The Failed Bank Crisis –
Current D&O Litigation Update
Leveraging Developments in Standards of Liability, Statute of Limitations and Adverse Domination, Discovery, Insurance Coverage, and ESI

TUESDAY, OCTOBER 1, 2013
1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today’s faculty features:
Mary C. Gill, Partner, Alston & Bird, Atlanta
Steven C. Morrison, Counsel, Professional Liability/Financial Crimes Group, FDIC, Jacksonville, Fla.
Linda D. Kornfeld, Partner, Kasowitz Benson Torres & Friedman, Los Angeles

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THE FAILED BANK CRISIS: D&O LITIGATION UPDATE

A POINT / COUNTERPOINT DISCUSSION

MARY C. GILL
Partner – Alston & Bird LLP
Securities Litigation & Regulatory Enforcement
mary.gill@alston.com

STEVEN C. MORRISON
Counsel – FDIC
Professional Liability & Financial Crimes
stemorrison@fdic.gov
FDIC LITIGATION BY THE NUMBERS

The FDIC has filed 81 lawsuits against former D&Os of closed banks in 22 states:

- Georgia – 18
- California – 12
- Illinois – 11
- Florida – 9
- Washington – 5
- Nevada – 4
- North Carolina, Puerto Rico – 3
- South Carolina, Arizona – 2
- Missouri, Oregon, Indiana, Nebraska, New Mexico, Iowa, W. Virginia, Utah, Wyoming, Michigan, Kansas, Pennsylvania – 1
FDIC LITIGATION BY THE NUMBERS

- As of September 2013, the FDIC has authorized lawsuits against 1,007 D&Os in connection with 125 closed banks.
- Only one case has gone to trial, resulting in a jury verdict in favor of the FDIC.
- The FDIC has published settlements in 50 cases, which includes pre-litigation settlements.
- The amount of these settlements has ranged from $5,000 to $39.5 million.
- The settlement agreements often do not disclose the amount paid by D&O insurance or by the D&Os individually.

<table>
<thead>
<tr>
<th>Bank</th>
<th>Amount of Settlement</th>
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<tbody>
<tr>
<td>1. ANB Financial (AR)</td>
<td>$5,100,000</td>
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<tr>
<td>2. County Bank Merced (CA)</td>
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<td>3. Mirae Bank (CA)</td>
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<td>5. Vineyard Bank (CA)</td>
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<td>10. Metro Bank of Dade County (FL)</td>
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<td>11. Ocala National Bank (FL)</td>
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<td>28. Town Community Bank (IL)</td>
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<td>29. Wheatland Bank (IL)</td>
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</table>
D&O STANDARD OF LIABILITY – NEGLIGENCE OR GROSS NEGLIGENCE

• The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (“FIRREA”) established gross negligence as a national minimum standard for officer and director liability.

• The FDIC may also pursue claims against officers and directors under a stricter standard for liability (ordinary negligence), if permissible under state law.

• Gross negligence is the minimum standard for imposing liability upon bank officers and directors in most states.
Federal courts have dismissed FDIC negligence claims in the following jurisdictions:

**Georgia**


**Illinois**

**D&O STANDARD OF LIABILITY – NEGLIGENCE OR GROSS NEGLIGENCE**

**Florida**


**California**

D&O STANDARD OF LIABILITY – NEGLIGENCE OR GROSS NEGLIGENCE

Other courts have denied motions to dismiss FDIC negligence claims:

North Carolina

- “Because the business judgment rule presupposes the exercise of reasonable care, ‘North Carolina law may recognize director liability for simple negligence to the extent that such negligence falls outside the protection of the business judgment rule.’” *FDIC v. Willetts*, No. 7:11-cv-165-BO (E.D.N.C. Apr. 16, 2012); see also *FDIC v. Greenwood*, No. 1:11-cv-00337-MR-DLH (W.D.N.C.).

