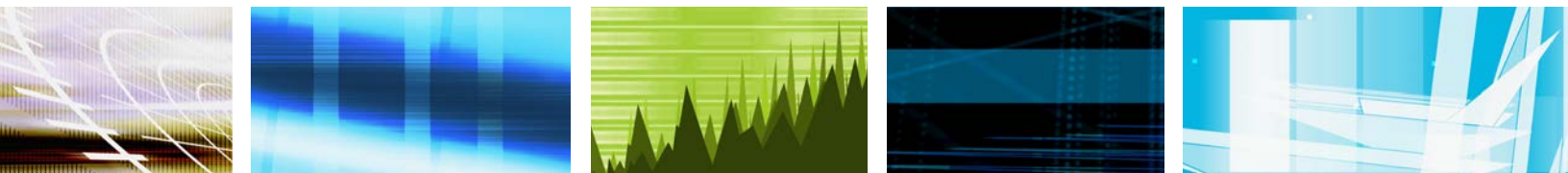


Characteristics of FDIC Lawsuits against Directors and Officers of Failed Financial Institutions



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By Abe Chernin, Catherine J. Galley, Yesim C. Richardson, and Joseph T. Schertler

This is the third in a series of reports that examines statistics and offers commentary on the characteristics of professional liability lawsuits filed to date by the Federal Deposit Insurance Corporation against directors and officers of failed financial institutions. Lawsuits may also be filed by the FDIC against other related parties, such as accounting firms, law firms, appraisal firms, or mortgage brokers, but we do not address these here.

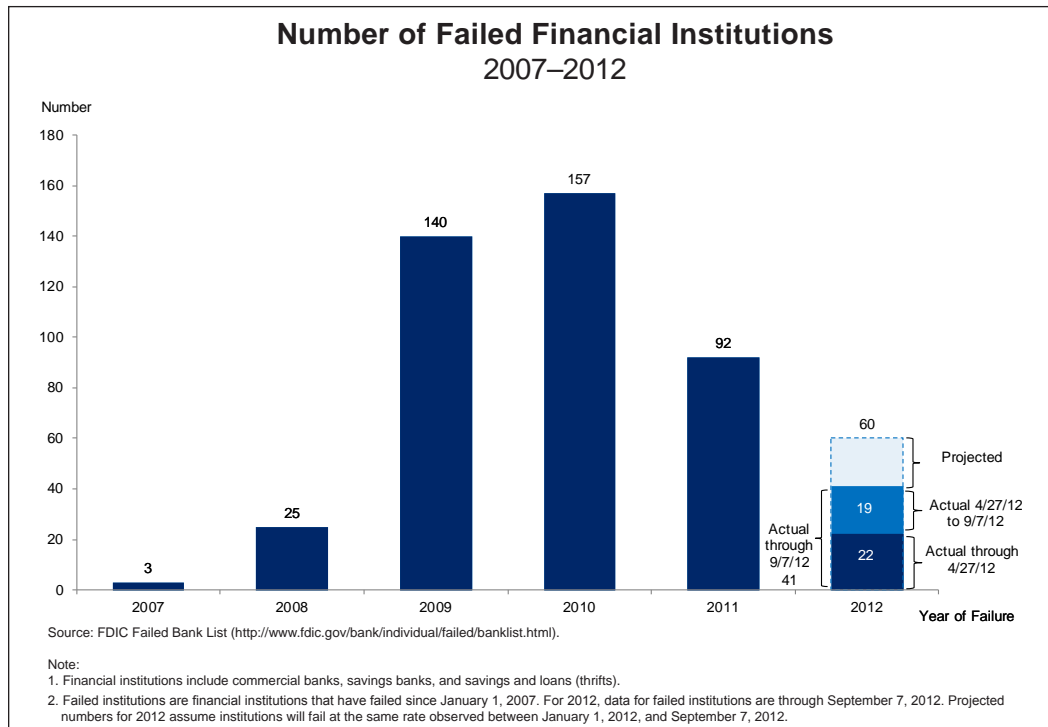
Overview

In our May 2012 report, we had observed a decline in the seizures of banks and thrifts by the FDIC in 2012 relative to 2011 and 2010 levels. This decline has continued during the past four months. FDIC litigation activity associated with failed financial institutions has also subsided—a reversal of the trend observed in our May 2012 report. During the past four months, the FDIC has only filed three new lawsuits against directors and officers of failed institutions. Although we understand that negotiations stemming from demand letters to directors and officers have continued, it is difficult to publicly observe the level of FDIC activity in this area. We do observe that the FDIC has been actively filing lawsuits against other related parties. For example, the FDIC has continued to litigate the terms of director and officer insurance policies with the insurance carriers. It has also initiated lawsuits on behalf of four failed institutions against investment banks and their subsidiaries related to their underwriting of residential mortgage-backed securities purchased by the now defunct institutions.

