

SPECIAL LIABILITY RISKS FOR DIRECTOR APPOINTEES TO BANKING ORGANIZATIONS

MARK V. NUCCIO, PAULO J. MARNOTO, AND EUGENE P. HWANG

This article describes potential sources of personal liability for directors of banking organizations that arise from federal banking laws and regulations, including as a result of common law causes of action, enforcement actions by federal regulators and statutory causes of action.

Private equity and hedge fund investment in the banking sector has increased with the prospect of obtaining superior returns as the economy recovers and asset values improve. While some sponsors and investors are seeking to control banking organizations,¹ accepting the regulatory burdens imposed on the industry, others more typically seek to structure their investments to avoid the acquisition of “control” of the bank or bank holding company in order to avoid becoming entities regulated by the Federal Reserve Board of Governors of the Federal Reserve System (the “FRB”) pursuant to the Bank Holding Company Act. In either case, controlling and non-controlling investors may find themselves in a position to appoint members to the board of directors of banking organizations in which they are invested. Individuals appointed to serve on the board of directors of a banking organization are subject to certain heightened legal requirements that differ from

Each of the authors is a member of the Banking Group of Ropes & Gray LLP. Mark V. Nuccio is a partner based in the Boston office and chairs the practice group. Paulo J. Marnoto is counsel and is based in the firm's Boston office. Eugene P. Hwang is an associate based in the Chicago office. The authors may be contacted at mark.nuccio@ropesgray.com, paulo.marnoto@ropesgray.com and eugene.hwang@ropesgray.com, respectively.

those generally applicable to corporate directors and are exposed to a greater risk of personal liability and enforcement actions by federal regulators.² And with looming regulatory reform proposals in Congress, the burdens of being a bank director are likely to become greater. This article describes some of those legal requirements.

COMMON LAW CAUSES OF ACTION AGAINST BANK DIRECTORS

As a general rule of corporate law, a corporation or its shareholders may bring a lawsuit against a director for breaches of fiduciary duties. Many private lawsuits against directors of banking organizations arise out of claims that the directors breached their fiduciary duty to the banking organization. Regardless of whether a banking organization is chartered by a state or by the federal government, the standard for determining the level of fiduciary duty applicable to directors of such banking organization and the defenses available to such bank directors are governed by state law.³ Furthermore, the Supreme Court has held that directors of banking organizations are not held to a greater duty of care than are directors of non-banking corporations.⁴ For the most part, therefore, the standard of care and the corresponding liability of a bank director for common law claims alleging breaches of fiduciary duties are equivalent to those facing directors of non-banking corporations.

One exception to the general applicability of state law standards of fiduciary duties results from the passage of the Financial Institutions Reform, Recovery and Enforcement Act ("FIRREA") in 1989, which, among other things, created a federal cause of action against directors of any depository institution insured by the FDIC for gross negligence, as that term is defined by state law.⁵ This cause of action has been interpreted to preempt state laws requiring a showing greater than gross negligence.⁶ States remain free to impose a stricter standard of liability, such as simple negligence, but for those states that would require conduct more culpable than gross negligence before finding a director of a corporation liable, bank directors will be held to the stricter standard of gross negligence by the operation of FIRREA.

ENFORCEMENT ACTIONS AGAINST BANK DIRECTORS AS INSTITUTION-AFFILIATED PARTIES

Enforcement actions brought by bank regulators⁷ against bank directors pursuant to §8 of the Federal Deposit Insurance Act (the "FDI Act")⁸ pose the most significant risk of personal liability for bank directors. Bank regulators have the authority to institute a broad range of enforcement actions against banking organizations and a nearly coextensive authority to institute enforcement actions against their Institution-Affiliated Parties ("IAPs").⁹ An IAP of an entity is defined to include any individual who participates in the conduct of the affairs of an institution; directors and officers of banking organizations fall squarely within the core of the definition.¹⁰ This section describes a number of the more significant enforcement actions that bank regulators may take against bank directors, as IAPs, that could result in personal liability, and concludes with a discussion of the limitations on indemnification of bank directors for expenses arising from such enforcement actions.

