December 2015 • Vol. XXVIII • Number 12

Inside This Issue

PLUS
PROFESSIONAL LIABILITY UNDERWRITING SOCIETY
Journal
YOUR SOURCE FOR PROFESSIONAL LIABILITY EDUCATION AND NETWORKING

Jonathan Reich *was counsel of record in what have been recognized as two of the most important insurance cases in North Carolina in 2014. Jonathan has counseled policyholders, brokers, managing general agents, carriers, and reinsurers regarding insurance coverage and claims. He also advises on the insurance implications of corporate mergers and commercial financial transactions, as well as regulatory issues with captive insurance companies and insurance premium finance companies. He blogs about insurance issues at www.wcsr.com/AllRisks. Contact him at jreich@wcsr.com.*

Business Judgment Rule Rebutted When Bank Officers Failed to Follow Procedures

By Jonathan Reich

Federal Deposit Insurance Corporation v. Rippy, 799 F.3d 301 (4th Cir. 2015), also known as *FDIC v. Willetts*, is a closely-watched case arising from the failure of a community bank in eastern North Carolina. The case included heavy amicus involvement from the U.S. Chamber of Commerce, the North Carolina Commissioner of Banks, and over 55 other banking associations. The Fourth Circuit's ruling, even if inarticulate, does not deviate from widely-accepted views of the business judgment rule, as adopted in North Carolina or Delaware. Corporate leaders must continue to adhere to a deliberative and informed process in corporate decision-making.

The rise & fall of Cooperative Bank

Cooperative Bank's history is not an uncommon one. Founded in Wilmington, North Carolina in 1898, it operated as a thrift until 1992, focusing its business on providing loans for single-family housing. Likely as a result of the savings and loan crisis, in 1992 the Bank converted into a state-chartered savings bank, regulated by the FDIC. Ten years later (2002), the bank's leadership decided to increase its assets from $443 million to $1 billion by 2005.[1] This growth strategy focused on commercial real estate lending.

As part of this goal, the bank's senior leadership approved 86 loans made between January 2007 and April 2008. As the New York Times reported, "[t]he bank's most innovative loan program allowed customers of certain real estate developers to buy overpriced building lots with no money down and no payments—of principal, interest, or even closing costs—for two years."[2] It comes as no surprise that some of those loans were, in retrospect, of questionable quality. Eventually, Cooperative entered receivership. The FDIC claims it lost a total of $216 million due to Cooperative's failure.[3]

The bank concentrated its lending in the acquisition, development, and construction loan segment of the market. Among the questionable loans were "lot loans" for vacation properties.[4] A bank customer would attend an investment seminar and become convinced that they could buy a coastal North Carolina building lot, with views of the water, without spending any money out of pocket for two years (i.e., no closing costs, no down payment, and no payments towards principal or interest). From the customer's view, within two years, the value of the lot will have appreciated and they would be able to flip the building lot to another buyer as property values continued to appreciate. This was presented to customers as being a risk free investment with no money out of pocket. The average price of these lots was approximately $280,000 (ranging from $101,900 to $999,000, with most in the $200-350,000 range).[5] The FDIC claims that Cooperative lost 66 percent of the money lent through this program.

Additionally, the officers and certain directors approved nine commercial real estate loans (mostly for real estate development and construction in the greater Wilmington area) for between $1.5 and $10.5 million each. Each lending transaction was allegedly woefully deficient; either because of stale financial documents, insufficient cash flow to service the debt load, inadequate or wrongly valued security, etc. The FDIC estimates its loss on these nine loans was over $20 million.

After the bank's failure in 2009, the FDIC, as receiver, sued the bank's directors and officers alleging simple negligence, gross negligence, and breach of fiduciary duty. The FDIC alleged that the approval of these loans by the bank's leadership varied from the underwriting standards adopted by the bank, published guidelines on

continued on page 10

Outgoing President's Message:
Continue to Grow Our Reach

James Skarzynski
2015 PLUS President

As my year as the 2015 PLUS President comes to an end, I want to thank the many PLUS members, volunteer leaders and staff who I've worked with over the past 12 months. We've had some tremendous successes in 2015, due in great part to the passion and dedication of everyone involved with our great organization.