With the three new lawsuits filed between April 27, 2012, and September 7, 2012, the FDIC has filed 14 lawsuits this year against directors and officers. It has filed a total of 32 lawsuits related to 31 failed institutions since 2010.

Financial Institution Failures

In the past four months, the FDIC seized 19 financial institutions. The pace of seizures in May through August is slightly less than the first four months of 2012, when the FDIC seized 22 institutions. If this pace continues, 60 institutions will be seized by the end of the year—fewer than in any year since 2008.



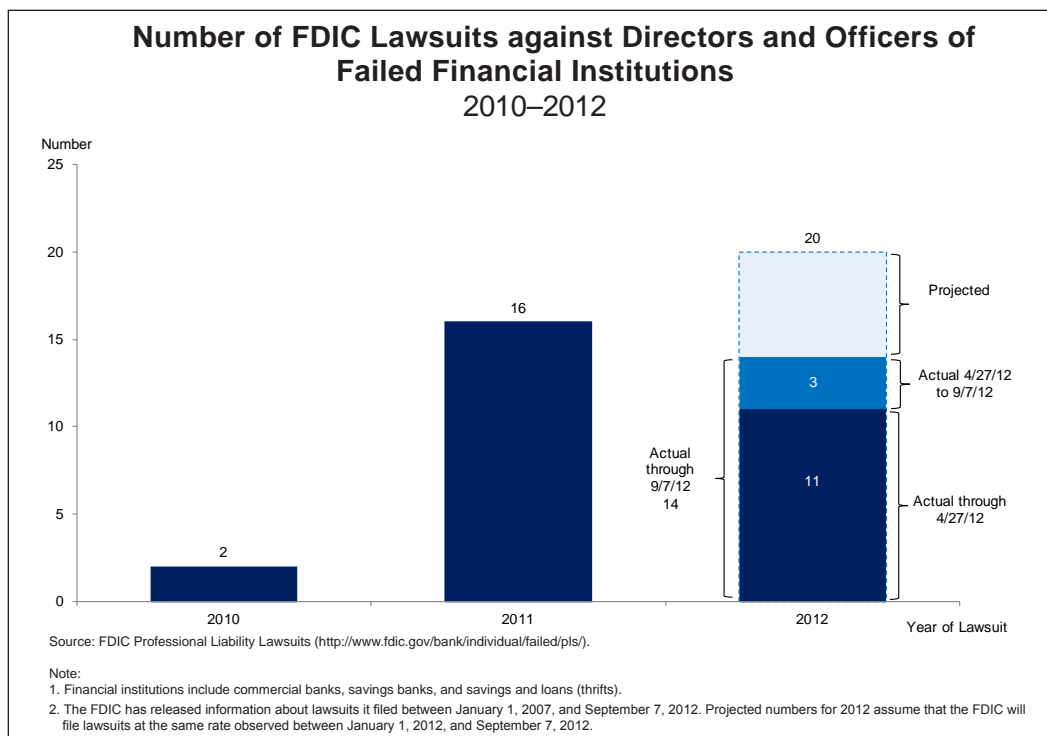
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FDIC seizures in 2012 continue to be concentrated in the Southeast. Nine of the 41 institutions that failed this year were in Georgia. Since 2007, 84 institutions in Georgia have been seized, representing 18 percent of all failures. Florida has the second highest financial institution failure rate, with five failures in 2012 and 63 failures since 2007. Illinois and California follow, with 53 and 39 failures, respectively, since 2007.

Based on the FDIC’s estimates at the time of seizure, California—where financial institution failures have cost \$21 billion since 2007—has the highest total estimated failure cost. Florida and Georgia each have more than \$10 billion in estimated failure costs, followed by Illinois, Puerto Rico, and Texas.