Civil Money Penalties

One potent enforcement tool of the federal bank regulators is their ability to assess civil money penalties ("Penalties") on IAPs for "violations"¹¹ of laws or regulations, violations of certain final orders issued by regulators, violations of written conditions imposed by regulators, violations of "written agreements entered into with the agency,"¹² breaches of fiduciary duty and "unsafe or unsound practices."¹³

Penalties are divided by statute into three tiers based on the activity giving rise to the Penalties and the level of culpability of the banking organization or its IAP. The first tier, which includes all violations of any law or regulation, of certain final orders issued pursuant to the bank regulator's enforcement authority, of written conditions imposed by a regulator, and of written agreements with regulators, allows bank regulators to assess Penalties of up to \$7,500 per day.¹⁴ Second-tier Penalties can be assessed in amounts of up to \$37,500 per day, and include (a) any misconduct that would result in a first-tier Penalty, (b) recklessly engaging in an unsafe or unsound practice or (c) breach of a fiduciary duty, with the additional requirement that such activity

(x) be part of a pattern of misconduct, (y) cause or be likely to cause more than a minimal loss to the banking organization or (z) result in pecuniary gain to the IAP.¹⁵ Third-tier Penalties allow the regulator to assess a Penalty on an IAP of up to \$1,375,000 per day. A regulator can assess a third-tier Penalty on an IAP by showing that such IAP (a) knowingly (b) committed any misconduct that would result in a second-tier Penalty, and (c) the IAP knowingly or recklessly caused a substantial loss to the banking organization or a substantial gain to himself resulting from such violation, practice or breach.¹⁶

Violations of certain provisions of the Federal Reserve Act,¹⁷ the National Bank Act¹⁸ and the Bank Tying Act¹⁹ also allow bank regulators to assess Penalties against IAPs, using the same three-tiered structure described above.

The assessment of Penalties, especially third-tier Penalties, can represent tremendous liability for an individual bank director. Moreover, when a bank regulator assesses a Penalty on a bank director, the banking organization on whose board the director serves is prohibited from indemnifying the bank director for the payment of that Penalty either directly or through a liability insurance policy; legal expenses arising out of such enforcement actions may be reimbursed through a liability insurance policy, but not directly by the banking organization. Even when such enforcement action is settled by a consent order in which the IAP does not admit wrongdoing, the consent order is typically conditioned upon the IAP not seeking or accepting any indemnification or reimbursement from the banking organization except as permitted by the FDIC's indemnification policy.²⁰ As a result, the cost of such Penalties, and potentially the associated legal fees, must be borne by such director personally.

Because of the higher elements of proof for second-tier and third-tier Penalties, however, outside directors who are not engaged in fraud are most likely to run afoul of first-tier Penalties. The FDIC's assessment of a first-tier Penalty on an outside director and member of the Audit Committee of Cornerstone Community Bank in 2003 is illustrative of the potential for unwitting personal liability against an outside director. The administrative law judge and the FDIC had found that certain of Cornerstone's interactions with its holding companies amounted to extensions of credit in violation of §§23A and 23B of the Federal Reserve Act.²¹ The administrative law

judge had accepted the outside director's claim that she did not know of the violations before being notified by the FDIC examiners and also her claim that, as an outside director, she could not have prevented the violations. In upholding the assessment of the Penalty, however, the Board of Directors of the FDIC noted that a first-tier Penalty may be assessed on a showing of a violation of law, and does not require a showing of knowledge or intent on the part of the IAP.²² The Board of Directors of the FDIC also stressed the fact that the FDIC examiners had repeatedly criticized Cornerstone for failing to implement an internal audit program, and that the outside director could have discovered and remedied the violations before the FDIC examiners discovered them if the Audit Committee had established the proper audit procedures and internal controls.²³ As the Cornerstone matter demonstrates, outside bank directors may be found personally liable for Penalties for failure to properly implement or oversee the internal controls of a banking organization, even in the absence of knowledge or bad faith on the part of the bank director.

Permanent Cease-and-Desist Orders

Bank regulators also have the authority to issue cease-and-desist orders against banking organization and their IAPs.²⁴ A bank regulator may seek a cease-and-desist order when it believes that an IAP has taken, is taking or will take any of the following actions: engaging in an unsafe or unsound practice; violating a law, rule or regulation; violating a written condition of a bank regulator; or violating a written agreement with a bank regulator.²⁵

In addition to orders not to engage in certain violations of law or unsafe or unsound practices, cease-and-desist orders may require the IAP to take affirmative actions to correct such violations or practices or to pay restitution to or reimburse, indemnify or guarantee the banking organization against loss.²⁶ A bank regulator may only seek restitution if the violation or practice resulted in unjust enrichment of the IAP or involved a reckless disregard for the IAP's legal obligations, which include applicable laws, regulations or prior orders of the bank regulator.²⁷ Although the bank regulators' authority to seek restitution is not limited to a set dollar amount as Penalties are, the amount of the restitution order may not exceed the bank's actual uncompensated loss.²⁸ Unlike Penalties,

amounts that bank directors are required to pay pursuant to a restitution order in a final cease-and-desist order may be indemnified by the banking organization through a liability insurance policy, although the banking organization may not directly indemnify the bank director for such restitution amounts.