You may recall in the January issue of the PLUS Journal I highlighted several of my key initiatives for the year. As we close 2015 I want to look back at that article, titled "Expanding Our Reach," to see how PLUS has grown and "reached out" over the past 12 months, and how we are positioned for continued success into the future.

Global Development

2015 was a great year for PLUS as it relates to international events. Our newly-created Global Development Committee and strong volunteer leaders in Singapore, Hong Kong, and London helped us organize and host three events in Asia and two in Europe in 2015, the most events we've ever held in a single year outside of North America!

PLUS Journal

As I wrote in January, one of the best educational resources PLUS offers is the PLUS Journal. In fact, the Journal has become even more valuable this year as it has expanded from 12 to 16 pages, packing an incredible amount of content and analysis into PLUS members' mailboxes each month. I hope you enjoy reading it as much as I do.

Webinars

One of my goals for 2015 was for PLUS to host a webinar each month throughout the year. While that goal was not fully met, we did organize and host seven terrific webinar sessions throughout 2015. These virtual events covered a variety of important industry topics, from the confluence of cyber and D&O risk to the insurance implications of the growing medical marijuana industry. I hope you were able to attend some of them, but if not recordings of each one are available to PLUS members in the Multimedia Library on the PLUS website. Next time you have a free lunch hour I encourage you to enjoy one of these webinar recordings on-demand.

Educational Products

PLUS is synonymous with professional liability education, and 2015 was a big year for the Society's educational products. More than 150 industry professionals completed their RPLU or RPLU+ designations this year. Additionally, PLUS introduced its new *e*ssentials product line. If you are not familiar with PLUS *e*ssentials I encourage you to check it out. This suite of 5 online, on-demand and interactive courses are a perfect tool for your new staff to learn the basics of professional liability insurance. Whether you use just a few or all five as a training program for your new hires and support staff, they are a fantastic new offering that brings real value to our industry.

LAMP

One initiative that I did not mention in January but is a big part of our success in 2015 is the introduction of the LAMP, or Diversity, Leadership and Mentoring Program. LAMP provides support, education, access and service opportunities to individuals from diverse and traditionally underrepresented groups and backgrounds. Our inaugural LAMP class of 15 industry professionals is an impressive and strong one, and I look forward to working with these individuals in the years to come.

New Executive Director

Of course perhaps the biggest news at PLUS in 2015 was the naming of our organization's new executive director, Robbie Thompson. Since officially joining the PLUS team in July Robbie has hit the ground running, attending many chapter events across the country and working to connect with members, staff, and PLUS leaders. He's off to a great start, and I look forward to working with him and incoming PLUS President Heather Fox over the coming year.

My sincere thanks to all PLUS members, sponsor companies, volunteers and leaders for your support of PLUS, and of me personally, over the past year. It has been my privilege and honor to have served as your 2015 PLUS President.

Our 2016 PLUS President

In closing, I extend my congratulations to Heather Fox, our incoming 2016 PLUS President. Heather is the 28th PLUS President, and the first woman to hold this position since Michelle Duffett was our 2001-2002 President. I am confident that under Heather's leadership, PLUS will continue to thrive in fulfilling its mission to is members.

Whistleblowers: Implications for D&O Cover

By William Allison & Evi Hava

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Evi Hava *has a broad general professional indemnity training and experience. She specialises in solicitors' claims having spent a considerable period on secondment at a qualifying insurer's claims practice. She can be reached at ehava@dacbeachcroft.com.*

The UK regulators are actively promoting self-reporting and whistleblowing; a process whereby employees are encouraged to speak up where they suspect fraud or unlawful conduct by their employers, confident that their concerns will be investigated without any personal repercussions.