Characteristics of Director and Officer (D&O) Lawsuits

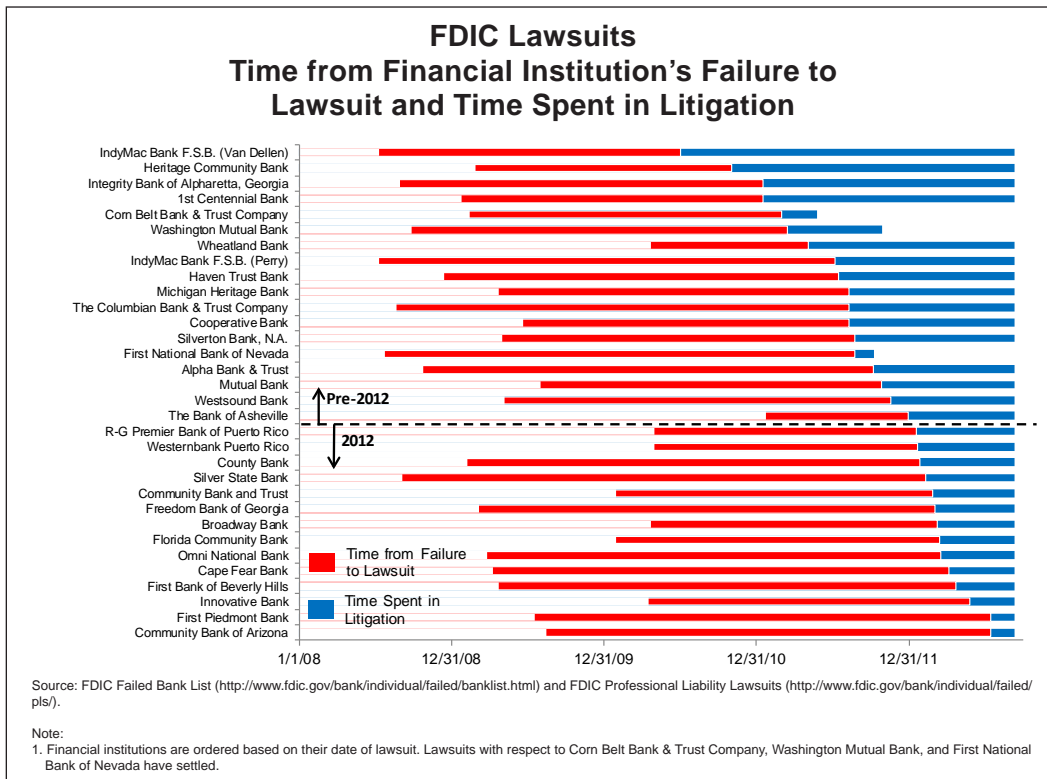
While the pace of D&O lawsuits has increased in 2012 relative to previous years, the FDIC has filed new lawsuits in the past four months at a significantly slower rate than in the first four months of the year. Only three lawsuits were filed in the last four months compared with 11 in the first four months of the year. If the average rate for the first eight months of 2012 persists for the remainder of the year, the FDIC will file 20 D&O lawsuits this year, four more than in 2011. However, if the pace of new lawsuits observed in the last four months continues for the remainder of the year, only 17 lawsuits will be filed in 2012, just one more than in 2011. This would be noteworthy given the fact that the FDIC's three-year statute of limitations for filing tort lawsuits related to the 140 financial institution failures that occurred in 2009 is likely to expire this year, although tolling agreements can extend the deadline.¹



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¹ The FDIC is subject to a unique statute of limitations in its role as receiver, allowing up to six years to file a contract claim and up to three years to begin a tort suit.

In our May 2012 report, we had observed that while the pace of lawsuit filings has increased in 2012, the FDIC has not shortened the time it takes to file a lawsuit following a failure. The median time between an institution's failure and the filing of an FDIC lawsuit was 2.9 years in 2012, compared with 2.3 years in 2007 through 2011. Two of the three most recent lawsuits have been filed just prior to the expiration of the FDIC's three-year statute of limitations for tort lawsuits. Among the 14 lawsuits that have been filed in 2012, six are related to financial institutions that failed in 2010, seven that failed in 2009, and one that failed in 2008.



To date, 7 percent of financial institutions that have failed since 2007 have been the subject of FDIC lawsuits. These lawsuits generally have targeted larger failed institutions and those with a higher estimated cost of failure. The 31 financial institutions targeted in lawsuits had median total assets of \$836 million, more than 3.5 times the median size of all failed institutions and more than five times the median size of institutions active at mid-year 2012. The three most recent lawsuits involved smaller institutions, with asset sizes between \$100–300 million.

The 31 institutions targeted in lawsuits had a median estimated cost to the FDIC of \$200 million at the time of seizure. This compares with the median estimated cost of failure of \$58 million for all failed financial institutions. The financial institutions subject to lawsuits in the first four months of 2012 had higher estimated failure costs than previously sued institutions. However, consistent with their smaller asset size, the institutions that were subject to the three FDIC lawsuits filed in the past four months had a median cost of failure of only \$29 million.

