



COMMUNITY BANK LENDING

Practices and Failures, and the
Role of Directors and Officers
(D&O) Liability Insurance

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Executive summary



The economy is recovering, but for many community banks, it is too little too late. Plagued by bad construction and commercial real estate loans, largely put on the books during the early and mid-2000s, many have shuttered their doors, and others teeter at the brink of disaster. In order to maximize recoveries for failed banks, the Federal Insurance Deposit Corporation (FDIC) is increasingly pursuing legal actions against their directors and officers. Directors and officers of distressed and failed banks also may face lawsuits from investors and other stakeholders, and publicly-traded community banks may face

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investigations and enforcement actions from the Securities and Exchange Commission. The last line of defense for certain claims against many of these banks and their directors and officers may be their Directors and Officers (D&O) Liability insurance.

Introduction

In what would prove to be an early signal of the chaos that would engulf the international banking system, on February 7, 2007, multinational banking and financial services company HSBC announced it expected to see larger than anticipated losses from rising defaults of subprime mortgages in the United States. In a remarkably short period of time, the collapse of the subprime mortgage market surged throughout the global financial markets, claiming victims from not only those organizations that held bad mortgages directly, but especially from the many investors in securities backed by those mortgages. Lending ground to a near-halt in a badly rattled banking system, and the U.S. economy was thrust into the worst slow-down since the Great Depression.

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The meltdown of the U.S. subprime mortgage market had severe repercussions for banks throughout the world. On Main Street America, however, community banks largely avoided the subprime debacle. Community banks, in fact, were viewed as potentially an important part of the recovery process. “We could see a renaissance in Main Street banking,” said Sheila Bair, FDIC chairman, to the audience at a 2007 American Community Bankers Association convention. “So while you haven’t been part of the current problem ... you can now be a BIG part of the solution.”¹

From mid-2008 through 2010, the strongest of the smaller banks did in fact increase their lending.² However, despite the fact that community banks did not typically lend to subprime home buyers, many were pummeled by the credit crisis and ensuing recession triggered by the implosion of the subprime mortgage market. A large number of community banks had embraced construction and development lending as well as commercial real estate (CRE) lending in the early and mid-2000s. Construction came to a near standstill in many regions, leading to a surge in construction and development loan defaults. Soon afterwards, CRE delinquencies and defaults skyrocketed. Many community banks found themselves in deep trouble, and a growing number failed.

Not surprisingly, a wave of litigation ensued, and continues to grow. As of May 15, 2012, the FDIC had authorized suits in connection with 63 failed banks against 549 individuals for directors and officers liability. Twenty nine of those suits have been filed, naming 239 former directors and officers.³

The Plague of Construction & Development and Commercial Real Estate Loans

Consumer credit, credit cards and home mortgages were once the bread and butter of Main Street banks. But due to an increase in competition for these products by Wall Street banks and, especially, by unregulated mortgage companies, many community banks turned to construction and development loans and commercial real estate loans.

While construction and development and commercial real estate loans initially seemed quite profitable, community banks were left in a precarious situation when the economy slowed. Construction and development loans were the first to see delinquencies and defaults rise, but commercial real estate loans emerged as the principal driver of non-performing loans in the third quarter of 2009.⁴

Bank failures rose sharply in 2008, from 3 to 25, and then rocketed to 140 in 2009 and 157 in 2010. Failures declined in 2011 to 92, but still were at a highly elevated level.

Community banks have now significantly reduced their exposure to commercial real estate lending, sometimes through heavy write-offs of problem loans. However, many remain vulnerable to further deterioration in real estate markets. Based on FDIC criteria, 26.7 percent of community banks remain overexposed to CRE loans.⁵ Compounding the seriousness of the situation, the delinquency rate for U.S. commercial real estate loans remains stubbornly high. The 90-plus-day delinquency rate for commercial mortgages held by FDIC-insured banks and thrifts fell 0.13 percentage points in the first quarter this year, but remains at an elevated 3.44 percent.⁶

