

# FAILED FINANCIAL INSTITUTION LITIGATION: REMEMBER WHEN\*

RICHARD D. BERNSTEIN  
JOHN R. OLLER  
JESSICA L. MATELIS\*\*

## INTRODUCTION

As the global economic crisis continues, the effect of the credit crisis and fair value accounting will create a likely upsurge in litigation, reminiscent of the wave of lawsuits spawned by the Savings and Loan crisis of 1988-1994 (“S&L crisis”). The body of law developed during the S&L crisis provides a ready starting point for this new round of failed financial institution litigation. Moreover, new developments since the S&L crisis will also be tested in the coming years.

The Federal Deposit Insurance Corporation (“FDIC”) and the Resolution Trust Corporation (“RTC”), in their capacity as receivers,<sup>1</sup> and the Office of Thrift Supervision (“OTS”), in its regulatory capacity, spearheaded much of the S&L litigation. The FDIC, RTC, and OTS aggressively pursued officers and directors of failed banks and thrifts, as well as various third parties, including audit firms, law firms, and a then-major investment bank, that provided services to the failed institutions. At the height of the S&L crisis, the combined direct and indirect payments by the FDIC and the RTC to outside counsel in 1991 reached over \$700 million.

The collapse of Washington Mutual in September 2008 represented the largest bank failure in U.S. history;<sup>2</sup> added to IndyMac’s collapse in July 2008 and the failure of a number of

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\* “We lived and learned, life threw curves/There was joy, there was hurt/Remember when.” *Remember When*, lyrics by Alan Jackson.

\*\* Richard Bernstein and John Oller are partners with the law firm of Willkie Farr & Gallagher LLP. Jessica Matelis is an associate with that firm who contributed to this article.

1. The RTC was dissolved in 1995. Unless Congress creates a new bailout corporation or agency, the FDIC will be the sole federal receiver going forward.

2. See Robin Sidel, David Enrich and Dan Fitzpatrick, *WaMu is Seized, Sold off to J.P. Morgan, In Largest Failure in U.S. Banking History*, Wall St. J., Sept. 26, 2008, at A1.

other financial institutions, these events may mark the start of a surge of bank and thrift failures similar to that seen during the S&L crisis. Banks in four U.S. states with more than \$1 billion in assets were closed by regulators in a single day on February 13, 2009, the most in one day since 1992. State and federal regulators closed 25 banks in 2008, matching the total for 2001-2007, as home foreclosures soared and bank profits tumbled.<sup>3</sup>

The constant media attention on the “subprime crisis,” the stock market meltdown, as well as the recent Bailout Plan using “taxpayer” money<sup>4</sup> to prop up financial industry giants such as AIG, Fannie Mae and Freddie Mac are likely to fan the flames for myriad government agencies to pursue litigation against all parties associated with failed institutions. Many firms will lobby the FDIC to hire them to represent the institution in lawsuits. The OTS, the Office of the Comptroller of the Currency (“OCC”), the Department of Justice (“DOJ”), and the Securities and Exchange Commission (“SEC”) will all play their roles in pursuing claims as well.<sup>5</sup>

In addition, there may be insurance company failures, and the principles applicable to litigation by insurance company receivers and liquidators are very similar to those applicable to claims by the receivers of failed banks and thrifts. Added to all of the above is a giant question mark over the vast, unregulated market in credit default swaps, the bills for which are only starting to come due.<sup>6</sup>

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3. See Margaret Chadbourn, *Regulators Shut 4 Banks, Toll Reaches 13; Deposit Fund Shrinks*, Bloomberg News, Feb. 15, 2009.

4. While funds from the FDIC to support failed banks come from a pool of money collected from the banks themselves as insurance premiums, this nuance is often lost in press reports. There have, however, already been reports that the FDIC will likely seek a loan from the Treasury Department to assist in funding its bank receiverships. See Damian Paletta & Jessica Hoelzer, *FDIC Weighs Tapping Treasury as Funds Run Low*, WALL ST. J., Aug. 27, 2008, at A11.

5. Federal prosecutors are adding personnel to investigate New York-area financial institutions for fraud, with plans to employ strategies used in the successful prosecutions of executives of Enron and Refco. See David Glovin, Patricia Hurtado & David Voreacos, *Prosecutors Look to Enron, Refco in Subprime Probes (Update 3)*, BLOOMBERG.COM, Oct. 16, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=avvIf4Bco0NA#>.

6. See, e.g., Mary Williams Walsh, *Insurance on Lehman Debt Is the Industry's Next Test*, N.Y. TIMES, Oct. 11, 2008, at B1; Vikas Bajaj, *Joint U.S.-New York*

## I. THE CURRENT "CRISIS"

While any economic situation is a combination of numerous factors, there are a few factors underlying the current wave of losses and failures that are particularly identifiable. The change in the housing market, coupled with the increased origination of subprime home loans,<sup>7</sup> is a fairly straightforward factor. The rapid increase in securitizing these loans and accounting for these securities are complicating factors, further contributing to dramatic losses seen on Wall Street.

As the markets tightened, many of these securities and related collateralized debt obligations ("CDOs"), thinly traded at the outset, stopped trading at all. Since there was no active market against which to mark them, accounting for them became difficult; instead, many financial institutions had to rely on complex models. This decreased appetite for securitizing mortgages also left many lenders/originators "holding the bag" after originating mortgages with the intention of securitizing them, only to find that there were no buyers left. Some of the originators that had intended to sell these loans also had to account for them under mark-to-market accounting. However, if loans were classified as being held until maturity, a financial institution still faced judgmental accounting, such as whether a loan was impaired and what need existed for loan loss reserves on its investment portfolio. With the government takeover of Fannie Mae and Freddie Mac on September 7, 2008, all of these accounting considerations are likely to garner additional attention. Critics of the two mortgage giants question whether the loans being held to maturity should also have been marked to market, as well as the decision to extend

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*Inquiry Into Credit-Default Swaps*, N.Y. TIMES, Oct. 20, 2008, at B4 (reporting joint investigation by New York Attorney General Andrew Cuomo and United States Attorney Michael Garcia into trading in credit-default swaps).

7. Over the course of the ten years from 1995 to 2005, the origination of subprime loans increased from 5% of all new loans originated to 20%. See *Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Regulated Financial Institutions: Hearing Before the Subcomm. On Financial Institutions and Consumer Credit of the H. Comm. On Financial Services*, 110th Cong. 13-14 (2007) (testimony of Sandra F. Braunstein, Director, Division of Consumer and Community Affairs—Federal Reserve Board).

the delinquency period on loans from ninety days to as much as a year before recognizing losses.<sup>8</sup>

Under the recently passed Emergency Economic Stabilization Act (the “Bailout Plan”), the U.S. Treasury can purchase “troubled assets,” defined as residential or commercial mortgages, any mortgage-related security, or any other financial instrument that the Treasury Secretary determines is necessary to promote financial market stability from any financial institution. The manner in which the Bailout Plan will be implemented remains uncertain. The most recent focus has been on direct equity investments in banks rather than asset purchases. However, if these assets are purchased at a deep discount to market, the financial institutions might have to take huge writedowns, which may further hurt their operations and ability to raise capital. The direct infusion of equity into some of the largest U.S. banks, pursuant to the Bailout Plan, will certainly help those institutions, but weaker banks may be left to founder.<sup>9</sup>

## II.

### POTENTIAL PARTIES

There are numerous potential parties on all sides of failed financial institution litigation. Possible plaintiffs run the gamut from the several federal agencies involved in the regulation of the banking industry to the DOJ, SEC and private shareholders of bank holding companies. In the search for defendants, the list of targets may run even longer, from the obvious officers and directors of the failed institution to the more creative, such as auditors, the investment banks that sold or underwrote the now worthless investment products purchased by the failed institutions and law firms.

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8. On October 20, 2008, the Federal Housing Finance Agency, as conservator, moved to intervene in any litigation by or against Fannie Mae. Motion of the Federal Housing Finance Agency to Intervene as Conservator for Fannie Mae, No. 1:04-cv-01639 (D.D.C. Oct. 17, 2008).

9. In view of the shifting focus of the Bailout Plan—initially on the purchase of troubled assets, later on the direct infusion of equity into banks and other troubled institutions—as well the speed with which events continue to unfold, the comments on the Bailout Plan and other current market observations in this article should be viewed as subject to change.

### A. *A Plethora of Plaintiffs*

The FDIC and other bank regulators are the most likely plaintiffs to be out front in any new round of failed bank litigation. The FDIC, acting in its capacity as a receiver, succeeds to all the rights of the failed institution, and consequently, it can pursue all claims against parties that may have injured the failed institution, including lawyers, auditors, and other third parties that provided professional services or advice to the institution.<sup>10</sup> The OTS and the OCC have considerable litigation weapons at their disposal, and during the S&L crisis, they readily used these enforcement tools even when claims were independently being pursued by the FDIC.

### B. *The FDIC*

During the S&L crisis, the FDIC pursued claims against third parties, particularly auditing and law firms, and asserted broad theories of liability. Because officers and directors of failed institutions will often have limited ability to pay and limited or no available liability insurance, the FDIC may seek to bring actions against third parties with deeper pockets. In the present environment, given the complexity of many of the subprime-related securities marketed by the investment banks, it is possible that the FDIC will pursue claims against investment banks that sold the securities to the failed institutions, as it did when it sued Drexel Burnham Lambert during the S&L crisis. In its role as receiver, the FDIC can pursue as varied a universe of claims as a private litigant, can use bank assets to fund the litigation, and has the ability, as seen in the S&L crisis, to hire outside legal counsel to pursue these claims.<sup>11</sup>

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10. The FDIC as receiver also has the ability to assign these claims to the FDIC acting in its corporate capacity. 12 U.S.C. § 1823(d)(3)(A) (2008).

11. On October 20, 2008, the FDIC stated in a Delaware bankruptcy court filing that it may have significant claims against Washington Mutual. FDIC's Statement, Response and Limited Objection to Motion of Debtor's Pursuant to Sections 105(a), 361, 362 and 542(b) of the Bankruptcy Code Seeking Approval of a Stipulation and Agreement Concerning Deposit Accounts at JPMorgan Chase Bank, National Association, *In re Wash. Mut. Inc.*, Case No. 74, 2008 WL 4678646 (Bankr. D. Del. Oct. 20, 2008).