Oregon

D&O STANDARD OF LIABILITY – NEGLIGENCE OR GROSS NEGLIGENCE

Arizona


Illinois

AVAILABILITY OF CERTAIN AFFIRMATIVE DEFENSES

Pre-O’Melveny & Myers v. FDIC

- Affirmative defenses raised by bank D&Os in post-S&L crisis litigation were often rejected or stricken by courts because of so-called “no-duty” rule.
- The policy behind “no-duty” rule was that “any affirmative defense calling into question the pre- or post-bank closing action of the FDIC [is] insufficient as a matter of law because the FDIC owes no duty to the D&Os of a failed bank either in its pre-failure regulation of a bank or in its post-failure liquidation of the same.” FDIC v. Schreiner, 892 F. Supp. 848, 853 (W.D. Tex. 1985).
AVAILABILITY OF CERTAIN AFFIRMATIVE DEFENSES


• In O’Melveny & Myers v. FDIC, the Supreme Court rejected the premise of “federal common law,” upon which the FDIC had primarily relied in arguing that the “no duty” rule afforded it unique protections from affirmative state-law defenses.

• The Court held that neither federal policy nor FIRREA itself created a federal rule to protect the FDIC, concluding that “any defense good against the original party is good against the receiver.” Id. at 86.
AVAILABILITY OF CERTAIN AFFIRMATIVE DEFENSES

Recent decisions that have rejected “no-duty” rule:


- *FDIC v. Willetts*, No. 7:11-cv-165-BO (E.D.N.C. Oct. 3, 2012) (denying FDIC’s motion to strike affirmative defenses and holding “[t]hat after *O’Melveny*, ‘state law controls what defenses are available against the FDIC when the agency is acting as the receiver of a failed financial institution.’”).

AVAILABILITY OF CERTAIN AFFIRMATIVE DEFENSES

Recent decisions that have continued to accept “no-duty” rule:

• **FDIC v. Van Dellen**, No. 2:10-cv-04915-DSF-SH (C.D. Cal. Sept. 27, 2011) (barring defendants from raising certain affirmative defenses to extent they were based on FDIC’s post- or pre-receivership conduct, because the defenses could not have been asserted against the bank).


STATUTE OF LIMITATIONS

Generally, FDIC has three years from the date of receivership to bring claims of gross negligence or breach of fiduciary duty for claims that were viable on the date of the bank closing.

  - (i) in the case of any contract claim, the longer of: (1) the 6-year period beginning on the date the claim accrues; or (2) the period applicable under State law; and
  - (ii) in the case of any tort claim, the longer of: (1) the 3-year period beginning on the date the claim accrues; or (2) the period applicable under State law.

- **12 U.S.C. § 1821(d)(14)(B):** Date on which the SOL begins to run on any claim described in such subparagraph shall be the later of:
  - (i) the date of the appointment of FDIC as conservator or receiver; or
  - (ii) the date on which the cause of action accrues.
TOLLING OF STATUTE OF LIMITATIONS

In a recent decision, a court refused to enforce a tolling agreement to extend a statute of limitations comparable to the FIRREA provision.

ADVERSE DOMINATION & STATUTE OF LIMITATIONS

“To permit bank directors who control and dominate the affairs of a bank to benefit from their own inaction by finding that, as a matter of law, limitations run from the moment of their commission of improprieties, is a result which justice could not tolerate.” FDIC v. Bird, 516 F. Supp. 647 (D.P.R. 1981).


DISCOVERY AND ELECTRONICALLY STORED INFORMATION ("ESI")

Discovery disputes over ESI protocols are prevalent, with the FDIC seeking to impose cost-shifting for production of ESI.

Courts granting motions to compel and/or denying motions to impose cost-sharing on D&Os:

- **FDIC v. Baker**, No. 1:12-cv-4173-RWS (N.D. Ga. April 18, 2013);
DISCOVERY AND ELECTRONICALLY STORED INFORMATION ("ESI")

Courts entering ESI protocols that require cost sharing:


Other discovery disputes have arisen over whether the FDIC must produce documents from FDIC-C related to the regulatory oversight of the bank.