Cease-and-desist orders requiring IAPs to pay restitution often also mandate that the IAP perform affirmative actions and/or desist from performing certain actions, and may also be combined with other enforcement actions. For example, in 2006 the OCC initiated prohibition, cease-and-desist and Penalty proceedings against the former president, CEO and director of Terrabank, National Association.²⁹ The executive entered into a consent agreement with the OCC that required that he:

- (1) indemnify the bank for 50 percent of any judgments entered against the bank with respect to certain allegedly unsafe guarantees made by the bank,
- (2) reimburse the bank for up to \$100,000 for professional services fees arising from such guarantees,
- (3) make separate restitution to the bank of \$406,927 for certain debt charged off by the bank,
- (4) pay a Penalty of \$100,000, and
- (5) not participate in the affairs of or act as an IAP of any banking organization.³⁰

As the Terrabank matter illustrates, cease-and-desist authority may be used in connection with other enforcement powers of the bank regulators. It also demonstrates the distinction between restitution payments and Penalties; while restitution payments are intended to make the bank whole, Penalties serve a means to deter certain types of behavior and are paid directly to the bank regulator.

Temporary Cease-and-Desist Orders, Asset Freezes and Prejudgment Attachment

Cease-and-desist orders may generally only be issued upon notice to the IAP and following a hearing at which the IAP has the opportunity to ap-

pear.³¹ If the bank regulator determines that the violation or practice may cause serious harm to the bank prior to the hearing, the bank regulator may issue a temporary cease-and-desist order pending completion of the permanent cease-and-desist proceeding.³² Temporary cease-and-desist orders may require the IAP to take any action authorized by a permanent cease-and-desist order, including the payment of restitution.³³ Bank regulators have used temporary cease-and-desist orders to freeze the assets of bank directors pending the outcome of permanent cease-and-desist proceedings, which courts have found to be within the statutory authority of the bank regulators.³⁴ Bank regulators can therefore temporarily freeze the assets of a bank director before such bank director has received notice or the opportunity to appear at a hearing, upon a determination by the bank regulator that certain violations or unsafe or unsound practices have occurred and that severe harm is likely to occur prior to the completion of permanent cease-and-desist proceedings. Because the amount of assets to be frozen by such a temporary cease-and-desist order relates to the amount of money that could be ordered as restitution pursuant to a permanent cease-and-desist order, such temporary cease-and-desist orders can require IAPs to post significant security and may prohibit the IAP from selling or encumbering any personal assets, except for a monthly allowance for reasonable living expenses. For example, in 2002, the FDIC issued a temporary cease-and-desist order against the former chairwoman of Connecticut Bank of Commerce, a failed bank, after the chairwoman was accused of insider abuse and fraud. The temporary cease-and-desist order required the chairwoman to post as security \$34 million and prohibited her from selling, transferring or encumbering any personal assets.³⁵

Bank regulators may also petition a court to issue a restraining order to aid in the enforcement of any administrative enforcement action, including permanent and temporary cease-and-desist orders. If the banking organization is not in receivership, a bank regulator may seek a restraining order prohibiting any person subject to an enforcement action from transferring or disposing of any funds, assets or property.³⁶ Once a banking organization has entered receivership, bank regulators have separate statutory authority to request prejudgment attachments of the assets of any person, even if no enforcement action is outstanding.³⁷ It is unclear to what extent a private equity or hedge fund sponsor or its investment vehicles could be held responsible

for a violation of any of the aforementioned laws or regulations by a director representative.

In order to issue a temporary cease-and-desist order freezing the assets of an IAP or to obtain a restraining order issued by a court freezing an individual's assets, the bank regulator must make a showing of facts required by Rule 65 of the Federal Rules of Civil Procedure, although no showing of irreparable injury must be made.³⁸ Rule 65 requires a showing of injury, loss or damage that is immediate and irreparable and a separate showing that notice to the non-moving party should not be required.³⁹ The court in the Connecticut Bank of Commerce matter found the standard to be satisfied when the FDIC made a prima facie showing that the chairwoman was responsible for the bank's loss, supported by sworn declarations.⁴⁰

In the event that a bank director violates a permanent or temporary cease-and-desist order, the bank regulator may seek an injunction from a United States district court to enforce the order,⁴¹ or may assess a Penalty for violation of the cease-and-desist order. As with all Penalties, the amount of the Penalty will depend on the culpability of the IAP and the degree to which such violation threatens harm to the banking organization.