### C. *Other Bank Regulators and Their Powers*

In addition to the FDIC in its role as receiver, a failed institution's regulator is another likely plaintiff or administrative adversary. After the enactment of the Financial Institutions Reform, Recovery and Enforcement Act ("FIRREA") in 1989, bank regulators used their wide range of formal enforcement tools with much greater frequency. These mechanisms include cease-and-desist orders, civil money penalties, the ability to freeze assets, prohibition, and removal. Also, "an appropriate federal banking agency"<sup>12</sup> can use these tools against all "institution-affiliated parties."<sup>13</sup>

The cease-and-desist power is particularly daunting because that order can include affirmative relief to correct the actions that prompted it. During the S&L crisis, the OTS aggressively pursued "restitution" under its cease-and-desist power, arguing that restitution consisted of the federal deposit insurance losses and that this "restitution" was independent of any amount pursued by the FDIC in litigation. Because of these dual proceedings and exposure as a result of numerous bank failures, large third parties, such as auditing and law firms, found it necessary to negotiate and settle simultaneously with OTS, RTC, and/or the FDIC. In 1991, Sherman & Howard did this parting the course of the litigation following the failure of the Denver-based Silverado Savings and Loan Association. In 1992, Ernst & Young became the first of the large accounting firms to enter into a global settlement when it agreed to pay \$400 million.<sup>14</sup> By the end of 1993, both KPMG Peat Marwick and Deloitte & Touche had entered global settlements, and in 1995 Arthur Andersen did the same, bringing

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12. The appropriate federal banking agency differs based on the nature of the institution. The OCC has jurisdiction over national banks, the Federal Reserve Board regulates state member insured banks and bank holding companies, the FDIC regulates nonmember insured banks and the OTS regulates savings associations and savings and loan holding companies. Additionally, affiliated parties of FDIC insured banks that are primarily regulated by OCC, OTS or the Federal Reserve Board may also face enforcement actions by the FDIC.

13. See 12 U.S.C. § 1818 (2001 & Supp. 2008).

14. See FDIC, *MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE 1980-1994* 280 (1998).

the total collected by the FDIC from those four accounting firms to over \$1 billion.<sup>15</sup>

The ability to freeze assets is also a potent tool and often prompts parties to consider settlement seriously. The OTS proceeding against the law firm Kaye Scholer is a dramatic illustration of the power wielded by the regulators when they utilize their ability to obtain asset freezes. Kaye Scholer, one of several counsel to Lincoln Savings and Loan, faced an administrative claim of \$275 million after the OTS filed ten charges against the firm and three of its lawyers.<sup>16</sup> Though Kaye Scholer had significant arguments that the claims were contrary to its ethical obligations, the firm settled with the OTS for \$41 million only six days after the claims were filed and OTS froze the firm's assets, limiting the ability of all its partners to transfer assets.<sup>17</sup> According to the firm, it found it impossible to do business under the asset freeze because its banks threatened to close its credit lines.

After the S&L crisis, the OTS shifted its focus to open institutions and instituted very few claims for monetary remedies against firms or persons associated with failed banks. In response to the current credit crisis, the OTS could revert to its former aggressive pursuit of civil liability claims.

#### D. SEC and DOJ

In addition to the primary bank regulators, other government agencies are likely to appear in the litigation mix after a financial institution failure. Many banks issue securities, which are subject to the general antifraud provisions of the securities laws and are run through a publicly traded holding company. Thus, the SEC may have an interest in pursuing any securities law violations that occurred at a failed institution, and the DOJ, with its broad civil and criminal authority, is a significant threat to any defendant.

During the S&L crisis, the SEC pursued individuals associated with failed banks, utilizing its power to bar individuals

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15. *Id.*

16. Stephen Labaton, *U.S. Moves to Freeze Assets of Law Firm for S&L Role*, N.Y. TIMES, Mar. 3, 1992, at A1.

17. See Michael M. Neltner, *Government Scapegoating, Duty to Disclose, and the S&L Crisis: Can Lawyers and Accountants Avoid Liability in the Savings and Loan Wilderness?*, 62 U. CIN. L. REV. 655, 693-95 (1993).

from serving as directors or officers of publicly traded companies, as well as its cease-and-desist and injunction remedies. In 1991, the SEC brought an enforcement action against eight former executives of Lincoln Savings and Loan and its former parent company, three of whom were lawyers and four of whom were accountants;<sup>18</sup> it alleged violations of the reporting and antifraud provisions of the federal securities laws;<sup>19</sup> and it charged the former chairman of the parent company, Charles Keating, with insider trading.<sup>20</sup> The SEC also brought actions for accounting violations, including a case against Richard Paul, the President of American Pioneer; in this action, the SEC alleged that Paul knew or was reckless in not knowing that the bank's Financial Accounting Standards ("FAS") 5 allowances were inadequate and that the foreclosed real estate on the bank's books was not properly accounted for under FAS 15.<sup>21</sup>

In today's environment, the SEC may well pursue potential fraud, disclosure, accounting, and insider trading violations associated with any failed bank.

#### E. *U.S. Treasury*

Under Section 101(a) of the Bailout Plan, the Treasury Secretary is authorized to purchase troubled assets from any financial institution "on such terms and conditions as are determined by the Secretary." Section 106(a), in turn, provides that the Secretary may, "at any time, exercise any rights received in connection with troubled assets purchased under this Act." Together, these provisions create the possibility that the U.S. Treasury could, itself, become a plaintiff as the holder of causes of action on the acquired assets. Although a sale of a security or bond does not automatically carry with it an assign-

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18. SEC v. Keating, Lit. Rel. No. 13118, 50 SEC Docket 607, 607 (Dec. 12, 1991).

19. *Id.*

20. *Id.*

21. *In re Paul*, Securities Act of 1933 Release Rel. No. 7043, 55 SEC Docket 2594, at 2595 (Feb. 1, 1994). Statements of Financial Accounting Standards ("FAS") are formal statements issued by the Financial Accounting Standards Board (FASB), which detail accounting standards and guidance on selected accounting policies. FAS 5 sets forth the standards for accounting for contingencies. FAS 15 establishes accounting standards for debtors and creditors when accounting for and reporting on restructuring of debt.



ment of the right to sue third parties on claims relating to the seller's original purchase, such as a claim for securities fraud,<sup>22</sup> the Secretary might require, as a condition to buying a troubled asset, an express assignment of such rights.<sup>23</sup> To the extent the Treasury acquires such rights, it could decide to bring claims against the sellers or underwriters that sold subprime mortgage-related securities to the now-failed institutions.

#### F. *Private Plaintiffs*

Finally, private parties are another pool of plaintiffs. Shareholders of bank holding companies, employees who participated in retirement funds that were heavily invested in the holding company's stock and trustees of the bank holding companies, supported by activist plaintiffs' law firms, will all appear on the scene of any failed financial institution. Because of the automatic stay of discovery required under the Private Securities Litigation Reform Act of 1995 ("PSLRA"), securities class actions remain in their preliminary stages while a motion to dismiss is pending.<sup>24</sup>

#### G. *And a Deluge of Defendants*

The FDIC is supposed to pursue actions only where it would be cost effective to do so. While officers and directors are the most readily identifiable defendants, they often offer limited opportunities for financial recourse. Directors and officers insurance may be available, but there are often applicable exclusions that make this availability problematic, as dis-

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22. See, e.g., *Bluebird Partners, L.P. v. First Fidelity Bank, N.A.*, 85 F.3d 970, 973-74 (2d Cir. 1996); see generally William K. Wang, *Is a Seller's Rule 10b-5 Cause of Action Automatically Transferred to the Buyer?*, 1988 COLUM. BUS. L. REV. 129.

23. *Lowry v. Baltimore & Ohio R.R. Co.*, 707 F.2d 721, 739-40 (3d Cir. 1983) (Gibbons, J., dissenting) ("The first question is whether section 10(b) claims are assignable at all. It has been held repeatedly that they are."), *petition for modification denied*, 711 F.2d 1207 (3d Cir. 1983), *cert. denied*, 464 U.S. 893 (1983); *id.* at 746 (Seitz, C.J., and Becker, J., concurring in part and dissenting in part) ("[T]he section 10(b) claim is [expressly] assignable as a matter of federal law, and both relevant case law and commentary indicate that this is so."); see also Wang, *supra* note 22, at 129 & n.2.

24. Subsection (b) of the PSLRA, codified at 15 U.S.C. § 78u-4(b), provides for a stay of discovery in securities cases until motions to dismiss are decided, unless the court, upon motion of a party, finds that limited discovery is necessary to preserve evidence or prevent undue prejudice.

cussed further below. Thus, as the S&L crisis illustrated, regulators will eagerly pursue third party advisors and professionals as a source of monetary recovery. Owners of the failed institution or holding company, including other companies and individual owners, might also be pursued. Appraisal firms, particularly in the present circumstances, may wind up as defendants if they have assets or insurance. And, as discussed above, regulators may search out additional defendants based on broad theories of liability, as they did when they pursued Drexel Burnham Lambert for its sale of junk bonds to failed institutions.

#### H. *Attorneys, Accountants and Appraisers*

During the S&L crisis, bank regulators often targeted professionals that serviced failed institutions, particularly audit firms, law firms, and appraisers.<sup>25</sup> It is unlikely that today's regulators will be less aggressive with respect to these parties. Appraisal firms are particularly likely to face scrutiny in the present environment given the housing slump and subprime crisis. Allegations of collusion between banks and appraisers have received attention in recent months.<sup>26</sup>

#### I. *Investment Banks*

The FDIC's pursuit of Drexel Burnham Lambert for its role in the S&L crisis may serve as a precursor to similar claims arising from the credit crisis, to the extent that banks have been forced to write down billions of dollars of investments linked to mortgage-backed securities sold by other banks. In its

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25. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), 12 U.S.C. § 1811 (2006), requires that all federally insured banks with over \$150 million or such amount as the Corporation may prescribe by regulation, in assets submit an annual report to the FDIC that includes audited GAAP financial statements and an assessment of internal controls, thus making audit firms potential defendants every time a bank fails.