12 U.S.C. § 1821(o) provides: “whenever the [FDIC] has been appointed as receiver for an insured depository institution, the appropriate Federal banking agency shall make available all supervisory records to the receiver which may be used by the receiver in any manner the receiver determines to be appropriate.”
Courts that have compelled the FDIC to produce FDIC-C documents:

- *FDIC v. Galan*, No.12-cv-1029 (D.P.R. Apr. 9, 2013);

Courts that have declined to require the FDIC to produce FDIC-C documents:

The Failed Bank Crisis: Update On The Insurance Debate

Linda Kornfeld
Kasowitz Benson Torres & Friedman
lkornfeld@kasowitz.com
424.288.7902
Introduction

• Multiple years in to this event, what issues are driving the insurance discussion?
  ➢ Settlements/assignments
  ➢ Insured v. Insured exclusion
  ➢ “Loan Loss” exception
  ➢ Regulatory exclusion
  ➢ “Prior acts” exclusions/retroactive dates
USE OF SETTLEMENTS/ASSIGNMENTS TO MUTUALLY BENEFIT FDIC/EXECUTIVES

• Generally speaking the insurers, not the executives have the deep pockets.
• The FDIC seeks access to the insurance proceeds and has a deeper pocket to pursue coverage litigation.
• Executives should consider using the settlement/assignment approach to resolve the FDIC’s claims for minimal financial exposure.
USE OF SETTLEMENTS/ASSIGNMENTS TO MUTUALLY BENEFIT FDIC/EXECUTIVES

• FNB Nevada (D. Ariz.)
  ➢ Defendants and FDIC agreed to $20 million settlement.
  ➢ Defendants agreed to entry of consent judgment against them.
  ➢ Defendants assigned rights to insurance proceeds to FDIC.
  ➢ FDIC agreed not to execute on judgment.
USE OF SETTLEMENTS/ASSIGNMENTS TO MUTUALLY BENEFIT FDIC/EXECUTIVES

- IndyMac (C.D. Cal)—alternative approach
  - Defendants in Trustee litigation agreed to $35 million in settlements with Trustee.
  - Defendants and Trustee did not agree to consent judgments, instead:
    - Defendants assigned the insurance.
    - The parties agreed to dismiss the litigation.
    - But, dismissal was conditioned upon Trustee prevailing in coverage litigation.
USE OF SETTLEMENTS/ASSIGNMENTS TO MUTUALLY BENEFIT FDIC/EXECUTIVES

• The Benefit:
  ➢ FDIC or Trustee can get direct access to insurance.
  ➢ Defendants can avoid paying for settlement and coverage litigation.

• The Negative:
  ➢ Defendants may be required to have judgment entered against them.

• Practice Pointer:
  ➢ Insurer must have denied coverage for assignment to work.
  ➢ Insurers will argue that the settlement is collusive, so make sure that the settlement is arms length and reflects good faith evaluation of exposure.
Insured vs. Insured Exclusion

- Is underlying action “collusive”?  
- Does the policy contain a “bankruptcy trustee” carveout?  
- Is the FDIC truly acting as or on behalf of the “company”?  
- Is the FDIC a “genuinely adverse party”?  
- Is the FDIC acting as a creditor representing other creditors?  
- Is the exclusion at least “ambiguous” with respect to application to FDIC?
Insured vs. Insured Exclusion

Michigan Heritage Bank (E.D. MI 2012), insurer summary judgment motion denied:

“the FDIC has shown that some ambiguity exists in the insured vs. insured exemption [sic] due to the 'security holder exception,' the omission of a regulatory exclusion, and statements by plaintiff that regulatory suits, which might include the instant action are covered.”
Insured vs. Insured Exclusion

W. Holding Co., v. Chartis (D. P.R. 2012)

Exclusion inapplicable because:

- When regulatory agency asserts claims on behalf of both insured organization and third-party interests, its applicability is ambiguous.

- Purpose of exclusion is to deter collusion.

- Policy defined “organization” as named entity, each subsidiary and debtors in BK proceedings; none of which were the FDIC.
Insured vs. Insured Exclusion

Progressive v FDIC (N.D. Ga. 2013):
Exclusion inapplicable because:

- it is unclear whether the FDIC as receiver’s claims are “by” or “on behalf of” the failed bank.

- court cited multiple roles FDIC takes on in representing the insured, depositors, creditors, and shareholders to support conclusion that exclusion is ambiguous.
Insured vs. Insured Exclusion

Exclusion applicable:

- court relied upon O’Melvany & Myers, 512 U.S. 79 (1994) and concluded that the exclusion unambiguously applied.

