

Directors of Banking Organizations Face Special Liability Risks

As private equity and hedge fund investment in the banking sector increases—primarily due to the potential for superior returns on investments in FDIC-assisted acquisitions of failed banks—investors may find themselves in a position to appoint members to the board of directors of banking organizations. These investors must be cognizant of the potential liability that their appointed directors may face, however, because directors of banking organizations are subject to certain heightened legal requirements. In addition to those regulations generally applicable to corporate directors, bank directors also face a greater risk of personal liability and enforcement actions by federal bank regulators. Some version of regulatory reforms are likely to be enacted in the aftermath of the banking meltdown, which will almost certainly add to the burdens of being a bank director.

Federal bank regulators possess the authority to institute a broad range of enforcement actions against directors of banking organizations because the directors qualify as “institution-affiliated parties.” Activities subject to enforcement actions include violations of federal banking laws or regulations, violations of agreements with federal bank regulators, breaches of fiduciary duties, or unsafe or unsound practices. The most significant forms of such enforcement actions are the assessment of potentially significant civil money penalties and the issuance of cease-and-desist orders. The amount that regulators can assess in the form of civil money penalties against bank directors depends on the culpability of the bank director and the loss suffered by the bank, with penalties of up to \$1,375,000 per day for the most severe and culpable behavior. Cease-and-desist orders may require a director to take affirmative actions set forth in the order to correct the violation, breach or practice; may require the bank director to pay restitution to the banking organization up to the amount of uncompensated loss facing the bank; and may be accompanied by an order freezing the assets of the bank director pending the outcome of regulatory proceedings.

Additionally, federal regulations restrict the extent to which bank organizations may indemnify their directors for liability resulting from such enforcement actions. Depository institutions insured by the FDIC, their holding companies and subsidiaries and national banks are prohibited from directly indemnifying a bank director for any expense resulting from an administrative action or civil action instituted by a federal bank regulator that results in the assessment of a civil money penalty, judgment or cease-and-desist order, including restitution payments. Banking organizations are also prohibited from purchasing liability insurance which is used to reimburse bank directors for the cost of any civil money penalty or judgment assessed against a bank director. Banking organizations are also restricted from making advance indemnification payments to bank directors facing administrative proceedings or civil actions unless the banking organization’s board of directors makes certain statutorily defined findings and the director agrees to reimburse the banking organization in the event that the advance indemnification payments subsequently become prohibited payments due to an adverse ruling against the bank director. Accordingly, indemnification and insurance options available from outside a banking organization should be evaluated and implemented.

Bank directors may also be subject to civil actions brought by the Justice Department for violations of certain criminal banking laws, which include among other things laws relating to bank bribery, false statements or fraud. The potential liability under such civil actions is substantial, as the Justice Department may seek up to \$5 million for continuing violations. Moreover, while the government is generally required to prove criminal violations beyond a reasonable doubt, the statute permits the Justice Department to prove such violations by only a preponderance of the evidence, a much lighter evidentiary burden in any such civil action.

Investors in banking institutions and their appointed bank directors should also be aware of a number of other potential sources of liability that result from serving on the board of directors of a banking organization. Such sources of liability include potentially heightened standards of fiduciary duties resulting from the Financial Institutions Reform, Recovery and Enforcement Act; removal, prohibition or suspension orders issued by federal bank regulators; and private causes of action against bank directors created by statute.

Contact Information

If you have any questions about potential sources of liability facing directors of banking organizations, please contact your Ropes & Gray advisor.