26. For example, New York Attorney General Andrew Cuomo alleged in November 2007 that First American eAppraiseIT succumbed to pressure from Washington Mutual to use only "approved appraisers" that would inflate the properties' appraisal values. Complaint of the Attorney General of the State of New York against First American Corporation and First American eAppraiseIT filed with the Supreme Court of the State of New York, County of New York, on November 1, 2007 at 3, *available at* [http://www.oag.state.ny.us/media\\_center/2007/nov/EA%20Complaint.pdf](http://www.oag.state.ny.us/media_center/2007/nov/EA%20Complaint.pdf).

pursuit of Drexel, the FDIC and the RTC created a task force to “oversee a nationwide investigation into the losses suffered by failed thrifts caused by improper activities related to Drexel and junk bonds.”<sup>27</sup> The FDIC and RTC filed claims in Drexel’s bankruptcy on behalf of 45 failed institutions for losses exceeding \$11 billion,<sup>28</sup> making the FDIC and RTC the largest claimants in the bankruptcy proceeding. Ultimately, the FDIC collected over \$600 million through the Drexel bankruptcy proceeding.<sup>29</sup>

### J. *Stockholders and Other Persons with Influence*

Under FIRREA, regulators are also authorized to pursue claims against controlling stockholders, any person required to file a change-in-control notice with the appropriate regulator and “any shareholder (other than a bank holding company), consultant, joint venture partner, and any other person. . . who participates in the conduct of the affairs of an insured depository institution.”<sup>30</sup> FDIC decisions suggest that “participating in the affairs” of a bank requires that a person at least be positioned to “materially influence” the institution’s activities.<sup>31</sup> The FDIC’s suit against Charles Hurwitz as the indirect controlling force of the United Savings Association of Texas, while allegedly darkened by the political interests behind the suit, is an example of how individuals, who may have had no formal role at a bank, can still be pursued by the regulators as an institution-affiliated party.

### K. *Insurers*

Often, the deepest available pockets are those of the insurance companies that covered the officers and directors that served the financial institutions and the professionals who advised them. A more thorough discussion of particular insurance issues as they relate to failed bank litigation is included below.

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27. FDIC, *supra* note 14, at 282.

28. *Id.*

29. *Id.* at 283.

30. 12 U.S.C. § 1813(u) (2001).

31. *See, e.g., In re LeBlanc*, Case No. 94-17k (F.D.I.C. Oct. 11, 1995) *available at* <http://www.fdic.gov/bank/individual/enforcement/5229.html>.

## III.

## REGULATORY INVESTIGATIONS—PRE-COMPLAINT POWERS

As explained above, several regulatory agencies would likely investigate the circumstances of a failed institution, and counsel to the parties must be prepared to respond to these various requests. The FDIC as receiver, the OTS, and other relevant government agencies have broad subpoena power under 12 U.S.C. § 1818(n), which allows the agency conducting the investigation to “administer oaths and affirmations, to take or cause to be taken depositions, and to issue, revoke, quash or modify subpoenas and subpoenas duces tecum.” The SEC Enforcement Division has similar subpoena authority if the Commission has approved an investigation, or it may proceed through informal voluntary requests for information.

In the aftermath of a failed bank, during which several government agencies will take investigative interest and significant civil litigation will likely ensue, counsel should be thoughtful about its responses to the agencies’ requests. Documents produced in response to agency subpoenas may become fair game for discovery requests in civil litigation, so any waivers of attorney-client privilege or work product protection should be carefully considered. As receiver, standing in the shoes of the bank, the FDIC is also in a position to assert its right to request documents from the failed institution’s lawyers without a subpoena.<sup>32</sup> Thus, if testimony is sought, any consideration of a witness’s Fifth Amendment rights should be thoroughly vetted. In any civil action pursued by an investigating agency, the trier-of-fact may draw an adverse inference from a witness’s invocation of his Fifth Amendment rights. If there does not appear to be criminal exposure or interest, invocation of the Fifth Amendment may be a detrimental choice.

Bank regulators, like the SEC, are often willing to give defendants the opportunity to make submissions discussing why the agency should not proceed against the defendant. Depending upon the individual situation and counsel’s view of

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32. Because the FDIC’s ability to assert this right is dictated by state law or ethics policies controlling the attorney-client relationship, the validity of this assertion will vary. See JOHN K. VILLA, *BANK DIRECTORS’, OFFICERS’ AND LAWYERS’ CIVIL LIABILITIES* § 2.01[B] (2008-2 Supp. 2008).

the agency's appetite for the case, that submission may persuade the agency not to sue or, more likely, it will provide a starting point for settlement discussions. Because all government agencies are faced with limited resources, this aspect of an investigation can be critical. Many S&L civil cases were settled before adversary litigation had to be filed.

#### IV.

##### FREQUENT FACTUAL ISSUES

In the coming months, with more financial institutions predicted to fail, prospective or actual litigation will have its own unique factual issues. However, in light of the S&L crisis and the market pressures facing today's financial institutions, some common issues will likely arise from this new round of failed institutions. Accounting and public disclosure issues are likely to play a prominent role given the collapse of the subprime securities market. Disclosures made to bank examiners and the institution's board of directors may well be scrutinized. Internal controls and compliance, as well as underwriting and loan origination practices, could be investigated, including complaints or warnings from employees regarding the company's practices. Furthermore, the banking agencies will carefully assess whether the bank complied with regulations and internal guidelines.

##### A. *Accounting Issues*

The current market deterioration implicates accounting areas that are judgmental, require estimation or involve decisions regarding timing. The accounting is an easy target for criticism with the benefit of hindsight. Three accounting issues likely to face scrutiny are: (1) issues of valuation, (2) estimation of allowances and setting of reserves; and (3) issues regarding the impairment of assets. Each of these accounting issues may come into play on multiple fronts for banks that originated and serviced mortgages or related securities, held such assets for investment, sold mortgages for securitization, or purchased mortgage-backed or related securities.

Issues of valuation might surface in several areas. For example, as the appetite for mortgage-backed securities dissipated, a bank that originated a lot of mortgages with the intention of selling them for securitization may have found itself

holding a substantial number of “available for sale” loans. While the bank is holding such loans, it must account for them either at cost or fair value, whichever is lower. If a loan’s value dips below cost and fair value becomes the operative number, typically the bank will look to the market to identify the same or similar item to determine fair value. However, because the secondary markets for subprime loans dried up in 2007, there was no active market for assessing fair value, and so, banks were forced to estimate, a process for which there is no set accounting guidance. As the massive write-downs throughout Wall Street over the last several quarters have demonstrated, these same valuation issues also come into play when banks hold mortgage-backed securities that are no longer liquid.

Regulators and plaintiffs will also raise questions about the adequacy of loan loss reserves and the timing of write-downs for impaired assets—again, both areas require judgment and estimation. When it becomes doubtful that the carrying amount of a loan held for investment will be recovered, the loan is considered to be other than temporarily impaired (“OTTI”). But there is no set formula for determining when a loan is OTTI, and the process is likely to vary widely between institutions. If a loan is determined to be OTTI, then the carrying amount must be reduced and a loss recognized in the period of the impairment. Similarly, for portfolios of loans, banks need to assess the likely credit losses within the portfolio and put up a loan loss reserve in an equivalent amount. Again, there is no set process for estimating the loan loss reserve amount, and the process used by a failed bank may be closely investigated. Given the extreme volatility experienced in the markets over the past year and a half, determining when a loan is OTTI, and calculating the expected losses within a loan portfolio have been exceedingly difficult.

### B. *Disclosures*

A failed bank’s disclosures to its regulators, the SEC and its board of directors will also be closely analyzed. Because banks are highly regulated and subject to regular examinations, the relevant regulatory body will often feel it necessary to allege that the bank misled it during its examination. Otherwise, the bank can defend itself against attacks by noting that government examiners reviewed the same materials or ac-

counting issues and reached the same conclusions as the bank did at the time.

The SEC and private plaintiffs will be keenly focused on the public statements of the bank for potentially misleading statements or omissions. As the announcements about the massive write-downs at the investment banks came out after the close of the third quarter in 2007, many investors claimed to be shocked at the amounts because they were unaware that the investment banks had held such large chunks of these mortgage-backed securities. A bank's failure to disclose exposure from these securities or its large concentration of investment in one type of security has been raised by securities class action plaintiffs and likely will be raised by the FDIC and other regulatory agencies. Finally, the disclosures made to boards of directors will be reviewed to determine if management was misleading the board or if the board was aware of issues and failed to take action, opening up the directors to liability.

### C. *Compliance, Internal Controls, Whistleblowers*

The strength of an institution's internal controls, its compliance with those controls and how, if at all, it addressed concerns raised by employees is another area that is likely to be fully probed. Some questions likely to be raised include: (1) whether an institution's policies and procedures were sufficiently robust and focused on the areas of greatest risk; (2) whether there was a culture of compliance promoted within all divisions of the institution (particularly within the group originating loans or purchasing assets); (3) whether the institution had sufficiently knowledgeable personnel to ensure compliance with policies, regulations, and accounting rules; and (4) whether concerns or warnings from employees about poor practices were considered and investigated. Loan origination and documentation standards are certain to receive attention, and any deviations from stated lending standards are likely to be pursued. Media reports have been rife with stories about "low or no doc" loans being made by banks trying to maintain their high levels of origination and about mortgage brokers inflating the income of applicants. Regulators will certainly be taking a hard look at whether a failed institution complied with the myriad regulations to which a bank is subject.

V.  
FREQUENT LEGAL ISSUES

Each case will have its own specific legal issues; however, there are some that might arise more regularly as the current market turmoil works its way through investigations and litigation.