The Serious Fraud Office (SFO), Action Fraud (the national fraud and cyber-crime reporting centre operated by the City of London Police), and the Financial Conduct Authority have all reported increases in the volume of whistleblowing reports received.

Critics have raised concerns about funding problems for these regulators. During the 12 months ending 31 March 2014, the SFO only opened 12 new investigations into suspected fraud and corruption despite receiving 2,508 reports through its whistleblower service over a similar period. Action Fraud received more than 210,000 reports in 2013/14 and only 544 investigations into financial crime followed. Of course, not all whistleblowing reports will contain the high quality information needed to justify a full investigation, but critics are suggesting that this data shows that the SFO lacks the resources to pursue all available leads and that it is having to prioritise cases.

Nonetheless, we understand that the SFO has been able to secure additional funding from the Treasury for large cases, and with the regulators' focus on senior decision-makers, we expect more regulatory claims in the future.

These developments are troublesome for directors and officers and their insurers for a number of reasons.

In the US, where the legislation is more advanced, studies have shown that whistleblowers have enabled the regulators to obtain judgments which would not otherwise have been obtained, and to impose higher penalties than would otherwise have been the case.

Whilst fines and penalties are not typically covered under most D&O policies, an insured will want to think seriously before jeopardising any cover in respect of the defence costs of expensive investigations and litigation. Insurers may also want to consider the scope of available cover in light of the likely increase in internal investigations (as opposed to formal investigations).

Also, whether a particular admission made in a whistleblower report or settlement with the authorities in exchange for leniency could trigger a policy exclusion will depend on the specific wording of the policy. If the exclusion is only triggered if there is "deliberate" misconduct, then it may be possible for an insured to phrase an admission carefully so as to avoid any suggestion that the misconduct was "deliberate". Where, for example, a "final adjudication" provision in the policy is determinative of whether or not the exclusion is triggered, then the process surrounding the admission (e.g. whether a court order will be obtained) will be relevant.

More worryingly in the US, the culture of whistleblowing has led to an increase in frivolous complaints against companies, resulting in distraction, burden and expense for businesses. This could also lead to shareholder litigation and civil claims being pursued by companies against their own board members.

An Increased Focus on Individual Accountability? What it Might Mean for D&O Insurance

By Tammy Yuen, Rachel Simon & Joshua Sato

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Rachel Simon *is a vice president and D&O claim expert at Swiss Re Corporate Solutions. Rachel can be reached at Rachel_Simon@swissre.com.*

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Corporate malfeasance is nothing new. Not surprisingly, the government's pursuit of wrongdoers often intensifies following particularly egregious episodes that draw public sentiment or have implications for the markets or during difficult economic times. Also predictably, corporations often protect their individual employees, directors and officers for a variety of reasons including that liability against these individuals exposes the corporation to liability based on respondeat superior. On September 9, 2015, Deputy Attorney General Sally Quillian Yates of the U.S. Department of Justice issued a memorandum (the "Memo") that may test the bonds between corporations and these individuals and may change the way that both defend government investigations and lawsuits. While it is too early to know, the Memo may increase the exposure of individuals under D&O policies.

The Memo recommits the DOJ to focusing on individual accountability in dealing with corporate misconduct. In summary, the Memo lays out the following six steps aimed at ensuring that individual wrongdoers are held accountable for corporate wrongdoing:

1. Corporations must provide all relevant facts about the individuals involved in corporate misconduct to the DOJ to be eligible for any cooperation credit.
2. Criminal and civil investigators should focus on individual wrongdoers from the start of an investigation.
3. Criminal and civil attorneys handling corporate investigations should be in regular communication with each another.
4. Absent extraordinary circumstances or approval by the relevant Assistant Attorney General or U.S. Attorney, the DOJ will not release culpable individuals from civil or criminal liability when resolving a matter with a corporation.
5. When resolving corporate cases, DOJ attorneys must have a clear plan to resolve related individual cases before the statute of limitations expires.
6. DOJ civil attorneys should consistently focus on individuals as well as the company and ensure that their decisions to bring suit against an individual are based on considerations beyond that individual's ability to pay.