Comparison of Asset Size and Failure Cost All Financial Institutions with Those That Failed and Those Subject to FDIC Lawsuits			
	Number of Institutions	Median Total Assets (Millions)	Median Cost of Failure (Millions)
Institutions Subject to FDIC Lawsuits			
Filed between 1/1/07 and 12/31/11	17	\$735.07	\$158.10
Filed between 1/1/12 and 4/27/12	11	\$1,181.72	\$354.50
Filed between 4/28/12 and 9/7/12	3	\$158.52	\$29.00
All Institutions	31	\$835.70	\$200.00
Failed Institutions (1/1/07–9/7/12)	458	\$226.68	\$58.05
Active Financial Institutions (as of 6/30/12)	7,377	\$161.45	N.A.

Source: FDIC Failed Bank List (<http://www.fdic.gov/bank/individual/failed/banklist.html>), FDIC Professional Liability Lawsuits (<http://www.fdic.gov/bank/individual/failed/pls/>), and Highline Financial Intelligence based on regulatory filings.

Note:

1. Financial institutions include commercial banks, savings banks, and savings and loans (thrifts).
2. Total assets as of the last reporting period prior to seizure by the FDIC.
3. Institutions that are the subject of multiple FDIC lawsuits are counted only once.
4. Cost of failure is the FDIC's estimate of the cost to the DIF (Deposit Insurance Fund) at the time of seizure of the failed institution, when available. Otherwise, the cost of failure is based on FDIC estimates from December 31, 2010.

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Defendants and Claims

Defendants named in the 32 filed lawsuits included 266 former directors and officers. The number of cases in which only inside directors and officers were named as defendants remained at nine during the past four months. Outside directors were named as defendants in addition to inside directors and officers in the three cases filed during the past four months, bringing the total number of such lawsuits since 2010 to 23. CEOs were named as defendants in 29 cases, including the three most recent cases. Other officers commonly named as defendants included CFOs (five cases—no change since May 2012), chief loan officers (nine cases—no change since May 2012), chief credit officers (11 cases—two additional cases since May 2012), chief operating officers (six cases—no change since May 2012), and chief banking officers (two cases—no change since May 2012). In addition, the number of lawsuits that named insurance companies as defendants remained at three, and the number of cases that identified a law firm as a defendant remained at one. The number of cases that also named spouses of the directors and officers as defendants remained at three.

All three recent lawsuits included allegations of negligence and gross negligence, and two included allegations of breach of fiduciary duty. Overall, allegations of negligence, gross negligence, and breach of fiduciary duty were made in 29, 29, and 25 of the 32 lawsuits, respectively.

Recent Trends in FDIC Litigation Activity

Insurance Exclusions

D&O insurance is designed to protect individuals from personal liability for actions taken in their roles as directors and officers. These insurance policies are the most likely source of recovery in cases brought against directors and officers of failed institutions. Insurance coverage limits define the amount of proceeds the FDIC or other agencies may recover, although recoveries may be prevented or further limited by other terms of the insurance policy. Such terms include the presence and enforceability of policy exclusions, such as insured-versus-insured exclusions, regulatory exclusions, and fraud or dishonesty exclusions.

One current controversy in FDIC litigation is the applicability of the typical D&O insurance policy's insured-versus-insured exclusion. The insured-versus-insured exclusion excludes coverage for claims made by or on behalf of an insured person or entity against another insured party. The question is whether the FDIC, as receiver pursuing the failed bank's claim against the bank's former directors and officers, is acting as an "insured" under the D&O policy, leading to the preclusion of coverage. To date, issues regarding the applicability of insured-versus-insured exclusions have arisen in numerous FDIC lawsuits against director and officers.

The enforceability of regulatory exclusion provisions in D&O policies is another issue likely to be litigated between the FDIC and insurance companies. If included in a D&O policy, a regulatory exclusion provision precludes coverage for claims brought by the FDIC and other regulators. Not all policies have this provision, but in instances where it is included in the policy, insurance carriers are almost certain to rely on it to contest coverage.