A. *Federal Banking Regulators—What Law Applies?*

Although the FDIC usually sues in federal court and has the right to remove most actions to federal court,<sup>33</sup> state law, rather than federal common law, generally governs claims and defenses. As the receiver, the FDIC assumes a bank's claims and becomes subject to defenses against these claims.<sup>34</sup> Courts have upheld the application of state law rather than federal common law regardless of whether a bank is federally- or state-chartered and, in *Atherton v. FDIC*,<sup>35</sup> the Supreme Court affirmed the view that state law was applicable, unless a specific federal law established a higher standard of conduct.<sup>36</sup> Thus, for example, although under FIRREA, 12 U.S.C. § 1821(k), a director or officer of a federally insured bank may become liable for monetary damages for "gross negligence" or more seriously culpable conduct, directors may be held liable upon a lesser showing of culpability, such as simple negligence, if applicable state law provides such lesser standard.<sup>37</sup> On the other hand, FIRREA preempts state law and permits claims against directors and officers for gross negligence, regardless of whether state law would require greater culpability.<sup>38</sup> In other words, "state law sets the standard of conduct as long as the state standard (such as simple negligence) is stricter than that of the federal statute. The federal statute nonetheless sets a 'gross negligence' floor, which applies as a substitute for state standards that are more relaxed."<sup>39</sup>

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33. 12 U.S.C. § 1819(b)(2)(B) (2006).

34. See *O'Melveny & Meyers v. FDIC*, 512 U.S. 79, 86 (1994).

35. 519 U.S. 213 (1997).

36. See JOHN K. VILLA, *BANK DIRECTORS', OFFICERS' AND LAWYERS' CIVIL LIABILITIES* § 1.02[A] (2004-2 Supp. 2004).

37. See *Atherton*, 519 U.S. at 215-17.

38. *Id.*

39. *Id.* at 216.



The applicable state law for claims against bank and S&L officers and directors for breach of fiduciary duty or other malfeasance will generally be the bank's state of incorporation or, in the case of federally chartered institutions, the institution's principal place of business.<sup>40</sup> Pursuant to statute and regulation, Fannie Mae and Freddie Mac have adopted Delaware General Corporation Law, which applies to matters of corporate governance, directors' potential liability, and the demand futility analysis for shareholder derivative suits involving those entities.<sup>41</sup> Suits on behalf of failed institutions against third parties, for example tort or breach of contract claims, would not necessarily be governed by the law of the state of incorporation or principal place of business but rather by the applicable state law as determined by the choice-of-law rules of the forum state.

Although state law generally controls and certainly controls with respect to standard director and officer fiduciary duties, certain federal law and the federal regulators hold officers and directors of banks to heightened standards, such as the duty to investigate. In a manual prepared by the OCC entitled *The Role of a National Bank Director*, the responsibilities and expectations for a bank director are set out, including a "duty to investigate."

When circumstances alert a director to an actual or potential problem, the "duty to investigate" requires that the director take steps to learn the facts and to resolve the situation. For instance, if a director learns about an examiner's or auditor's criticism, whether by informal communication or written report, the director is responsible for ensuring that the board and management review the matter and that

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40. See, e.g., *Resolution Trust Corp. v. Gregor*, 872 F. Supp. 1140, 1150 (E.D.N.Y. 1994) (hereinafter "RTC"); *FDIC v. Cohen*, 1996 WL 87248, at \*9 (S.D.N.Y. Feb. 29, 1996). See also *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 263-64 (2d Cir. 1984) (under New York choice-of-law rules, directors of corporation incorporated in Panama but with its principal place of business in New York were subject to the substantive law of New York).

41. See *Pirelli Armstrong Tire Corp. Retiree Medical Benefits Trust v. Raines*, 534 F.3d 779, 783 n.1 (D.C. Cir. Aug. 8, 2008) (citing 12 U.S.C. § 4513; 12 C.F.R. 1710.10(b); Fannie Mae By-laws); *In re Fed. Nat'l Mortgage Assoc. Sec. Derivative*, and "ERISA" Litig., 503 F. Supp. 2d 9, 14-15 (D.D.C. 2007).

any necessary corrective action is taken. Also, the recurrence of a situation that previously caused problems should alert the director to monitor the matter even more carefully, because the director will be considered to have been put on notice the first time the problem was discovered.<sup>42</sup>

The FDIC has pursued claims against directors when they become aware of problems and fail to investigate them under what is essentially a constructive knowledge theory. Regulators have also targeted lawyers and auditors for failing to investigate.

A viable defense to a claim that a director or attorney failed to investigate is that the individual justifiably relied on management. While some degree of reliance on management has been recognized for decades as an essential element of being a director,<sup>43</sup> it is important that directors be able to document, in some fashion, an active role in supervising the activities of the bank. If there are red flags, particularly warnings from regulators, auditors or lower-level employees, then directors must be sure that they make sufficient inquiries of management.

### B. *Common Defenses*

Given the position of the FDIC as receiver, standing in the shoes of the failed institution, there are several defenses that potentially can be used against the FDIC.

### C. *Imputation*

In *O'Melveny & Meyers v. FDIC*, the Supreme Court specifically held that state law controlled the availability of an imputation defense in litigation with the FDIC.<sup>44</sup> Consequently, *if*

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42. OFFICE OF THE COMPTROLLER OF THE CURRENCY, THE ROLE OF A NATIONAL BANK DIRECTOR 80 (1997).

43. See *Atherton v. Anderson*, 99 F.2d 883, 888-90 (6th Cir. 1938). In that case, however, the court sustained a finding of liability against certain directors who claimed to have relied on management, stating that "ordinary prudence required something more . . . they had their own duties of oversight and supervision to perform. . . . This duty of supervision is not performed by reposing confidence in such officers, however worthy of confidence they may seem to be."

44. 512 U.S. 79 (1994).

the relevant state law recognizes the doctrine of imputation, third-party defendants may argue that the knowledge of former officers or directors of the failed institution is imputed to the FDIC. For example, if officers and directors participated in misconduct or directed the actions of a third party, such as an audit or law firm, then such a firm might be able to successfully impute that misconduct or knowledge to the FDIC, barring it from pursuing claims against the third party. Some state courts have recently restricted third-party professionals' ability to use this defense. In 2006, the New Jersey Supreme Court ruled that the defense of imputation did not shield an auditing firm from claims of negligence brought by a trustee of the bankrupt audit client.<sup>45</sup>

#### D. *Statute of Limitations*

FIRREA, enacted in 1989, specifically addressed statutes of limitations for claims brought by the FDIC as a receiver. For contract claims the statute of limitations is the longer of either six years or the period prescribed by applicable state law. For tort claims it is the longer of either three years or the period prescribed by applicable state law.<sup>46</sup> In both instances, the statute of limitations begins to run on any claim at the later of when the FDIC becomes the receiver or when the cause of action accrues.<sup>47</sup> Because of the extended statute of limitations for contract claims, the FDIC sometimes tries to construe claims as contract instead of tort claims. If a claim is not timely at the time that the FDIC becomes the receiver, courts have generally not applied the extended statute of limitations found in FIRREA.<sup>48</sup> Courts look to the relevant state law to

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45. *NCP Litigation Trust v. KPMG LLP*, 901 A.2d 871 (N.J. 2006). The court did note that the defense may still be available against large shareholders with some ability to oversee a company's operations. In *Sunpoint Securities, Inc. v. Cheshier & Fuller*, 377 B.R. 515 (Bankr. E.D. Tex. 2007), the court applied Texas law to preclude imputation of the wrongdoing of a dominant (but not sole) shareholder to the trustee in bankruptcy of a corporation, and held that the trustee was entitled to recover damages from an outside auditing firm for negligently failing to detect the insider's wrongdoing.

46. 12 U.S.C. § 1821(d)(14) (2008).

47. *Id.*

48. *See, e.g., FDIC v. Alexander*, 78 F.3d 1103, 1106 (6th Cir. 1996).

determine if a claim is still timely when the institution goes into receivership.<sup>49</sup>

### E. *Comparative Negligence*

State law also governs the comparative fault defenses available for use against the FDIC when it acts as receiver. Thus, the doctrine of comparative or contributory negligence will often apply when the FDIC pursues claims of negligence or malpractice against third-party professionals.<sup>50</sup> In jurisdictions adopting comparative negligence, courts will examine what proportion of a bank's losses from the transaction was attributable to the negligence of the failed bank's management. The FDIC's recovery will be reduced in proportion to this amount.<sup>51</sup> Contributory negligence creates an even stronger defense. In the few states that follow this doctrine, any negligence at all by the failed bank's management during the exchange will result in a complete bar to recovery.<sup>52</sup> Because many of the FDIC's suits are likely to be grounded in tort, these doctrines can play a significant role in limiting the agency's recovery.

### F. *The Theory of Deepening Insolvency*

One important theory, largely advanced against third-party professionals like auditors, is "deepening insolvency." States are divided both as to whether this is a viable claim and whether it is a stand-alone tort claim or a theory of damages. Deepening insolvency is essentially a claim that a defendant played a role in increasing an entity's indebtedness or exposure to creditors by prolonging its life. For example, if an auditor issues an unqualified audit opinion on financial statements that include improper transactions and accounting errors that later lead to the entity's bankruptcy, the auditor may be exposed to a claim of deepening the entity's insolvency.<sup>53</sup> Delaware has seemingly rejected this theory of liability,<sup>54</sup> while

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49. *See, e.g.*, *RTC v. Hecht*, 818 F. Supp. 894 (D. Md. 1992).

50. *See* *FDIC v. Ferguson*, 982 F.2d 404, 406 (10th Cir. 1991).

51. *Id.*

52. *See id.*

53. *See* *NCP Litig. Trust v. KPMG*, 945 A.2d 132 (Super. Ct. N.J. 2007).

