

DISTRESSED DEBT AND OTHER WOES: WHAT BANK DIRECTORS SHOULD BE DOING... NOW

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The distressed debt crisis and financial turmoil facing many, if not most banks, exposes bank directors to regulatory criticism and shareholder dissatisfaction. Already asset valuations and borrower delinquencies are causing an increasingly difficult search for capital and eroding shareholder equity. Regulator-forced write downs and demands that banks shore up capital have placed bank directors at the center of the storm. A general sense of dissatisfaction and finger pointing toward bank executives and directors pervades the current environment, evidenced by the trend of resignations, terminations, and replacement of top bank management and directors. Estimates of the total losses from the credit crisis from the IMF, Goldman Sachs, and prominent hedge funds, range from \$1 trillion to \$1.6 trillion. However, the second shoe has yet to drop. This article outlines the liabilities embroiling bank directors and recommends steps bank directors need to take now to proactively manage their rights and risks.

Here Come the Regulators

The current distressed debt crisis has origins familiar to observers of the S&L crisis of the 1980s and the commercial credit crisis of the 1990s where problems in the financial industry and broader economy led to price collapses, massive losses for taxpayers, and federal bailouts. From 1987 to 1994, more than 1,100 banks and nearly 1,000 savings and loan institutions failed or required federal assistance. Banking

legislation following the S&L crisis focused on strengthening the regulatory framework and bringing banking regulation in line with other segments of the financial industry. Court decisions clarifying director negligence made it easier for the Federal Deposit Insurance Corporation (FDIC), after being appointed as conservator or receiver of a troubled bank, to pursue claims against directors of failed institutions. Such regulatory enforcement actions have included, and will include, suspensions, removals, civil money penalties, and criminal liabilities. The FDIC has brought suits (or settled claims) against former directors and officers of the banks that have failed since 1985. The Department of Justice, Securities and Exchange Commission, and state attorneys general may also launch investigations and file claims against directors and officers of banks and their holding companies.

The Department of the Treasury in March 2008 released a "Blueprint for a Modernized Financial Regulatory Structure" proposing a stronger regulatory framework with recommendations to improve coordination and oversight between the various federal and state banking regulators. These proposed recommendations generally increase regulation of investment banks and heighten the scrutiny of bank directors. However, regulators are already examining bank boards as to the adequacy of supervision over management, internal controls, and ongoing business operations in bank lend-

ing, investment, reserve, and asset valuations.

Current and former bank directors can be personally liable for losses sustained by a bank relating to certain nonconforming or illegal assets or failure of a bank to follow banking laws and regulations. The most common claim of dereliction of duty by bank directors is their failure to maintain reasonable supervision over the activities and affairs of the bank, its officers, and employees. Lawsuits against former insider directors of failed banks usually involve cases of dishonest conduct, condoning abusive transactions with insiders, violation of applicable laws or regulations, participation in unsafe or unsound activities, or failure to establish proper monitoring procedures. The most common action against an outside director involves insider abuse or situations where the director failed to heed warnings from regulators, accountants, or attorneys.

Regulators have broad discretion and authority to take action against bank directors. These actions include issuing a cease and desist order, imposing a civil money penalty, and removing directors. Banking regulations sharply limit bank directors' indemnification and insurance agreements for financial losses stemming from lawsuits challenging business decisions or activities of the board. Indemnification payments are generally not available for a director who is assessed a civil money penalty, removed from office, or prohibited from participating in the affairs of the financial institution. Regulations

prohibit or limit “golden parachute” or indemnification payments from troubled banks, including payments made from healthy depository institutions with troubled subsidiary banks and savings associations. Additionally, banks may not purchase insurance to pay directors’ civil money penalty assessments imposed by a bank regulatory authority. Such civil money penalties can reach upwards of \$25,000 a day for circumstances such as knowing and reckless behavior or a bad faith violation in contravention of the banking laws and regulations.

Angry Shareholders – Litigation and Proxy Battles

Banks’ boards have also been under increasing fire from disgruntled shareholders, alleging that boards failed to sound the alarm bell as banks piled up risk in the years leading up to the credit crisis. One of shareholders’ main criticisms has been the inexperience of many directors at prominent financial institutions. They charge that many directors with no financial background sit on board committees such as the audit committee with responsibility for oversight over a company’s risk assessment and risk management policies.

Some banks have already begun making structural corporate governance changes to quell shareholders’ discontent. In April, responding to shareholder criticism of the board’s inexperience and mismanagement, Citigroup, for example, announced that it was searching for new directors and placing specific emphasis on expertise in finance and investments.

Erosion of shareholder equity, often leading to either the “forced sale” of a bank to an opportunistic investor or the sale of equity to investors as part of the search for capital, subjects bank directors to increased scrutiny on many fronts. Plaintiffs’ lawyers and shareholders

are fired up to hold directors individually accountable for alleged poor judgment, passivity, and failure to satisfy fiduciary duties. Reports indicate that the current wave of litigation is already dramatically outpacing the savings-and-loan litigation of the early 1990s. Soon after banks began writing down massive losses in late 2007, shareholders began filing suit against officers and directors of banks, alleging, among other things, that they violated their fiduciary duties by allowing the banks to misrepresent their financial results and deceive investors while piling up risky subprime loans. Already, shareholders have brought suit individually against directors at Citigroup, Merrill Lynch, and Morgan Stanley. Although neither directors’ basic fiduciary duties of care and loyalty nor the applicability of the business judgment rule change with market conditions, directors are still at an increased risk for liability given the more litigious environment.

Moreover, as many directors of troubled banks venture into the world of restructuring, they must also be especially cognizant of how their fiduciary duties may change, since when a company approaches insolvency, directors must be mindful not only of what is best for the corporation and its shareholders, but also what is best for its creditors.

Proxy battles will likely increase as activist shareholders such as hedge funds gun for bank directors at annual shareholder meetings. Shareholder advisory firms, which make proxy recommendations to large shareholders, are urging shareholders to vote out directors and officers they claim should have been awake rather than sleeping at the wheel to prevent the crisis. These include Marcus Ospel, former chairman of UBS, who resigned in April after shareholders at the bank’s annual meeting blamed him

for the company’s \$19 billion debt write-down and fiercely opposed his proposed rescue plan of selling 10% of the company to foreign investors; former Merrill Lynch CEO Stan O’Neal, who faced intense criticism after a \$7.9 billion writedown and an unauthorized merger approach to a rival bank; and former Washington Mutual CEO Kerry Killinger, who shareholders voted to remove in April.

What To Do—Now

Mark Twain said, “History doesn’t repeat itself, but it does rhyme.” If history from the S&L crisis is any predictor of the future, regulators and shareholders will aggressively pursue banks, management, and individual directors and officers. Bank directors are urged to obtain the advice of independent counsel to proactively manage their rights and risks. Independent counsel is needed because the bank’s counsel may be conflicted in representing the board as a result of its prior involvement with the bank or may not be acceptable to the board’s insurance carriers. Such independent counsel should:

- evaluate the adequacy of D&O, professional liability, and fidelity/crime policies and exclusions under such policies to understand how fully the board is protected;
- support the board in structuring its D&O insurance policies and pressing management to fill gaps in coverage and from exclusionary clauses;
- keep directors apprised of the shifting framework of potential liabilities;
- brief the board on developments relevant to the activities of the bank;
- advise the board on specific compliance issues that may arise; and
- help manage relations with the bank regulators during any period of crisis or stress so as to better enable a successful outcome. **[BD]**

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