibition is "ultimate sanction" and the government "must show a degree of culpability well beyond mere negligence, i.e., there must be a showing of scienter."
2. Doolittle v. NCUA, 992 F.2d 1531, 1539 (11th Cir. 1993)
   - "Personal dishonesty" required
3. Seidman v. OTS, 37 F.3d 911 (3d Cir. 1994)
   - Removal power is "extraordinary" and should be "carefully exercised"; not "every appearance of wrongdoing justifies the sanction of removal and prohibition.

Administrative Enforcement Actions Since the Great Recession

1. As of 9/30/13, the FDIC had taken enforcement action in 19% of the failed institutions since the Great Recession
   a. 275 enforcement actions associated with 87 failed institutions out of 465 total failed financial institutions
   b. Of the 275 enforcement actions, 128 were R&P orders against IAPs associated with 75 failed institutions (16% of the 465 failed financial institutions)
   c. By comparison, the FDIC took enforcement action for only 6% of the institutions that failed during the S&L crisis.

2. The total amount of CMPs imposed by the FDIC is relatively modest
   a. 63 individuals for $4.1 million

3. Recent OIG report
   a. Recommends more aggressive approach to R&P orders based on willful or continuing disregard for safety or soundness (most actions to date have been predicated on personal dishonesty).
   b. Encourages use of personal C&D orders because they have a lower burden of proof.

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Financial Institution Letter 14-2012

1. "Former directors and officers may have a legitimate need to access certain limited confidential financial institution records in order to prepare for, or defend against, litigation that may arise following the placement of a financial institution into receivership." FIL 14-2012 at 3.

2. Required to enter into suitable confidentiality arrangement.

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Atherton v. FDIC, 519 U.S. 213 (1997)

1. "There is no federal common law that would create a general standard of care applicable to these cases." *Id.* at 226.

2. "The statute's 'gross negligence' standard provides only a floor – a guarantee that officers and directors must meet at least a gross negligence standard. It does not stand in the way of a stricter standard that the laws of some states provide."
Id. at 227.

Common Defenses Raised by Third-Party Professionals

1. *In pari delicto* / unclean hands / imputation
2. Causation (both proximate cause and factual cause)
3. Statute of limitations
4. No fiduciary duty

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