54. *See* *Trenwick America Litig. Trust v. Ernst & Young LLP, et al.*, 906 A.2d 167 (Del. 2006).

other forums, such as New Jersey, seem willing to entertain the theory.<sup>55</sup>

### G. *Creditor Theories*

During the S&L crisis, the FDIC argued that the various defenses that would have been good against the bank did not apply to the FDIC because the FDIC, acting in its corporate capacity, also sued as the subrogee of depositors, not merely as the successor to the bank itself.<sup>56</sup> Once the FDIC has paid the insured depositors for their loss, the FDIC then holds the claims of those depositors, often making the FDIC one of the largest claimants in any proceeding. This allows the FDIC to pursue claims on behalf of depositors of the “institution or branch.”<sup>57</sup> The FDIC has attempted to use this part of the statute for creative ends, advancing claims against third parties in its corporate capacity when suing in its capacity as receiver would subject it to compelling defenses or unappealing contractual limitations.<sup>58</sup>

Following *O'Melveny*, courts have applied state law to subrogee tort claims.<sup>59</sup> This will allow defendants access to many of the defenses available against these tort claims under state law. For example, in New York, organizations acting as subrogees are required to establish a privity-type relationship with a professional third party before being able to prevail on a claim of negligent misrepresentation.<sup>60</sup> Under New York law, filling in for a customer of a bankrupt broker-dealer did not create a sufficient nexus between the subrogee and the third-party professional to form the basis of a negligent misrepresentation

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55. See *NCP Litig. Trust*, 945 A.2d at 143.

56. 12 U.S.C. § 1821(g)(1) (2008).

57. *Id.*

58. See, e.g., *FDIC v. Ernst & Young, LLP*, 374 F.3d 579, 581 (7th Cir. 2004) (FDIC sued failed bank's auditors in its corporate capacity in order to avoid the arbitration clause and punitive damages waiver in the bank's contract with its auditors).

59. See, e.g., *Sunpoint Sec., Inc. v. Cheshier & Fuller, LLP*, 377 B.R. 515 (Bankr. E.D. Tex. 2007) (applying Texas law to tort claims of SIPC, as subrogee of corporation's customers, against auditing firm for negligence and negligent misrepresentation).

60. See *Sec. Investor Prot. Corp. v. BDO Seidman, LLP*, 222 F.3d 63, 70 (2d Cir. 2000) (although this case involves the SIPC acting as a subrogee, the Court specifically examined the similarity between the SIPC and FDIC).

claim.<sup>61</sup> A bankruptcy court applying Texas law recently held similarly on a claim by the Securities Investor Protection Corporation (SIPC) as subrogee against an outside auditing firm.<sup>62</sup>

Additionally, states like New York and Pennsylvania require plaintiffs claiming fraudulent misrepresentation grounded in state law to show actual reliance.<sup>63</sup> Thus, under some state law, the FDIC as subrogee must show that the depositor whose interests it is asserting relied on the statements of the third-party professional and that this reliance caused the subrogee's losses.<sup>64</sup> Unable to rely on a fraud-on-the-market theory that prevails in federal securities fraud cases, the FDIC will have to establish that the depositor placed its funds in the bank or failed to remove them as a direct result of the advice the third party rendered to the failed bank.<sup>65</sup>

A third-party defendant can also challenge the FDIC's showing of proximate cause. In California, for example, proximate cause requires that the defendant be able to reasonably foresee the injury to the plaintiff.<sup>66</sup> In many cases involving failed banks, a third-party professional who is unaware of adverse material facts may not foresee any damage to individual depositors when providing advice to the bank.<sup>67</sup>

#### H. *Spoliation Claims*

In the S&L crisis, the FDIC often claimed that documents were missing and therefore were destroyed in contravention of the defendant's retention policies. One antidote is to show that the regulators also have missing documents under their own retention policies.

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61. *Id.* at 76.

62. *Sunpoint Sec., Inc.*, 377 B.R. at 559-61.

63. *See Sec. Investor Prot. Corp.*, 222 F.3d at 73. *See also* *Aubrey v. Sanders*, WL 4443826, at \*8 n.11 (W.D. Pa. Sept 26, 2008) (Pennsylvania rejects fraud on the market theory for common law fraud).

64. *See Seidman*, 222 F.3d at 73; *Aubrey*, 2008 WL 4443826, at \*6. *See also Sunpoint Sec., Inc.*, 377 B.R. at 559-61.

65. *See Seidman*, 222 F.3d at 73.

66. *FDIC v. Imperial Bank*, 859 F.2d 101, 103 (9th Cir. 1988).

67. *See id.*

## I. Causation

Third-party agents who find themselves defending against the FDIC for the professional services they rendered to a failed bank will likely rely strongly on concepts of causation. Loss causation is a necessary element of any securities fraud action<sup>68</sup> and is also required for the common law actions of deceit and misrepresentation. An important question in the coming wave of receiver litigation will be the extent to which absence of loss causation is a defense. For example, assume that a state follows deepening insolvency as a theory and an FDIC receiver alleges that a third-party professional's tort enabled a bank to stay open and thus to suffer credit crisis losses. In a securities case, the plaintiff cannot establish causation for losses resulting from general economic conditions.<sup>69</sup> Will the same be true when the FDIC and other receivers sue? In today's dynamic economic environment, excluding the host of alternative causes for the declining value of a failing bank's securities will likely prove difficult.

Lack of loss causation could be an effective defense for third-party professionals who advised a failed institution. In the S&L cases, courts were willing to reject certain claims as being too attenuated or speculative, noting that "the existence of a simple 'but for' relationship" between the alleged malpractice of counsel and the injury is insufficient.<sup>70</sup> Most S&L cases had concluded by 1994, however, and principles of loss causation as a securities law defense largely developed after 1994. The credit crisis cases will tell to what extent those principles will also apply in receiver cases.

Even the establishment of "but for" causation against third-party professionals could be problematic for receivers in credit crisis cases. In the S&L cases, receivers could allege "but for" causation by arguing that because of the professional's malpractice, the thrift continued to make new, risky loans that

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68. *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 343 (2005).

69. *See id.* (explaining that alternative causes could include "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of [the] lower price").

70. *RTC v. Stroock & Stroock & Lavan*, 853 F. Supp. 1422, 1427 (S.D. Fla. 1994); *FDIC v. Ernst & Young*, 967 F.2d 166, 171-72 (5th Cir. 1992); *see also* JOHN K. VILLA, *BANK DIRECTORS', OFFICERS' AND LAWYERS' CIVIL LIABILITIES* § 2.01[B] (2008-2 Supp. 2008).

proved unrecoverable. Credit crisis cases are more likely to focus on subprime-related assets that were already owned by financial institutions at the time of the alleged professional negligence and which thereafter continued to decline in value. Given that many of these assets were illiquid and essentially unsaleable, it may prove difficult for plaintiffs to show that, but for the professional's negligence, the institution could have sold the assets at a higher price at an earlier time.

### J. *Damages*

Under 12 U.S.C. § 1821(l), recoverable damages for the "improvident or otherwise improper use or investment of the institution's assets" include "principal losses and appropriate interest." Late in the S&L crisis, the FDIC took the position that, under this section, the measure of recoverable damages is specifically established by federal law, not state law.<sup>71</sup> In one case, where the RTC had no claim for damages against a law firm under state law, the court rejected the position that federal law controlled, reasoning that Section 1821(l) merely required prejudgment interest for a claim that was otherwise viable under state law.<sup>72</sup> In a later case, however, a district court held that a state statute limiting damages was overridden to the extent it conflicted with the damages the FDIC could recover under Section 1821(l).<sup>73</sup> One can safely predict that the FDIC will argue in credit crisis cases that Section 1821(l) preempts all manner of state law defenses that would preclude or reduce liability.

### K. *Non-Party Fault*

In more than 40 states, whether by statute or common law, joint-and-several liability has been eliminated to the extent that a defendant can plead and prove the proportionate fault of another defendant or a non-party. These states have

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71. See *Stroock & Stroock & Lavan*, 853 F. Supp. at 1426-27.

72. *Id.* (The RTC argued that under the statute, interest earned by the S&L on junk bonds on which it suffered a principal loss – which interest made the transactions profitable to the S&L overall – should not be taken into account in determining whether there had been a "loss." The court rejected what it called this "seemingly irrational interpretation" that would have constituted "a major intrusion into a traditional area of common law.").

73. *FDIC v. Cohen*, 1996 WL 87248, at \*12 (S.D.N.Y. Feb. 29, 1996).



abandoned joint-and-several liability in favor of either modified joint-and-several liability or pure several liability.<sup>74</sup>

If a defendant is sued in a state that has limited or eliminated joint-and-several liability, he may want to consider naming uninsured officers, insolvent appraisers, or developers as non-parties at fault. If the defendant can provide sufficient evidence to show that these other parties were at fault, his damages are reduced even if the non-party is not capable of paying damages for its share of the fault.

Non-party fault is usually raised in the answer as an affirmative defense. Pleading this defense requires balancing the need to satisfy Federal Rules of Civil Procedure (“FRCP”) 8 and 9(b) against the risk of endorsing or proving the claims alleged by plaintiff in the complaint. Pleading an affirmative defense of contributory liability may be more difficult after last year’s Supreme Court decision in *Bell Atlantic Corporation v. Twombly*, which increased the pleading standard under Rule 8.<sup>75</sup> Although *Twombly* was an antitrust case, it will likely impact other complex financial litigation as well.<sup>76</sup> Under *Twombly*, a pleading must state sufficient facts to push a claim “across the line from conceivable to plausible.”<sup>77</sup> An affirmative defense will also need to satisfy any applicable particularity standard under FRCP 9(b). In the S&L crisis, the FDIC often moved to dismiss or strike non-party fault affirmative defenses for insufficient pleading of a factual basis. Additionally, the FDIC may

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74. For example, in 1986, Colorado passed tort reform that eliminated joint and several liability, enabling defendants to present evidence of the liability of other non-parties in order to reduce or eliminate their own. COLO. REV. STAT. § 13-21-111.5 (2008). A 1987 amendment allows joint liability when tortfeasors consciously acted in a concerted effort to commit a tortious act. § 13-21-111.5. Other states, such as Tennessee, have eliminated the application of joint-and-several liability through common law. See *McIntyre v. Balentine*, 833 S.W.2d 52, 54 (Tenn. 1992).

75. 550 U.S. 544 (2007).