Community Bank Failures

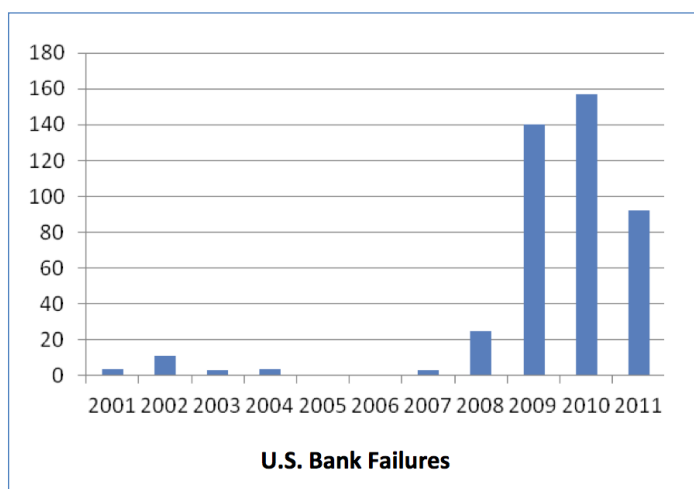
Bank failures rose sharply in 2008, from 3 to 25, and then rocketed to 140 in 2009 and 157 in 2010. Failures declined in 2011 to 92, but still were at a highly elevated level. Many of these failures were community banks. An analysis of the banks that failed in 2010 found

that, of the 157 bank failures, about 83 percent involved institutions with less than \$1 billion in assets and about 29 percent involved institutions with less than \$100 million in assets.⁷ It should be noted that, although the number of failures skyrocketed during 2009-2010, at their highest point failures represented less than 2 percent of total banks.⁸

Recent bank failures are not evenly distributed across the country. By state, California, Florida, Washington, Georgia and Illinois lead the way, while by region, the South has, by far, experienced the most failed banks. Failures are largely concentrated in those regions that experienced highly distressed real estate markets and large declines in economic activity,⁹ though other factors

were significant on a region-by-region basis.

Another measure of the health of the banking sector is the FDIC's problem bank list, which peaked at 888 on March 31, 2011. The FDIC considers a bank a "problem institution" when it is rated either a 4 or 5 on the FDIC's one-to-five scale of supervisory concern. As of that same date, there were 7,574 insured institutions in the United States,¹⁰ meaning that at that point in time more than 11 percent of U.S. banks were on the list. The number of problem banks remains a very high level, but it is decreasing. As of the end of the first quarter of 2012, there were 772 problem banks, the lowest number since year-end 2009.¹¹ Nonetheless, this still represents about 10.5 percent of all reporting institutions.



In the past, the FDIC usually only brought suits alleging that officers and directors of failed banks acted with gross negligence or intentionally committed actionable conduct.

The current surge in bank failures is often compared to the savings and loan (S&L) crisis of the late 1980s and the early 1990s, in which 2,912 financial institutions failed. While there are some similarities, there are even more differences between the two events. The S&L crisis was an outcome of tax reform, deregulation, brokered deposits, imprudent real estate lending and, in some cases, outright fraud.¹² At the root of the present situation, however, was an unsustainable appreciation in home prices. While a few isolated voices were warning of impending economic doom, most people, including bankers and regulators, were unaware of the existence of the housing bubble. The collapse of the housing market triggered a credit crunch and, subsequently, a deep recession, which were factors underlying most of the recent failures. Although some community banks had broadened their risk appetites and loosened their underwriting standards, many analysts agree that the abysmal economic situation was the principal driver of the surge in bank failures.

Directors and Officers Litigation

The FDIC has been conducting dozens of investigations of former executives, directors and employees of failed banks. Hundreds of “demand” letters have been sent, putting them on notice of potential claims. The number of lawsuits is rising sharply.

“Lawsuits brought by the FDIC against former directors and officers of failed banks are instituted on the basis of detailed investigations,” according to the FDIC’s Statement Concerning the Responsibilities of Bank Directors and Officers. “Suits are not brought lightly or in haste.”¹³ Some observers, however, believe that an overwhelmed FDIC is falling short of its avowed standards in this most recent round of suits. According to these critics, the FDIC is taking more of a shotgun approach, and is targeting the directors and officers of community banks with little regard as to any alleged culpability.

