FDIC’S ORDINARY NEGLIGENCE CLAIMS REVISED BY FOURTH CIRCUIT

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BANK CORPORATE GOVERNANCE DEVELOPMENT – DIRECTORS AND OFFICERS - U.S. Court Of Appeals For the Fourth Circuit Concludes That: (1) FDIC May Sue Directors and Officers Of Failed Bank Under North Carolina Law For Ordinary Negligence As Well As Gross Negligence And Breach Of Fiduciary Duty; And (2) Bank’s Directors Are Protected Against Personal Liability By An Exculpatory Provision In The Bank’s Articles
In a case of significant interest to bank directors and officers and their counsel, on August 18, 2015, a unanimous three judge panel of the U.S. Court of Appeals for the Fourth Circuit (the “Appellate Court”), in a case captioned \textit{FDIC v. Rippy} (the “Case”), concerning the liability of former directors and officers of a failed bank, affirmed in part and reversed in part the dismissal by the U.S. District Court for the Eastern District of North Carolina (the “District Court”) of claims brought by the Federal Deposit Insurance Corporation (the “FDIC”) against former directors (the “Director Defendants”) and former officers (the “Officer Defendants”) of a failed North Carolina-chartered commercial bank, Cooperative Bank, Wilmington, North Carolina (the “Bank”).

The Appellate Court, in an opinion written by Judge Gregory, ruled that, under North Carolina law, the FDIC could sue both the Director Defendants and the Officer Defendants for ordinary negligence as well as gross negligence and breach of fiduciary duty, but that the Director Defendants are protected against personal liability by an exculpatory provision (the “Exculpatory Provision”) in the Bank’s articles of incorporation. The Exculpatory Provision, however, does not, by its terms, protect the Officer Defendants.

\textbf{BACKGROUND OF THE CASE}

In 2002 the then board of directors of the Bank approved an aggressive growth strategy for the Bank that was focused on the extremely rapid growth of the Bank’s commercial loan portfolio. In its 2011 complaint, the FDIC as Receiver for the Bank alleged that the Director Defendants and the Officer Defendants (sometimes collectively referred to as “the D&Os”)) are liable for ordinary negligence, gross negligence, and breach of fiduciary duty because they approved 86 commercial real estate loans (the “Loans”) in 2007 and 2008 using imprudent loan underwriting standards and loan administration practices. The FDIC also alleged that it and the North Carolina Commissioner of Banks (the “NCCB”) had criticized the Bank’s loan underwriting standards and credit administration practices in multiple reports of examination issued prior to the Bank’s failure in 2009. There is no evidence in the Case of bad faith, conflict of interest or disloyalty to the Bank on the part of the D&Os. An unresolved issue is whether the D&Os were adequately informed when they made decisions to approve the respective...
Loans. As a result of the Bank’s failure the FDIC suffered an approximately $40 million loss with respect to the Loans.

In response to the FDIC’s claims, the D&Os stressed that in the 2007 and 2008 reports of examination of the Bank issued by the FDIC and the NCCB, respectively, the bank regulators had concluded that the Bank was operating in a satisfactory manner and had each given the Bank a composite CAMELS rating of 2. The D&Os conceded that the FDIC and NCCB in their reports of examination had noted certain deficiencies in the Bank’s credit administration and loan underwriting practices that Bank management had agreed to correct. In response to the FDIC’s claims the D&Os further argued that North Carolina’s business judgment rule shielded them from the FDIC’s claims of negligence and breach of fiduciary duty.

THE DISTRICT COURT’S DECISION

The FDIC’s claims in the Case were first considered by Judge Boyle of the District Court. The District Court granted summary judgment to the D&Os holding that North Carolina’s business judgment rule “applies and shields [the D&Os] from liability on the ordinary negligence and breach of fiduciary duties claims”. The North Carolina business judgment rule, stated Judge Boyle, protects directors and officers in those cases where the decisions of the directors or officers that are being questioned are found to be “either rational or employed in a good faith effort to advance the corporate interests.” In granting summary judgment to the D&Os, the District Court found that the D&Os, in approving the Loans, used a rational process and acted with a rational business purpose. The District Court also determined that the D&Os had not acted with gross negligence as the FDIC had failed to demonstrate that the D&Os “engaged in wanton conduct or consciously disregarded [the Bank’s] well-being”.