76. See, e.g., *ATSI Commc’ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 98 n.2 (2d Cir. 2007) (applying *Twombly* to a securities litigation matter); *Phillips v. County of Allegheny*, 515 F.3d 224, 230-35 (3d Cir. 2008) (applying *Twombly* to § 1983 state-created danger claim); *In re Ocwen Loan Servicing, LLC Mortgage Servicing Litig.*, 491 F.3d 638, 648-49 (7th Cir. 2007) (suggesting that the district court, on remand, should consider whether complaint complied with *Twombly* pleading standards notwithstanding that “the present case is not an antitrust case”).

77. *Twombly*, *supra* note 75, at 570.

try to avoid non-party fault defenses by attempting to characterize a claim as not sounding in tort—by characterizing malpractice as a breach of contract, for example.

#### L. Procedural Issues

The increased pleading standards under *Twombly* will be useful to defendants, however, in challenging the pleading of causation and other issues alleged in complaints. For example, in a securities fraud case, defendants can argue that the combination of *Twombly* and the Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*<sup>78</sup> requires a plaintiff to plead with particularity what portion of a stock's decline was due to the alleged misconduct of the defendants as opposed to other market reasons, such as the decline in the real estate and credit markets.<sup>79</sup>

When litigating with regulators, other procedural issues that defendants should keep in mind are the use of the “at-issue” doctrine to circumvent government privileges and the possibility of obtaining regulatory documents, such as those held by the OTS, through the FDIC. If the FDIC is alleging certain facts that will necessarily require it to use materials it would otherwise claim as protected government information in order to prove its allegations, then a defendant may be able to argue that the FDIC must produce that information during discovery because the FDIC has put it “at issue.”<sup>80</sup> Additionally, an argument may be made that the FDIC retains custody or control of supervisory records held by other banking agencies because it is entitled to access them upon being appointed receiver for a failed bank.<sup>81</sup> The argument for FDIC control over these documents is bolstered by the fact that Congress gave the agency broad latitude in using these supervisory records for any purpose the receiver (FDIC) deems “appropriate.”<sup>82</sup>

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78. *Dura Pharms, Inc. v. Broudo*, 544 U.S. 336 (2005).

79. Richard D. Bernstein and Michael D. Gorfinkle, *Pleading & Proving Loss Causation in § 10(b) Credit Crisis Cases*, in SECURITIES LITIGATION REPORT, Vol. 5, Issue 5 (May 2008).

80. See 6 JAMES W. MOORE, ET AL., MOORE'S FEDERAL PRACTICE § 26.70[6][c] at 26-466 (3d ed. 1997) (a party “impliedly waives work product protection if it PLACES the substance of the DOCUMENTS for which the protection is claimed AT ISSUE”).

81. 12 U.S.C. § 1821(o) (2008).

82. See *id.*

## VI. WHEN OTS IS THE PLAINTIFF

Since the mid-1990s, the OTS has rarely sued in contested litigation. Unlike the FDIC, which can and does hire outside counsel because the receiver's litigation is funded by the assets of the failed bank, OTS's only funding source is its own litigation budget.

As discussed above, the OTS has broad remedies available to it should it choose to sue. Congress has provided regulating agencies like the OTS with incredibly wide discretion. Specifically, they are allowed to initiate administrative enforcement proceedings so long as in their "opinion" the institution or an affiliated party has engaged or is planning to engage in "un-sound business practices" or has violated or plans to violate "a law, rule, or regulation, or any condition imposed in writing by the agency."<sup>83</sup>

Moreover, an OTS suit is an enforcement proceeding in an administrative forum, not a federal court. The OTS enjoys longer statutes of limitations, lower evidentiary burdens, and fewer state law defenses than would be available in a civil court proceeding. In addition, there is no impartial jurist; an administrative judge hears the case and makes a recommendation to the OTS director, who reviews the case *de novo*. The director makes a final decision that is appealable only to the United States Court of Appeals. The court may reverse the decision only if the director abused his discretion, violated the Constitution, or made a decision unsupported by substantial evidence.<sup>84</sup> OTS can also combine multiple failed banks in one litigation and sue third parties in a global proceeding rather than on a transactional basis; for example, it threatened to do this against Deloitte and KPMG during the S&L crisis.

### A. *Restitution Theory*

Congress has specifically granted OTS the ability to bring cease-and-desist proceedings as part of its enforcement power.<sup>85</sup> The ability to require restitution to compensate for

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83. *CityFed Fin. Corp. v. OTS*, 58 F.3d 738, 741 (D.C. Cir. 1995).

84. *See* *FDIC v. Hurwitz*, 384 F. Supp. 2d 1039, 1091 & n.372 (S.D. Tex. 2005) (citing 5 U.S.C. § 706).

85. *See* 12 U.S.C. § 1818(b) (2000).

losses is a component of this grant.<sup>86</sup> However, before it can use this power to order restitution, the OTS must first establish that the defendants were either “unjustly enriched” or acted with “reckless disregard” for the law.<sup>87</sup>

Courts differ in determining precisely what conduct constitutes unjust enrichment under the statute. The D.C. Circuit followed the common law. It held that a party has been unjustly enriched only if (1) an institution has conferred a benefit upon a party, (2) the party accepted the benefit, and (3) it would be unjust for the party not to repay the institution for the benefit’s value.<sup>88</sup> The Fifth Circuit, on the other hand, interpreted the phrase more broadly than the common law. It held that a party could be unjustly enriched merely by receiving a “personal benefit” from the institution.<sup>89</sup> Courts have been uniformly careful to narrowly construe “reckless disregard” as applying only to situations involving misconduct more egregious than simple errors of judgment.<sup>90</sup> Courts have also limited the amount retrieved under restitution orders to the actual uncompensated loss suffered by the institution.<sup>91</sup>

### B. *Asset Freeze*

In connection with OTS’s attempts to obtain restitution or other monetary relief, Congress has authorized the OTS to obtain an asset freeze prohibiting a defendant from “withdrawing, transferring, removing, dissipating, or disposing” of any funds.<sup>92</sup> Upon issuance of the order, a temporary receiver is appointed to administer it.<sup>93</sup> The standard governing the issuance of such an asset freeze is much like that of Federal Rule 65, which controls temporary restraining orders.<sup>94</sup> However, it is more permissive in one critical respect. Although Rule 65 requires the movant to show that “immediate or irreparable” loss will accrue without a prejudgment injunction, this require-

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86. § 1818(b)(6)(A).

87. *Id.*

88. *Rapaport v. U.S. Dep’t of the Treasury*, 59 F.3d 212, 217 (D.C. Cir. 1995); *see also* VILLA, *supra* note 32, at § 3.04[c][4].

89. *Akin v. OTS*, 950 F.2d 1180, 1184 (5th Cir. 1992).

90. VILLA, *supra* note 32, at § 3.04[C][4].

91. *See id.*

92. § 1818 (i)(4)(A)(i).

93. § 1818(i)(4)(A)(ii).

94. § 1818(i)(4)(B)(i).

ment is lacking for an administrative asset freeze.<sup>95</sup> Thus, in order to freeze the assets of a defendant, the OTS must establish by affidavit or verified complaint only that damage will result to the institution without a preliminary freeze. This scheme provides the OTS with extraordinary leverage.

At least one defendant has argued that the imposition of restitution remedies by the OTS constitutes a violation of the separation of powers, because it allows an administrative law judge to set penalties that ought to be reserved for Article III courts.<sup>96</sup> However, the court rejected this argument.<sup>97</sup> It found that Congress had created an enumerated list of exceptions that allowed cases to avoid Article III adjudication, one of which was reserved for cases involving public rights.<sup>98</sup> Enforcement of the thrift laws protected the thrift industry, the thrift depositors and the federal insurance fund.<sup>99</sup> For this reason, the court held, the OTS's cease-and-desist proceedings enforcing the thrift laws constituted a "public rights" case and did not require action by an Article III judge in assessing penalties.<sup>100</sup> Additionally, the court noted that defendants were entitled to appellate review in the circuit courts, presumably also lessening the need for Article III action at the fact-finding level.<sup>101</sup>

## VII.

### CREDIT DEFAULT SWAP ISSUES

Financial institution failures present special issues concerning the rights and liabilities of participants in the multi-trillion dollar credit default swap ("CDS") market.

By way of background, the explosion in the use of credit default swaps is a relatively recent phenomenon, fueled in part by the desire of the owners of subprime mortgages and other mortgage-related, credit-backed instruments, such as CDOs, to "hedge" their risk. They do so by buying "credit default protec-

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95. *See id.*; FED. R. CIV. P. 65(b)(1)(A).

96. *Simpson v. OTS*, 29 F.3d 1418, 1422 (9th Cir. 1994).

97. *Id.*

98. *Id.*

99. *Id.* at 1423.

100. *Id.*

101. *Id.*

tion” that resembles insurance.<sup>102</sup> A credit default swap is a derivative contract between two parties in which a “protection buyer” makes periodic payments, in the nature of a premium, to a “protection seller,” in return for a contingent payment, similar to insurance, if a credit instrument or other “reference obligation” goes into default, or on the occurrence of a specified credit event (such as a bankruptcy or receivership) on the part of a “reference entity.”

Counterparties to credit default swaps generally document their transactions through standardized Master ISDA<sup>103</sup> Agreements (as modified by individually negotiated schedules), often accompanied by separate credit support annexes providing for the daily calculation of exposures so that the protection seller or buyer may be required to post additional collateral to cover the exposure (in essence a margin call). Failure to post such additional collateral (among other events of default and termination events) gives the non-defaulting party the right to terminate all trades between the parties and calculate one net settlement amount in respect of all of the terminated trades (basically by adding up the mark-to-market value of each trade). The non-defaulting party may then set off, to the extent provided for in the agreement, any amounts it owes against what it is owed by the defaulting party under other agreements.<sup>104</sup> The enforceability of the close-out netting and set-off provisions is vital to financial institutions active in the derivatives market since the ability to net allows them to allocate capital against only the net figure they would have to pay on close-out of an ISDA Agreement rather than against the gross amount. Under ISDA Agreements, and in connection with a credit default swap, a net settlement amount could re-

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102. The main difference that distinguishes credit default swaps from insurance is the absence of any requirement that the “protection buyer” own the asset on which it is buying protection or that it suffer any loss. Other significant differences include that payment upon settlement may be more than the loss (if any) suffered by the buyer, and the absence of rights of subrogation.