In the past, the FDIC usually only brought suits alleging that officers and directors of failed banks acted with gross negligence or intentionally committed actionable conduct. In the new crop of suits, some defense lawyers assert the FDIC is making claims reflecting a much lower standard. For example, in many suits the FDIC has accused directors of permitting their bank to maintain a loan portfolio overly concentrated in commercial and construction real estate loans¹⁴ – which was perhaps imprudent, but likely not rising to the level of gross negligence. Additionally, the FDIC is bringing suits against the directors and officers of banks for which it had affirmed their overall sound condition and risk management prior to failing by assigning high CAMEL ratings. CAMEL represents (C) Capital, (A) Asset quality, (M) Management, (E) Earnings, and (L) asset Liability management. According to attorneys

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James Manley and Jay Shah of McKenna Long & Aldridge, if the FDIC now claims that the directors and officers of these failed banks are responsible for the banks' demise, it stands to reason the FDIC also should take responsibility for the situation since, by issuing now seemingly inflated CAMEL ratings, it failed to "properly exercise its backup supervisory authority."¹⁵

A number of legal experts express concern that the FDIC is conducting a retroactive review of a failed bank's loan portfolio, internal loan policies, and specific lending transactions to make a case that "some form of improper conduct, on the part of bank leadership caused, or helped cause, the bank's failure."¹⁶ Attorney Harold Reichwald of Manatt, Phelps & Phillips notes that "In many ways, the FDIC is attempting to substitute its after-the-fact judgment for that of the board made in real time."¹⁷ Daniel O'Rourke, Cody Vitello, Randall Lending and Daniel McKay, II of Vetter Price concur: "The FDIC and other regulators have unfairly benefited from 20/20 hindsight in their PL [professional liability] allegations.... Essentially, directors and officers are victims not of what they did, but of what they did not predict—a ubiquitous and precipitous collapse in real estate values."¹⁸

As previously noted, between January 1, 2007 and May 15, 2012, the FDIC authorized suits against 549 individuals representing 63 failed institutions, many of which are community banks. Of those 549 former directors and officers, 239 thus far have been named as defendants in 29 lawsuits. Two of those suits have been dismissed after settlement with the named directors and officers. The pace of filings is accelerating: 11 of the 29 suits were filed in the first five months of 2012. NERA Economic Consulting predicts that the directors and officers of 20 percent of the failed banks – 86 in total – will face lawsuits brought by the FDIC. NERA projects aggregate recoveries of about \$1.9 billion.¹⁹

Not reflected in the above numbers are settlements made before the FDIC files a suit. In some cases, a demand letter is sufficient to prompt directors and officers, and their D&O insurers, to seek a favorable settlement to avoid litigation altogether.

In addition to suits brought by the FDIC, failed banks are vulnerable to lawsuits brought by investors and other stakeholders. For example, two suits filed by shareholders of failed Sonoma Valley Bank in California against its directors allege the bank was brought down by unnecessarily risky lending activity, including nearly \$55 million in loans to a local developer and his associates. Allegations include violations of fiduciary duties to Sonoma Valley Bancorp and its shareholders, making false and misleading statements about the condition of the bank's business, and violations of lending standards of practice as well as legal lending limits. The value of the bank's stock fell from \$31 a share in 2007 to less than a penny after the bank's seizure on Aug. 20, 2010.²⁰

While directors and officers of failed community banks are facing difficult times today, some lawyers contend that many have strong defenses against FDIC claims.

Most publicly traded banks also have been potential targets of investigations and regulatory enforcement actions by the SEC. The largest of these continue to be at risk. While not a typical community bank, Texas-based Franklin Corp provides an example of potential SEC actions in the sector. Franklin Bank Corp. was characterized by Bloomberg as “the bank holding company for Franklin Bank, S.S.B., a savings bank that provided community banking products and services, and commercial banking services to corporations and other business clients, and originates single family residential mortgage loans primarily in Texas.”²¹ On November 12, 2008, Franklin Bank Corp. filed a voluntary petition for liquidation under Chapter 7 in the U.S. Bankruptcy Court for the District of Wilmington, Delaware. On April 6, 2012, the SEC filed a complaint alleging that two former officers engaged in a fraudulent scheme designed to conceal the bank’s deteriorating loan portfolio and inflate its earnings at the early stages of its financial crisis. The SEC alleges that in order to conceal the bank’s rising loan delinquencies and improve its earnings for the third quarter of 2007, the officials instituted several schemes by which non-performing loans were reclassified as performing.²²

Many community banks are now taking advantage of a new law that allows them to deregister with the SEC. The JOBS (Jumpstart Our Business Startups) Act, signed into law by President Obama on April 5, 2012, raises the threshold for triggering registration with the SEC from 500 to 2,000 shareholders of record for banks and bank holding companies. While many smaller banks claim to be taking advantage of this provision of the JOBS Act to relieve them of burdensome and expensive paperwork, it has the added benefit of enabling them to avoid some securities law tripwires.