Removal, Prohibition and Suspension Orders

Bank regulators have the authority to issue orders removing or suspending bank directors from office and prohibiting them from participating in the affairs of any banking organization in the future.⁴² Although a comprehensive discussion of the means by which an IAP may be subject to such a removal or prohibition order is beyond the scope of this article, the bank regulator must generally find (a) that the IAP violated a law or regulation, a final cease-and-desist order, a written condition imposed by a bank regulator or a written agreement with an agency, engaged in an unsafe or unsound practice or violated a fiduciary duty, (b) that the banking organization has or will suffer financial loss or damage, the interests of the banking organization's depositors will be prejudiced or the IAP has financially gained from such act and (c) that such act involves personal dishonesty or demonstrates willful or continuing disregard for the safety of the banking organization.⁴³ Although removal and prohibition orders may only be issued upon notice to the IAP

and following a hearing at which the IAP has the opportunity to appear, a bank regulator can issue a suspension order pending such hearing if it determines that such order is necessary to protect depositors.⁴⁴

Although such removal and prohibition or suspension orders do not expose bank directors to separate liability, violation of such orders can result in Penalties, enforcement actions in federal district court or criminal penalties of up to five years in prison and \$1,000,000 in fines.⁴⁵

Restrictions on Indemnification of Bank Directors

Certain regulations promulgated by bank regulators place restrictions on the extent to which directors of banking organizations may be indemnified by such banking organizations for violations of enforcement actions brought under §8 of the FDI Act. Most significantly, in 1996, the FDIC promulgated regulations under the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990 limiting indemnification of bank directors for expenses arising out of administrative or civil proceedings instituted by bank regulators.⁴⁶ The regulation applies to all depository institutions insured by the FDIC, as well as to their holding companies and subsidiaries.⁴⁷ Subject to certain exceptions, such insured depository institutions are prohibited from making "prohibited indemnification payments" to IAPs.⁴⁸

"Prohibited indemnification payments" are defined as indemnification payments by a banking organization to an IAP or former IAP to reimburse such IAP or former IAP for any liability or legal expense resulting from any administrative or civil action instituted by a federal banking agency that results in (a) the assessment of a Penalty,⁴⁹ (b) the removal from office or prohibition from participation in the conduct of the affairs of the banking organization⁵⁰ or (c) a cease-and-desist action or required affirmative action, including restitution payments.⁵¹ The prohibition of indemnification for expenses arising out of the circumstances listed above is a more strict standard of indemnification than the standard employed by Delaware for indemnification of directors generally, which permits a corporation to indemnify directors even if found liable (a) for third party civil actions if the director acted in good faith and in a manner reasonably believed to be in the best interests of the corporation, or (b) for criminal actions if the director had no reasonable

cause to believe his actions were unlawful.⁵²

The definition of “prohibited indemnification payments” includes two important exceptions: (1) a banking organization may purchase commercial insurance in the form of fidelity bonds, the proceeds of which may be used to pay for any fees or expenses, including restitution payments required by an enforcement action, but excluding judgments or Penalties, and (2) partial indemnification in the event that some of the underlying bases for the enforcement action are proven or admitted and others are not.⁵³ Additionally, a banking organization may make reasonable advance indemnification payments to IAPs who face administrative proceedings or civil actions, but only if:

- (1) the board of directors determines that the IAP acted in good faith and in a manner believed to be in the best interests of the banking organization,
- (2) the board of directors determines that the indemnification payment will not materially adversely affect the banking organization’s safety or soundness,
- (3) the payment is not a prohibited indemnification payment, and
- (4) the IAP agrees in writing to reimburse the banking organization in the event he or she is found to have violated a law, regulation or fiduciary duty.⁵⁴

However, it seems unlikely that a board would authorize advancement in the context of any alleged violation of the applicable banking laws or regulations given the seriousness of the allegations. Moreover, if a bank director is found liable in a final judgment or Penalty, the bank is not permitted to indemnify the director, either directly or through liability insurance.

The OCC has also promulgated regulations governing the indemnification of IAPs of national banks that are consistent with the FDIC’s regulations. For expenses arising from a civil or administrative enforcement proceeding initiated by a federal bank regulator, the OCC’s rule allows indemnification that is reasonable and consistent with the FDIC’s indemnification policy.⁵⁵ For expenses arising from civil or administrative actions not initiated by a federal bank regulator, indemnification is governed by state law.⁵⁶