103. International Swaps and Derivatives Association.

104. The most commonly used ISDA Agreement is the 1992 Master Agreement. There is also a 2002 version. “Confirmations” set forth the economic terms and transaction-specific modifications to the ISDA Master Agreement and Schedule and indicate which set of ISDA definitions are applicable. Together, the confirmations and Master Agreement and Schedule constitute a single agreement.

sult in a payment being owed to the protection buyer, such as a bank in FDIC receivership, even though it is the party in default. ISDA agreements also contain so-called “*ipso facto*” clauses allowing for termination, acceleration and netting upon the bankruptcy of the counterparty or appointment of a conservator or receiver.

Under the Bankruptcy Code, the non-bankrupt counterparty is permitted to enforce an *ipso facto* clause in its “swap agreements” and “master netting agreements” (which include credit default swaps), notwithstanding the automatic stay and other provisions of bankruptcy law that would ordinarily allow the trustee to avoid such clauses.<sup>105</sup> This allows the party to an ISDA Agreement to exercise the early termination, netting and set-off provisions of the agreement upon a bankruptcy filing by the counterparty (the trustee can also terminate the ISDA Agreement, even though by contract only the non-defaulting party has that right). Multiple transactions contained within an ISDA Agreement are viewed as a single “swap agreement,”<sup>106</sup> which prevents either party, including the bankruptcy trustee, from “cherry picking” by accepting profitable swaps and rejecting losing transactions.<sup>107</sup>

The FDIC has similar rights and faces similar constraints as a bankruptcy trustee, with some important exceptions. Under FIRREA, 12 U.S.C. § 1821(e), the FDIC as conservator and/or receiver may, within a reasonable period following appointment, disaffirm, or repudiate any contract to which the institution was a party where performance of the contract would, in the agency’s determination, be “burdensome,” and disaffirmance or repudiation would “promote the orderly ad-

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105. 11 U.S.C. §§ 560, 561 (2006); see generally *In re Enron Corp.*, 306 B.R. 465 (Bankr. S.D.N.Y. 2004) (explaining interplay of *ipso facto* clauses and bankruptcy law in context of derivative swap agreements). A credit default swap is a “swap agreement” entitled to this special protection under the Code. 11 U.S.C. § 101(53B)(A) (2006). Similarly protected are repurchase agreements or “repos,” which are commonly used to buy and sell CDOs, which serve as collateral for what are, in substance, secured loans. See 11 U.S.C. §§ 101(47), 559 (2006).

106. § 101(53B)(A)(v).

107. See Adam R. Waldman, Comment, *OTC Derivatives & Systemic Risk: Innovative Finance or the Dance into the Abyss?*, 43 Am. U.L. Rev. 1023, 1069 (Spring 1994) (hereinafter “*OTC Derivatives*”) (commenting on former 11 U.S.C. § 101(55C), now (53B)).

ministration of the institution's affairs."<sup>108</sup> While the FDIC may be liable for damages resulting from repudiation of a contract, those damages are limited by statute to actual direct compensatory damages determined as of the date of the receiver's appointment, and specifically exclude damages for "lost profits or opportunity," pain and suffering or punitive damages.<sup>109</sup>

The FDIC also has the power, under 12 U.S.C. § 1821(e)(13)(A),<sup>110</sup> to "enforce any contract. . . entered into by the depository institution notwithstanding any provision of the contract providing for termination, default, acceleration, or exercise of rights upon, or solely by reason of, insolvency or the appointment of a conservator or receiver." This provision thus allows the FDIC to avoid enforcement of an *ipso facto* clause predicated on a bank failure.<sup>111</sup> However, an exception is provided for certain market-sensitive financial contracts, referred to as "qualified financial contracts" ("QFCs"), defined to include mortgage-related securities, swap agreements, and similar agreements.<sup>112</sup> In the same way a bankruptcy trustee may not avoid enforcement of an *ipso facto* clause, the FDIC likewise cannot prohibit any person from exercising a right to terminate, liquidate or accelerate QFCs upon the FDIC's appointment as receiver.<sup>113</sup> In other words, during an FDIC re-

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108. 12 U.S.C. § 1821(e)(1), (2) (2006). The determination of burdensomeness is committed to the discretion of the FDIC, and a court's review of the decision by the FDIC to repudiate is narrowly circumscribed and the decision will not be overturned except for abuse of discretion. *See McCarron v. FDIC*, 111 F.3d 1089 (3d Cir. 1997).

109. § 1821(e)(3)(A)-(B).

110. § 1821(e)(12)(A) (formerly 12 U.S.C. § 1821(e)(12)(A) (2000) and sometimes referred to under the former number).

111. *See Bank of New York v. FDIC*, 453 F. Supp. 2d 82, 84-85 (D.D.C. 2006) (construing FIRREA to allow FDIC to decline to honor *ipso facto* clause in master trust indenture that provided for recovery by noteholders of their investments at accelerated rate upon appointment of receiver of NextBank, N.A.), *aff'd*, 508 F.3d 1 (D.C. Cir. 2007).

112. § 1821(e)(8)(D)(vi), (vii) (defining QFCs to include swap agreements, including a "credit swap" or other similar agreement, as well as any master agreement covering any such agreement); *OTC Derivatives*, *supra* note 107, at 1072 ("all OTC derivatives transactions clearly meet the [QFC] product requirement for protection under FIRREA").

113. The FDIC *can*, however, avoid *ipso facto* clauses in Qualified Financial Contracts when it acts as *conservator*, as opposed to receiver, because termination or acceleration of such contracts during conservatorship would jeopard-



ceivership, just as in the bankruptcy context, counterparties to ISDA Agreements may exercise any *ipso facto* clause that permits termination or acceleration upon appointment of a receiver, and fully enforce the netting and set-off provisions in an ISDA Agreement or similar swap agreement or derivatives contract.<sup>114</sup>

The FDIC does retain the right to repudiate a QFC in its entirety (as opposed to avoiding only a portion of the QFC, *i.e.*, an *ipso facto* clause). If the FDIC exercises this repudiation right, damages are determined at the date of *repudiation* (as opposed to the date of the receiver's appointment), and compensable damages include reasonable costs of cover, thereby making QFCs more expensive for the FDIC to repudiate than regular contracts.<sup>115</sup> By contrast, under the Bankruptcy Code, if the trustee rejects a swap agreement or the counterparty liquidates or terminates it, damages are measured as of the *earlier* of the date of such rejection or the date of such liquidation or termination.<sup>116</sup>

Disputes and litigation over the exercise of *ipso facto* termination rights under ISDA agreements are not uncommon and will become increasingly frequent between CDS counterparties as they attempt to calculate their exposure on thinly traded CDOs that serve as the reference credit risk.<sup>117</sup> For ex-

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ize the conservator's ability to operate the institution. See *RTC v. Cheshire Mgmt. Co.*, 18 F.3d 330, 336 (6th Cir. 1994).

114. See 12 U.S.C. § 1821(e)(8) (2008); *OTC Derivatives*, *supra* note 107, at 1072-73. In addition, like the Bankruptcy Code, FIRREA prevents "cherry-picking" by requiring that if the FDIC elects to transfer a QFC, it must either transfer *all* QFCs between the failed depository institution and its counterparty to a single depository institution, or *none* of such QFCs. § 1821(e)(9); *OTC Derivatives*, *supra* note 107, at 1073-74. See also *Cheshire Mgmt. Co.*, 18 F.3d at 336 (explaining "all or nothing" rationale for transfers of QFCs to prevent dispersion of QFCs among several banks and to preserve the ability of the holder of the QFC to set off its liabilities to the failed bank against its assets). The enforceability of netting provisions between financial institutions was further confirmed under the Federal Depositors Insurance Corporation Improvement Act of 1991, codified at 12 U.S.C. § 1811 (2006). See *OTC Derivatives*, *supra* note 107, at 1074-75 & n.352.

115. § 1821(e)(3)(C)(i); *Cheshire Mgmt. Co.*, 18 F.3d at 336.

116. 11 U.S.C. § 562 (2006).

117. See, *e.g.*, Complaint in *VCG Special Opportunities Master Fund Limited v. Citibank, N.A.*, No. 08 CV 01563 (S.D.N.Y. Feb. 14, 2008); see also *Drexel Burnham Lambert Prod. v. Midland Bank PLC*, 1992 U.S. Dist. LEXIS 21223 (S.D.N.Y. Nov. 10, 1992). The *Drexel* court upheld the enforceability of a so-

ample, if a counterparty elects to exercise its right to liquidate collateral after electing to terminate an agreement, and the FDIC were to repudiate at a later date, which is its right,<sup>118</sup> the damages under the statute would be calculated as of that later date. That produces an awkward result for swap market participants because no finality would exist, thus exposing them to market risks on the trade until the repudiation date. The FDIC would be limited, in theory, by the statutory requirement that it repudiate within a reasonable time after its appointment, but courts give the FDIC considerable latitude in defining what constitutes a reasonable period and rarely overturn attempts to disaffirm or repudiate as untimely.<sup>119</sup> Liquidations of esoteric, difficult-to-value collateral, such as CDOs, in an illiquid market, also raise issues concerning the reasonableness of the methods used to liquidate as well as the prices obtained.<sup>120</sup>

It remains to be seen how these disputes will play out in the context of failed financial institutions, but one should assume that the FDIC will aggressively exercise its statutory rights under FIRREA against CDS and other derivatives counterparties, including, if the agency deems it in the institution's interest, its broad contract repudiation authority.

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called "walkaway" clause, *i.e.*, one that purports to extinguish a payment obligation of a party that would otherwise exist, solely because of such party's status as a nondefaulting party in connection with the bankruptcy of the other party. FIRREA specifically renders unenforceable a "walkaway" clause in a QFC of an insured depository institution in default. § 1821(e)(8)(G).