In his discussion of the FDIC’s claims, Judge Boyle noted that the FDIC had an even higher than usual burden in attempting to disarm the North Carolina business judgment rule as a shield for the D&Os because, in approving the Loans, the D&Os were acting in the midst of “tumultuous market” conditions created by the then current financial crisis (the “Financial Crisis”). Judge Boyle also questioned in passing whether the FDIC was acting even handedly when it brought claims of this type against community bank directors (whose institutions had not received extraordinary government assistance) and refrained from bringing claims against directors of the largest banks (whose institutions
were the beneficiaries of massive government bailouts). Judge Boyle stated “Taking the position that a big bank’s directors and officers should be forgiven for failure due to size and an unpredictable economic catastrophe while aggressively pursuing monetary compensation from a small bank’s directors and officers is unfortunate if not outright unjust.”

THE APPELLATE COURT’S RULINGS

In late 2014 the FDIC appealed the District Court’s decision to the Appellate Court.

Appellate Court Decision With Respect To Director Defendants Only:

The Appellate Court affirmed the District Court’s grant of summary judgment to the Director Defendants on the FDIC’s claims of ordinary negligence, gross negligence and breach of fiduciary duty. The FDIC, accordingly, no longer has any surviving claims in the Case against the Director Defendants. First, the Appellate Court concluded that under the U.S. Supreme Court’s 1997 decision in Atherton v. U.S., the FDIC may sue both bank directors and bank officers of North Carolina-chartered banks for ordinary negligence (as well as gross negligence). The Appellate Court next concluded that the Director Defendants were protected against liability for monetary damages based on claims of ordinary negligence or breach of fiduciary duty by the Exculpatory Provision in the Bank’s articles of incorporation. The Exculpatory Provision shielded the Director Defendants (but not the Officer Defendants) from liability for ordinary negligence and breach of fiduciary duty unless the Director Defendants had breached their duty of loyalty or duty of good faith. The FDIC, noted the Appellate Court, had not contended that the Director Defendants breached their duty of loyalty and the FDIC claim that the Director Defendants’ approvals of Loans were made without adequate information is insufficient to support a claim of a breach of the duty of good faith. Furthermore, stated the Appellate Court, the strength of the FDIC’s claims against the Director Defendants were significantly undercut by the FDIC’s and NCCB’s awards of 2 CAMELS ratings to the Bank.

Appellate Court Decision With Respect To Officer Defendants Only:
The Appellate Court reversed the District Court’s grant of summary judgment to the Officer Defendants with respect to the FDIC’s claims for ordinary negligence and breach of fiduciary duty. As noted above, the protection provided to the Director Defendants by the Exculpatory Provision is not available to the Officer Defendants. The Appellate Court confirmed that the Officer Defendants may assert the protection of the favorable (but rebuttable) presumptions contained in the North Carolina business judgment rule that bank officers’ and directors’ decisions are presumed to have been made in good faith and in the best interests of the applicable bank. The Appellate Court concluded, however, that in this Case the FDIC had presented sufficient evidence to rebut the North Carolina business judgment rule’s presumptions because the FDIC had presented sufficient evidence to call into question whether the Officer Defendants approved the Loans without being adequately informed and without taking into account all relevant information available to them. In reaching its decision that the FDIC had presented sufficient evidence to rebut the business judgment rule presumptions, the Appellate Court cited in particular the testimony of the FDIC’s banking expert, who concluded that the Bank’s credit administration practices and loan underwriting standards were not in accordance with generally accepted banking practices. Accordingly, the Appellate Court vacated the District Court’s grant of summary judgment to the Officer Defendants on the FDIC’s claims of ordinary negligence and breach of fiduciary duty and remanded those claims to the District Court for further proceedings.

