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LEGAL ALERT

April 5, 2011

FDIC Seeks to Flex Muscles Notwithstanding Large Investigative Backlog

In March, the Federal Deposit Insurance Corporation (FDIC) sent clear signals of the aggressive posture it intends to take against the officers and directors of failed and troubled financial institutions, using tools both new and old.

First, the FDIC announced a Notice of Proposed Rulemaking for rules establishing the mechanism by which the FDIC can recover compensation that was paid to officers and directors of covered financial companies that subsequently fail. This implements the expansive new authority granted to the FDIC by last year's Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

Second, the FDIC filed a lawsuit against several former executives of Washington Mutual Bank (WaMu), which failed catastrophically at the height of the 2008 financial crisis. Demonstrating the extent of its power as receiver for the bank, the FDIC also named the wives of two former WaMu executives in the lawsuit. More significantly, the FDIC also sought a preliminary order freezing the individuals' personal assets, a highly unusual and aggressive step to take early in civil professional liability litigation.

Proposed Rules Addressing Executive Compensation Clawback

On March 15, 2011, the FDIC released a Notice of Proposed Rulemaking describing a framework by which the FDIC as receiver may claw back compensation from executives and directors of failed financial companies. Under the Dodd-Frank Act, covered financial companies are those companies that are resolved by the FDIC under the orderly liquidation provisions of Title II of the Act. This includes firms that derive 85 percent of their revenues from financial activities, but specifically excludes depository institutions, government sponsored enterprises, and government entities.

Section 210(s) of the Dodd-Frank Act allows the FDIC to recover compensation for the two-year period preceding receivership based on a determination that executives or directors were "substantially responsible" for the failure of the covered financial company. In cases involving fraud, clawbacks may apply to an unlimited time period. For the purposes of the proposed rule, compensation is defined as including not only salaried income but also any bonuses, incentives, benefits, deferred compensation, and other direct or indirect financial remuneration received from the company.

The recent proposed rule provides the FDIC a framework for determining whether individual executives and directors were "substantially responsible" for the financial condition of their companies and therefore subject to the compensation clawbacks. The proposal also includes a presumption of responsibility for the failed financial condition in the cases of some top executives and officers.

<u>Substantially Responsible</u>

Under the proposed rule's framework, the FDIC will first examine an executive's or a director's performance of their duties and responsibilities leading up to the financial company's failure. A determination that the executive or director exhibited the skill and care required of their position relieves the executive or director from the threat of recoupment of compensation. As the FDIC stated in its proposal for the new rules, "the health of the financial industry depends on these persons remaining committed to the industry."

On the other hand, if the FDIC determines that the executive or director failed to exhibit the requisite degree of skill and care, the FDIC will next inquire as to the impact of that failure on the financial company. If the financial company suffered a loss, and that loss is deemed to have been caused by the individual or collective failure by the executive or director, then the executive or director may be held responsible and face recoupment of wages. This judgment, of course, is made with the benefit of hindsight. The FDIC is soliciting comments on potential benchmarks used to evaluate whether a loss to a financial company contributed to its failure, and has suggested examining assets, net worth, and capital.

Presumption of Responsibility

Certain executives and officers may be *automatically* presumed substantially responsible for the financial condition of the company if the executive or officer is the chairman of the board of directors, chief executive officer, president, or chief financial officer. Additionally, even if the individual does not hold one of these named positions, the presumption of substantial responsibility may apply if the executive or officer carries out a similar role or was responsible for "the strategic, policymaking, or company-wide operational decisions of the covered financial company."

The presumption is rebuttable upon a showing that the individual performed his or her duties with the level of skill and care required by the position. The burden, however, is on the individual to demonstrate that his or her performance was adequate. The presumption of substantial responsibility also applies to executives or officers found liable for breach of his or her duty of loyalty to the financial company and to executives and officers whom the FDIC removed from their position. In this case the presumption can be rebutted only by a showing by the officer or executive that he or she did not cause, either individually or with others, any loss to the financial company.

Under the proposed rule, the presumption does not apply to those senior executives or directors who are employed for the specific purpose of improving a company's financial condition within two years of the FDIC receivership. These officers and directors may still be subject to compensation clawbacks, however, should the FDIC establish that they are substantially responsible for the company's financial failure. Written comments on the proposed rule must be received by the FDIC not later than May 23, 2011.