118. Most courts hold that FIRREA allows the FDIC to repudiate non-executory as well as executory contracts, which gives the FDIC greater rights than a bankruptcy trustee, who is limited to rejecting executory contracts. *See* *Hennessy v. FDIC*, 58 F.3d 908, 919 n.8 (3d Cir. 1995); *Employees' Ret. Sys. of Ala. v. RTC*, 840 F. Supp. 972 (S.D.N.Y. 1993). The reasoning of such decisions is based on the plain language of Section 1821(e), which provides that a conservator or receiver may disaffirm "any" contract.

119. *See, e.g.*, 1185 Ave. of the Americas Assocs. v. RTC, 22 F.3d 494 (2d Cir. 1994) (90 days). The reasonable period runs anew from the date of appointment as receiver even where the FDIC has previously served as conservator of the same institution. *Id.*

120. *See, e.g.*, *Primavera Familienstiftung v. Askin*, 130 F.Supp.2d 450 (S.D.N.Y. 2001) (liquidation of collateralized mortgage obligations in distressed market).

## VIII. INSURANCE ISSUES

### A. “Regulatory Exclusion”

As the S&L crisis ballooned, insurance carriers began including “regulatory exclusions” in their policies to avoid the crushing effect of all the claims against bank directors, officers, and lawyers. These provisions were written to preclude any government agency from recovering losses under the policy, even if other claimants could have recovered under the policy.<sup>121</sup> Before FIRREA was enacted, agencies were generally successful in defeating these provisions.<sup>122</sup> After its enactment, however, courts largely upheld the exclusion,<sup>123</sup> often relying on Congress’s failure to express a view on the issue as evidence that it did not believe these exclusions were contrary to public policy.<sup>124</sup>

### B. “Insured vs. Insured” Exclusion

The “insured vs. insured” exclusion, now standard in almost all directors and officers (“D&O”) insurance policies, also developed during the 1980s. The exclusion generally relieves the insurer of liability for covering suits by one insured against another insured.<sup>125</sup> The rationale is to prevent poten-

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121. See FDIC, *supra* note 14, at 272 (1998).

122. *Id.*; see also, e.g., *Branning v. CNA Ins. Co.*, 721 F. Supp. 1180, 1184 (W.D. Wash. 1989) (regulatory exclusion contrary to public policy because it hindered FSLIC’s exercise of its federal powers).

123. See, e.g., *Powell v. Am. Cas. Co. of Reading, Pa.*, 772 F. Supp. 1188 (W.D. Okla. 1991) (upholding regulatory exclusion despite argument that it violates public policy). See also *Am. Cas. Co. of Reading, Pa. v. FDIC*, 16 F.3d 152, 152 (7th Cir. 1994) (upholding regulatory exclusion that precluded payment to the FDIC under policy for actions brought by the FDIC against the bank’s directors).

124. FDIC, *supra* note 14, at 272-73. Congress commissioned a joint FDC, DOJ and Treasury Department study on regulatory exclusions and related provisions, then failed to act on the study’s recommendation that the FIRREA should be amended to assert a federal policy against enforcement of regulatory exclusions. *Id.* at 273.

125. See generally *Bodewes v. Ulico Cas. Co.*, 336 F. Supp. 2d 263, 272-77 (W.D.N.Y. 2004) (explaining the “insured vs. insured” exclusion and finding that the breach of fiduciary duty claims did not fall solely within this exclusion); *Murray v. Loewen Group*, 133 F. Supp. 2d 1110, 1117 (E.D. Wis. 2001) (holding that “insured vs. insured” exclusion in policy precluded claims against insurer).

tially collusive lawsuits, “such as suits in which a corporation sues its officers and directors in an effort to recoup the consequences of their business mistakes. . . , thus turning liability insurance into business-loss insurance.”<sup>126</sup> Typically an exception is provided for shareholder derivative suits,<sup>127</sup> which are undertaken nominally on behalf of an insured (the corporation) against its officers and directors, provided that the derivative suit is initiated totally independently from and without solicitation or encouragement by the company or any of its officers or directors.

The applicability of the exclusion is at issue when receivers such as the FDIC, liquidators, bankruptcy trustees and similar parties bring suit against the insolvent institution’s officers and directors. On the one hand, these parties are not the same entity as the insured institution, and thus may technically fall outside the exclusion for suits by the “insured.” On the other hand, these parties, like the FDIC, step into the shoes of the insured institution for purposes of prosecuting claims, and thus could be viewed as essentially the same entity as the insured, thereby falling within the exclusion. Courts have split on the issue,<sup>128</sup> and insurance companies have vigorously asserted this exclusion against regulatory agencies with mixed success. In one case brought by a failed S&L against its former officers and directors for mismanagement, waste, fraud, and abuse, and later taken up by the FDIC in its role as receiver, the court ruled that the insured versus insured exclusion did

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126. *Level 3 Commc’ns Inc. v. FDIC*, 168 F.3d 956, 958 (7th Cir. 1999).

127. *Bodewes*, 336 F. Supp. at 274.

128. *Compare Terry v. Fed. Ins. Co.*, 315 B.R. 674 (Bankr. W.D. Va. 2003) (bankruptcy trustee’s suit against debtor’s former officers was excluded under insured vs. insured exclusion); *Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376 (D. Del. 2002) (finding that insured vs. insured exclusion should not apply to claims brought by bankruptcy estate representative against former directors and officers of debtor where the debtor is the insured entity because representative and debtor “are separate entities”); *Am. Cas. Co. of Reading Pa. v. Sentry Fed. Sav. Bank*, 867 F. Supp. 50 (D. Mass. 1994) (conservator of a receivership’s claims against directors and officers were not barred from coverage as the conservator was not the “Institution” named in policy). *See also FDIC v. Surojon*, No. 07 Civ. -22819-Civ-Martinez-Brown, 2008 WL 2949438, at n.5 (S.D. Fla. Jul. 29, 2008) (citing conflicting authorities).

not apply since the possibility of collusion was not present.<sup>129</sup> In another case, however, the court applied the insured versus insured exclusion to claims the FDIC brought against former directors and officers of a bank, reasoning that the FDIC “stands in the shoes of the Security Bank in prosecuting claims.”<sup>130</sup> The resolution in each case will often depend on the precise wording of the exclusion and whether, in the court’s view, the underlying purpose of the exclusion is being advanced.

## IX. INDEMNIFICATION ISSUES

Closely related to insurance issues are issues concerning a financial institution’s ability or obligation to indemnify its officers and directors for claims against them in their capacities as such. Indemnification becomes particularly important when D&O insurance is unavailable due to application of an exclusion, such as the regulatory exclusion or insured versus insured exclusion discussed in the preceding section.

Banks and S&Ls are generally authorized to adopt indemnification provisions for their directors and officers similar to those utilized for other commercial companies. Such provisions require indemnification of officers and directors against expenses and costs incurred in regulatory or administrative proceedings and other civil actions, except to the extent they result in a final order assessing civil money penalties, removal from office, or cease-and-desist orders.<sup>131</sup>

However, federal receivers have consistently sought ways to dispute or eliminate the indemnification rights of officers

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129. *Fid. and Deposit Co. of Md. v. Zandstra*, 756 F. Supp. 429, 432 (N.D. Cal. 1990).

130. *Powell v. Am. Cas. Co. of Reading, Pa.*, 772 F. Supp. 1188, 1191 (W.D. Okla. 1991).

131. *See* 12 C.F.R. §§ 7.2014, 359 (2008) (indemnification of national bank directors); 12 C.F.R. § 545.121 (2008) (indemnification of insured savings and loan directors). Under § 545.121, the provisions of which are exclusive except where the S&L has a bylaw governing indemnification, a savings and loan director may be indemnified, notwithstanding a final adverse judgment, if a majority of disinterested directors determines that the individual was acting in good faith within the scope of his or her employment authority for a purpose he or she could reasonably have believed was in the best interests of the association or its members.

and directors of failed institutions, particularly in cases where the receiver is suing the former directors for mismanagement or malfeasance, and courts have shown receptivity to such efforts.<sup>132</sup> The FDIC also may seek to exercise its right under FIRREA to “disaffirm or repudiate,” on the grounds that it is “burdensome” to the failed institution, a contract that purports to provide director indemnification,<sup>133</sup> or even a by-law.<sup>134</sup> While the FDIC remains liable for direct compensatory damages to the directors for such repudiation, proving such damages would be difficult where the claims against the directors are not resolved clearly and completely in their favor, *i.e.*, where they can show they ultimately would have been entitled to indemnification absent the receiver’s repudiation. The receiver indeed can make life difficult for the former officers and directors of failed depository institutions, and the directors of failed S&Ls from the 1980s will no doubt “remember when.”

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132. *See, e.g.*, *Adams v. RTC*, 831 F. Supp. 1471, 1479 (D. Minn. 1993) (“when the RTC sues the directors for their wrongful conduct against the institution indemnification is simply unavailable”); *Gallagher v. RTC*, 1993 U.S. Dist. LEXIS 15301 (N.D. Ill. Oct. 29, 1993) (impliedly recognizing S&L director’s right to indemnification under 12 C.F.R. § 545.121 in suit by RTC against former directors for gross negligence, but denying director’s claim because of failure to comply with regulatory mandates and because indemnification was sought pursuant to board resolution, not association bylaw).

133. *See Gibson v. RTC*, 51 F.3d 1016 (11th Cir. 1995) (allowing RTC to repudiate contract between CenTrust Bank and law firm that set aside \$11 million in an account to be used to indemnification purposes to fund legal fees and any damage awards against officers and directors). The Eleventh Circuit held that because the RTC as receiver sought to exercise its authority under federal law to repudiate the agreement, federal law, not state law, governed, and was distinguishable from *O’Melveny & Meyers v. FDIC*, a case involving a state law cause of action brought by the FDIC. *See id.* at 1025.

134. *See Pyle v. Meritor Sav. Bank*, 1993 U.S. Dist. LEXIS 16593, at \*4 (E.D. Pa. Nov. 24, 1993) (noting, without commenting on propriety of the action, that FDIC had repudiated bank’s bylaws “and, thus, the officers’ right to indemnification”).