While directors and officers of failed community banks are facing difficult times today, some lawyers contend that many have strong defenses against FDIC claims. O’Rourke, Vitello, Lending, and McKay, for example, note that the “pervasive lack of premonition or precognition [of the collapse of the housing market] may be the difference that reduces or eliminates the ultimate culpability of failed-bank directors and officers today and which may ultimately lead to victory in the courtroom or at the negotiating table in the future.”²³

D&O Insurance

Many banks purchase directors and officers liability insurance (D&O) to indemnify the bank and its directors and officers for the costs of certain investigations and lawsuits, but some experts note that the availability of coverage for FDIC actions may rest on whether the bank’s D&O policy contains a regulatory exclusion or other relevant provisions, exclusions, or endorsements. Attorney Joseph Monteleone of Tressler LLP notes that in D&O coverage dis-

According to Maryann F. Hunter, Deputy Director, Division of Banking Supervision and Regulation, many community banks “remain vulnerable to further deterioration in real estate markets.”

putes arising during the S&L crisis, courts widely agreed that policies with regulatory exclusions did not provide coverage for suits brought by the Federal Savings and Loan Insurance Corporation (FSLIC). Monteleone also notes, however, that since the 1990s many insurers dropped the regulatory exclusion from their policies.²⁴

Under any circumstances, D&O insurance is essential for banks and their directors and officers. D&O insurance may provide coverage for certain claims against insured persons for wrongful acts committed while acting in their capacity as directors and officers of the bank. In addition to providing indemnification for settlements and judgments resulting from certain lawsuits, D&O insurance may also provide coverage for the costs of defending certain suits – which can exceed the cost of a settlement. Banks also should consider so-called Side A coverage for their directors and officers, which covers certain non-indemnifiable claims, and which often provides broader coverage than that available under a traditional D&O policy.

Distressed banks may have difficulty finding D&O coverage, but the market for healthy community banks remains robust. Banks should work closely with their brokers to assure they are buying appropriate coverage from financially secure insurers with expertise in financial institutions.

Conclusion

Community banks largely avoided problems with the subprime mortgage market meltdown that threw world financial markets into chaos, but the credit crunch and recession that followed led to skyrocketing delinquencies and defaults of construction and commercial real estate loans. The number of bank failures, and the number of banks on the FDIC’s problem bank list, is declining, but many community banks are not yet out of the woods.

According to Maryann F. Hunter, Deputy Director, Division of Banking Supervision and Regulation, many community banks “remain vulnerable to further deterioration in real estate markets.” They will “continue to face a challenging environment for some time as they work through financial difficulties brought on by the economic downturn.”²⁵ Community bank executives have shifted their lending strategies away from real estate related loan products and toward business lending, but the legacy of CRE lending continues to be a significant challenge to the sector. Defaults on CRE loans remain elevated and, despite write-downs and a return to more conservative underwriting standards, many banks remain highly exposed to these loans.

D&O insurance is essential, but the terms of coverage can vary widely among insurers.

Hand-in-hand with the threat of insolvency is the threat of regulatory investigations, civil lawsuits and criminal lawsuits. After a quiet couple of years, during which the FDIC was building cases against the directors and officers of failed banks, the number of lawsuits brought by the regulator grew sharply in 2011 and is increasing rapidly in 2012. Publicly traded community banks also may be subjected to investigations, regulatory enforcement actions and lawsuits by the SEC, though the recently-enacted JOBS Act allows many community banks to remove themselves from SEC scrutiny.

Community banks need to continue to actively manage troubled loans and to pursue conservative underwriting standards for new loans. They also should ensure that their directors and officers are protected to the greatest degree possible from the financial consequences of regulatory investigations and lawsuits. D&O insurance is essential, but the terms of coverage can vary widely among insurers. The bank's insurance buyer should work closely with a broker experienced with the D&O issues of community banks to assure that adequate limits of coverage at the best available terms are purchased, and the board of directors should take an active role in D&O buying decisions. ■

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