Washington Mutual Lawsuit

On March 16, 2011, the FDIC, acting in its role as Receiver of WaMu, filed a complaint in federal court in the state of Washington against three former officers of WaMu and against the wives of two of the officers. The FDIC is seeking unspecified damages, reportedly upwards of $900 million, from former CEO Kerry Killinger and his wife, from former COO Stephen Rotella and his wife, and from former home-loans president David Schneider.

The suit alleges gross negligence, ordinary negligence, and breach of fiduciary duty on the part of the officers in connection with WaMu's home lending program, as well as fraudulent conveyances of the officers' personal assets. This is the sixth lawsuit the FDIC has filed in the latest round of failed bank litigation, and in several respects indicates a new willingness on the part of the FDIC to employ hardball tactics.

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Though the small sample of lawsuits to date cautions against drawing firm conclusions about the FDIC's future plans, there is ample reason to believe the FDIC is sending a message that it plans to litigate aggressively throughout the spectrum of failed institutions. Of the 158 directors and officers against whom the FDIC has already authorized lawsuits,[1] fewer than 50 directors and officers have been named as yet.

Targeting the Spouses

Unlike the other five cases the FDIC has filed in the past year, the WaMu suit targets not just former officers, but their spouses as well. In so doing, the FDIC has looked beyond the scope and performance of the officers' duties to the bank, and instead targeted several transactions involving the officers' personal assets in the midst of the bank's failure.

The suit alleges that in August 2008, Killinger and his wife transferred ownership in their California and Washington residences to irrevocable trusts for which they retained trusteeship and possession. Similarly, the suit alleges that in March or April 2008, Rotella and his wife transferred ownership in their New York residence to an irrevocable trust for which they retained trusteeship and possession. The suit also alleges that Rotella transferred more than $1 million to his wife after WaMu's failure in September 2008.

The FDIC alleges these transfers were fraudulent attempts to protect these assets from the officers' "present and future creditors," noting that at the time of the transfers, Killinger and Rotella had already been named in "numerous lawsuits." The FDIC also argues that by the time of his transfers, Killinger had been removed from his position as Chairman of WaMu's board and WaMu was in the midst of a $9 billion "run on the bank."

Freezing Assets

Furthermore, the FDIC is asking the court to freeze the assets that it alleges Killinger and Rotella fraudulently transferred, as well as requiring both Killinger and Rotella to provide 30 days' notice to the FDIC before attempting to transfer any remaining assets of $10,000 or more. The FDIC wants the injunction to continue throughout the litigation and in any subsequent judgment for the FDIC.

In making this demand, the FDIC argues that a preliminary injunction freezing these assets is proper in light of the officers' efforts to transfer their assets in 2008 and the "insufficient" amount of assets remaining to satisfy a judgment for the FDIC.

Other Considerations

The FDIC is taking this hard line despite the fact that the closure of WaMu required no use of the Deposit Insurance Fund and resulted in no loss to the bank's uninsured depositors. The proceeds of any judgment for the FDIC thus are not needed to reimburse the insurance fund, but would instead accrue to the receivership and largely be used to repay the bank's creditors.

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[1] For information on the FDIC's Professional Liability Lawsuits, please see http://www.fdic.gov/bank/individual/failed/pls/index.html.

Several factors may be influencing the FDIC's aggressive posture in this case. WaMu remains the largest bank failure in U.S. history, with assets of $307 billion and total deposits of $188 billion at its closure in September 2008. Furthermore, the failure was extraordinarily high profile, occurring at the height of the recent financial crisis, and was followed a month later by tense negotiations over the proposed government bailout that became the Troubled Asset Relief Program, or TARP.

The aftermath of WaMu's failure has also been noteworthy for its contentiousness. WaMu's former holding company has filed suit against the FDIC and JPMorgan Chase seeking billions of dollars in damages, alleging in part that the FDIC sold WaMu for less than it would have been worth in liquidation. Both the FDIC and JPMorgan Chase have countersued, and the litigation is ongoing.

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If you have any questions regarding this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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