- court rejected all arguments relied upon by other courts in finding the exclusion inapplicable.
Insured vs. Insured Exclusion


However:

- court expressly stated that its decision was based upon the policy language before it.

- if policy also includes regulatory exclusion, opinion may not apply.

- not binding authority.

- public policy argument still may apply.
Insured vs. Insured Exclusion

Policyholders should consider the various rulings on the issue when purchasing coverage and consider language to address the issue.
“Loan Loss” Exception

Loss Definition sometimes excludes: “any unrepaid, unrecoverable or outstanding loan, lease or extension of credit to any … Borrower.”

- insurers now looking at this exception as additional basis to deny coverage.
- is this language ambiguous?
- does it apply to individual loans to bank executive?
“Regulatory” Exclusion

- Since 2008 inclusion in at least community bank policies significantly increased.
- No impact if talking about claims by BK trustee or shareholder or derivative litigation.
- Do such exclusions create “illusory” coverage given the primary nature of the risks confronted by bank directors and officers these days?
“Regulatory” Exclusion

• Extensively litigated in S&L crisis, but not necessarily here.

• FDIC not necessarily pursuing cases with solid exclusion.

• Silverton—the question litigated there is whether the policy contains the exclusion.
   Insurer claims that it “inadvertently” failed to include the exclusion in the policy and seeks reformation.
   Insureds and FDIC argue against reformation and based upon the facts seek to enforce the policy as issued.
“Related Claims/Sub-Prime” Exclusions

• Potentially relevant when multiple lawsuits or claims made during different policy years.

• In 2008, insurers sought to “ring fence” failed bank exposure through “related claims,” “subprime” exclusions.

• Insurer effort to limit exposure to one policy period, thereby reducing available limits to insureds.
“Related Claims/Sub-Prime” Exclusions

- IndyMac (C.D. Cal)
  - Securities litigation in 2008 policy year.
  - FDIC and Trustee litigation in 2009.
  - Insurers rely on interrelated wrongful acts/prior litigation exclusion to force all claims into 2008 year and benefit from one limit.
  - The lawsuits are based on different acts, transactions, at different times, but court broadly applied exclusion.
  - On appeal to the 9th Circuit.
“Retroactive” Date/”Prior Acts Exclusion

- FDIC v. Gallan (D. P.R.)
  - Policy purported to exclude acts prior to 2007.
  - XL pursuing summary judgment to relate all events to pre-2007 date.
  - Separate loans/separate events.
Cases to Watch

- Silverton—I vs.I/Reg. exclusion
- IndyMac—Prior litigation exclusion
- Gallan—Prior Acts Exclusion
- St. Paul Mercury v. MillerUnpaid Loan Carve-Out” language.
Biography

Linda D. Kornfeld is a partner in the Kasowitz’s Litigation Department and a member of the Insurance Litigation and Counseling Practice. A nationally recognized insurance coverage litigator whom Chambers USA has described as one of “the best attorneys in California” for coverage litigation, Ms. Kornfeld has extensive trial and appellate experience representing corporate and individual policyholders in high-stakes litigation in California and across the country.

Ms. Kornfeld has assisted clients in obtaining substantial recoveries in various types of insurance matters. Linda presently is representing clients in Directors and Officers coverage litigation related to failed banks.

Ms. Kornfeld has been repeatedly cited as an exceptional insurance litigator and one of the top women lawyers in California by leading legal publications and directories, including Chambers USA, since 2007; and in 2011 she was included as one of Lawdragon’s top 500 “leading lawyers” in America, and named by Benchmark Litigation as a “Litigation Star” both nationally and in California. Ms. Kornfeld also has been recognized by the Daily Journal as one of California’s top 100 women litigators, by Business Insurance as one of the country’s “50 Women to Watch” in insurance, in Southern California Super Lawyers, as one of the top 50 women lawyers in Southern California. Ms. Kornfeld also is included in the Legal Media Group’s Guide to the World’s Leading Insurance and Reinsurance Lawyers.