Mortgage-Backed Securities Cases

Since our May 2012 report, the FDIC has filed 11 lawsuits against large investment banks and their subsidiaries seeking damages stemming from mortgage-backed securities purchased by four failed institutions. The named defendants include over 15 major firms that served a variety of roles, including acting as underwriters or issuers, in the residential mortgage-backed securities (RMBS) market. In all 11 complaints, the stated claims against the defendants include allegations of untrue or misleading statements about: a) the loan-to-value ratios of the mortgage loans in the RMBS collateral pools and the appraisals of the properties that secured the loans; b) the occupancy status of the properties that secured the mortgage loans in the collateral pools; c) the underwriting standards of the originators of the mortgage loans in the collateral pools; and d) the ratings of the RMBS securities. These lawsuits and the claims made are similar to ones filed by the Federal Home Loan Banks.

The first three FDIC lawsuits were filed on May 18, 2012, nearly three years after the seizure of two Illinois institutions, Citizens National Bank and Strategic Capital Bank, on May 22, 2009. The FDIC filed a single suit in federal court in New York as receiver for both banks. It also filed two other suits, one in New York and one in California, as receiver for Strategic Capital Bank. The FDIC alleged that Strategic Capital Bank was misled into purchasing 18 RMBS securities for \$166.6 million and Citizens National Bank was misled into purchasing 10 RMBS securities for \$67.5 million, and that both banks subsequently suffered substantial losses. The total damages sought in these lawsuits are \$92 million.

On August 10, 2012, the FDIC filed five lawsuits—three in Alabama, one in New York and one in California—as receiver for Colonial Bank, which it seized on August 14, 2009. The FDIC claimed that Colonial Bank suffered losses of \$1.5 billion on the RMBS securities it purchased. The total damages sought are \$741 million.

Most recently, on August 17, 2012, the FDIC filed three lawsuits as receiver for Guaranty Bank, which it seized on August 21, 2009. The FDIC’s claims related to Guaranty Bank’s purchases of 36 RMBS securities for nearly \$5 billion. The lawsuits seek over \$2.1 billion in damages. All of these RMBS lawsuits were filed immediately prior to the likely expiration of the FDIC’s three-year statute of limitations for tort claims. The damages claimed in the 11 lawsuits are over \$2.9 billion, compared to \$2.4 billion claimed in the 32 director and officer lawsuits the FDIC has filed to date.² Given the typically limited sources of recovery available to the FDIC, the FDIC is likely to continue pursuing other RMBS lawsuits.

Settlements

No new resolutions of lawsuits have been publicly announced in the four months since our May 2012 report. As of September 7, 2012, three of the 31 lawsuits have settled.

- *FDIC as Receiver of Corn Belt Bank and Trust Company v. Stark et al.*
- *FDIC as Receiver for First National Bank of Nevada v. Dorris and Lamb*
- *FDIC as Receiver for Washington Mutual Bank v. Killinger et al.*

² Damage claims in 29 of 32 lawsuits totaled \$2.4 billion. Damages were unspecified in the three remaining lawsuits.

Future Director and Officer Lawsuits

These findings do not include the many negotiations and mediations the FDIC has undertaken with directors and officers of failed institutions, as statistics for these activities are unavailable. Nor do they reflect any tolling agreements that have been entered into. The number of lawsuits filed has yet to approach the numbers authorized by the FDIC, and the difference between the number of lawsuits authorized and the number filed has increased in 2012. As of August 14, 2012, the FDIC had authorized lawsuits against 617 individuals in connection with 73 failed institutions. The fact that 266 individuals have already been sued suggests that as many as 351 former directors and officers are awaiting a decision on whether the FDIC will file a lawsuit against them. This backlog of authorized lawsuits suggests that the FDIC is seeking to increase pressure on directors, officers, and their insurance carriers. Unless the disputes are resolved during negotiations and mediations, substantially more FDIC cases may be filed in upcoming months.

	Difference between Filed FDIC Lawsuits and Authorized FDIC Lawsuits					
	As of January 18, 2012		As of April 25, 2012		As of August 14, 2012	
	Filed	Authorized	Filed	Authorized	Filed	Authorized
Number of Institutions	18	44	28	58	32	73
Number of Individuals (D&O)	161	391	239	493	266	617
Damages Claimed (Billions)	\$1.7	\$7.7	\$2.4	N.A.	N.A.	N.A.

Source: FDIC Professional Liability Lawsuits (<http://www.fdic.gov/bank/individual/failed/pls/>) and complaints filed by the FDIC.

Note:
1. The FDIC has not disclosed total damages claimed in the lawsuits authorized as of April 25, 2012, and August 14, 2012. The FDIC has not disclosed total damages claimed in the lawsuits filed as of August 14, 2012.

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