COUNSELOR'S CORNER

Lessons From the Wake of Economic Collapse:

Avoiding Personal Liability in Loan Origination and Restructuring

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Although today's lending economy continues to follow a fairly steady path toward stability, the recent economic downturn has given rise to an increasing number of lawsuits by the Federal Deposit Insurance Corporation ("FDIC") seeking to impose personal liability against directors and officers of failed financial institutions.

In 2009, the FDIC received authorization to pursue 11 lawsuits against directors and officers for personal liability, while in 2012, the FDIC received authorization to pursue 369 personal liability lawsuits against directors and officers. As of April 15, the FDIC was on pace to authorize more than 400 lawsuits against directors and officers of failed institutions this year.

Officers of Washington banks have made some of the most recent headlines in this arena. For instance, on April 15, the FDIC filed a complaint in the U.S. District Court for the Western District of Washington against former officers of former Lynnwood-based City Bank. *(Federal Deposit Insurance Corporation as Receiver for City Bank v. Hanson, et al.*, U.S.D.C. W.D. Wash. No. 2:13-cv-00671.) In that case, the FDIC seeks to recover more than $41 million in damages from the officers and directors of City Bank personally based on breach of fiduciary duty, gross negligence, and unsafe and unsound banking practices. On April 26, the FDIC filed another complaint in the U.S. District Court for the Western District of Washington, this time against former officers of Everett-based Frontier Bank. *(Federal Deposit Insurance Corporation as Receiver for Frontier Bank v. Clementz, et al.*, U.S.D.C. W.D. Wash. No. 2:13-cv-00737.)

These cases rely on state and federal law, including 12 U.S.C. § 1821(k),which expressly provides that directors and officers of a failed institution "may be held personally liable for monetary damages in any civil action" by the FDIC as receiver for the failed bank." However, it is also important to note that the FDIC's ability to recover personal damages from bank employees extends beyond the officers and directors of failed institutions.

For instance, under 12 U.S.C. § 1818(b), the FDIC may also issue cease-and-desist orders to certain "institution-affiliated parties"—regardless of whether the institution has failed—if the affiliated party has either engaged in "unsound or unsafe practices" or violated federal banking law. Notably, the definition of "institution-affiliated party" includes employees or other "agents" of financial institutions. (12 U.S.C. § 1813(u)). Section 1821 further permits such a cease-and-desist order to require the employees to "take affirmative action to correct the conditions resulting from any such violation or practice," which courts have applied to impose personal liability on bank employees. (12 U.S.C. § 1821(b)(1); *del Junco v. Conover*, 682 F.2d 1338, 1341-44 (9th Cir. 1982)).

Although the FDIC has not invoked Section 1818 as regularly as it has invoked Section 1821(k), anyone employed by financial institutions must remain keenly aware of this provision. For instance, one area where these issues can arise is in the context of debt origination or restructuring. When lenders originate loans or where borrowers seek to restructure troubled debts rather than pursue liquidation, adherence with a bank's lending policies and procedures can be extremely important.

Along these lines, the complaints in the *City Bank* and *Frontier Bank* cases, as well as other similar lawsuits, provide guidance on ensuring sound and safe banking practices. For instance, in those cases, the FDIC has asserted

▶ **ECONOMIC COLLAPSE** — continued on page 12

▶ **ECONOMIC COLLAPSE** — continued from page 11

personal liability against directors and officers based on (among other things):

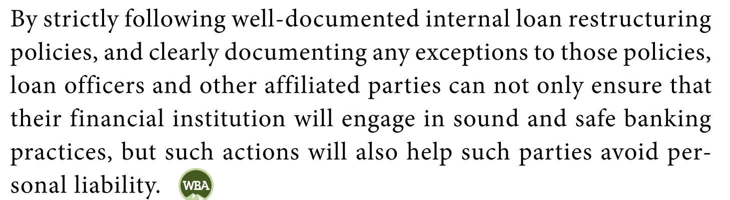
- Providing loans to borrowers who fail to concretely demonstrate ability to repay through earnings and cash flow.
- Failing to sufficiently explore information regarding applicable risks of extending credit, such as failing to adequately follow up on red flags raised by appraisals or credit reports.
- Approving loans to borrowers with "excessive liabilities."
- If banks elect to make exceptions to lending policies, then the banks should make sure that the grounds for such exceptions are thoroughly documented—ideally, at a minimum, in loan committee meeting minutes.
- Banks should ensure that borrowers can clearly demonstrate their ability to repay through earnings and cash flow analysis.
- Banks should regularly monitor the status of borrowers' markets.
- Banks should obtain appraisals of collateral from independent and reputable sources, consistent with federal law, and follow up on any red flags that the appraisal may raise.

By strictly following well-documented internal loan restructuring policies, and clearly documenting any exceptions to those policies, loan officers and other affiliated parties can ensure that their financial institution will engage in sound and safe banking practices.

- Approving loans outside the bank's written loan policies, without following proper procedures to obtain approval of such exceptions.
- Failing to adequately monitor the borrower's market through independent investigation and analysis.
- Failure to sufficiently collateralize the loan.
- Failing to obtain independent appraisals of collateral.

In today's lending market, with the FDIC taking an increasingly aggressive stance with respect to personal liability of bank directors and officers, it is especially important for banks to ensure implementation of sound practices and procedures regarding loan origination and restructuring. Among the key take-away lessons from *City Bank*, *Frontier Bank*, and others are:

- Banks should ensure that all employees have recently reviewed their current lending policies regarding credit restructuring.
- Banks should implement strong practices and procedures to enforce broad compliance with current lending policies, or provide clear paths to exceptions to those policies.



By strictly following well-documented internal loan restructuring policies, and clearly documenting any exceptions to those policies, loan officers and other affiliated parties can not only ensure that their financial institution will engage in sound and safe banking practices, but such actions will also help such parties avoid personal liability.

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