Appellate Court Decision With Respect To Both Director Defendants And Officer Defendants:

The Appellate Court affirmed the District Court’s grant of summary judgment to both the Director Defendants and the Officer Defendants on the FDIC’s claim that the D&Os had acted with gross negligence. The Appellate Court determined that to survive summary judgment the FDIC would have had to present evidence that the conduct of the D&Os was wanton or reckless and, in the view of the Appellate Court, the FDIC failed to meet that burden. The Appellate Court noted that although the D&Os had failed to address examiner criticisms concerning the Bank’s credit administration and loan underwriting, the FDIC and NCCB had granted the Bank satisfactory 2 CAMELS ratings. Given this inconsistent evidence, the Appellate Court found that the FDIC had
not presented sufficient evidence to support its gross negligence claims against the D&Os.

POINTS TO CONSIDER

1. In the aftermath of the Financial Crisis it has become more challenging for community banks to attract and retain qualified directors and a board of directors with the combined skill sets needed to oversee a 21st Century bank. The Appellate Court’s decision affirming summary judgment to the Director Defendants on the FDIC’s claims of ordinary negligence, gross negligence and breach of fiduciary duties should give substantial comfort to directors of North Carolina-chartered banks and, to a lesser extent, to directors of banks in other jurisdictions.

2. The Appellate Court’s revival of the FDIC’s claims of ordinary negligence against the Officer Defendants should be of some concern to officers of North Carolina-chartered banks (and, to a lesser extent, to bank officers of banks in other states), but the effect of the Appellate Court’s ruling is softened by the Appellate Court’s conclusion that North Carolina bank officers may use the North Carolina business judgment rule to shield themselves against liability for claims of ordinary negligence. It will be instructive to see how the District Court on remand deals with the revived ordinary negligence claims against the Officer Defendants. Should the FDIC prevail against the Officer Defendants on remand the FDIC will be encouraged to bring more actions for ordinary negligence against bank officers (and where directors are not protected by a version of the Exclusionary Provision) against bank directors. On the other hand, it should be noted that if bank D&Os are held to an ordinary negligence standard of liability it may have a chilling effect on their willingness to make decisions that put the bank at any risk, e.g., decisions that involve extensions of credit to non-standard borrowers. As a general matter, it is far less difficult for the FDIC to prove ordinary negligence than gross negligence in cases of this type.
3. The robust protection provided to North Carolina directors by the Exculpatory Provision were confirmed by the Appellate Court. There are many U.S. states that allow corporations to adopt such a provision in their articles or by-laws. In jurisdictions where a bank may adopt an Exculpatory Provision, it is in the interest of bank directors to urge their institution (if they do not already have such a provision) to adopt one.

4. The Appellate Court gave weight to the relatively high 2 CAMELS ratings awarded to the Bank by the FDIC and the NCCB. The FDIC found that the high ratings undercut the FDIC’s claims of gross negligence against the D&Os.

5. The Appellate Court rejected the District Court’s suggestion that the D&Os should not be held negligent for approving the Loans because those decisions were made during the Financial Crisis and the “tumultuous market” conditions that were prevailing at that time.

6. Given the current relatively healthy financial condition of most banks and the bank director – favorable conclusions of the Appellate Court, one would think that this is a propitious moment for banks to negotiate premium reductions for, and language concessions in the applicable bank’s directors and officers liability insurance policy. However, the Appellate Court’s revival of the FDIC’s claims for ordinary negligence against the Officer Defendants (and the likelihood that such claims would have been revived against the Director Defendants had they not been protected by the Exculpatory Provision) gives insurance carriers a valid basis for asserting that the Appellate Court decision has increased rather than decreased their loss exposure from a policy.