Recent commentary focuses largely on the Memo's first point addressing the threshold for a corporation to obtain cooperation credit—namely, that a corporation must turn over all relevant facts to be eligible for any such credit. Previously, pursuant to the Principles of Federal Prosecution of Business Organizations issued in 2008 (and commonly referred to as the "Filip Memo" for its author, then-Deputy Attorney General Mark Filip[1]), turning over information about individuals involved in wrongdoing was important, and even critical, in assessing the adequacy of a corporation's cooperation with an investigation for the purposes of granting a corporate deferred or non-prosecution agreement. However, providing information on individuals was never mandatory.[2]

One group of commentators believes that the Memo reiterates long-standing policy at the DOJ to vigorously pursue individual wrongdoers, and simply reflects a change in tone backed by stronger rhetoric. For example, one such commentator believes that the DOJ felt compelled to issue the Memo in order to: (i) address public sentiment that the DOJ has been too lenient on Wall Street executives; (ii) exert added pressure on defense counsel to encourage their corporate clients to cooperate with investigations against individual employees suspected of wrongdoing; and (iii) to ensure that the DOJ attorneys account for their investigations of individuals as they pursue charges against corporations.[3]

Another group of commentators believes that the Memo marks a significant shift in DOJ policy toward increasing the scrutiny on individual wrongdoers and their corporate employers. They also believe that this shift will have a number of consequences for how corporations defend government investigations and the coordination between corporations and employees, directors and officers.

Those commentators argue that while corporations have long felt pressure to turn over information about individual wrongdoers, in the past they did not have to turn over every stone and give up every employee involved in malfeasance in order to obtain cooperation credit. The Memo appears to incentivize corporations to turn over significantly more information in order to get that same level of credit, thus ensuring that corporations will conduct more robust internal investigations.[4] Some speculate that the DOJ will scrutinize the nature and scope of those internal investigations, along with the individuals conducting and supervising them, in deciding whether to award cooperation credit—another departure from the past.[5] The Memo's new cooperation requirement also forces companies to reconsider withholding the results of internal investigations on the basis of privilege for fear of being deemed as failing to hand over complete factual information.[6]

The relationship and coordination between corporation and individuals are also predicted to change, as their interests are no longer completely aligned. Corporations should no longer expect to have the opportunity to negotiate a release of liability for individual

employees as part of a corporate resolution.[7] Rather, after turning over all its information, the corporation should expect to negotiate on its own behalf while the investigation continues against the individuals.[8]

For D&O carriers, the Memo raises concerns about increased costs in defending government investigations. In particular, we could expect to see an uptick in the number of investigations as well as an increase in the length and intensity of the DOJ investigations and the pursuit of discovery. The DOJ may pursue investigations with greater resources in claim scenarios that may not have generated as much governmental interest in the past.

Whether the Memo demonstrates an actual shift in the DOJ's policy may be clarified if the DOJ makes examples of a few individuals early on in order to send a clear message to the markets. There may also be increased political pressure with the DOJ to show results, and that could lead to more aggressive pursuit of investigations, less willingness to settle without a finding against individual wrongdoers, or a greater likelihood of keeping investigations open against individuals even after settling with the corporation. However, it is unclear whether the Memo may lead to an increased focus on lower-level employees who may or may not fall under the definition of Insureds under the relevant D&O policy, as the Memo makes clear that individuals should be pursued regardless of their ability to pay.

As the stakes increase, we can expect insureds to seek to devote more resources to the defense of the investigation, and individual insureds to seek to retain their own independent counsel sooner and taking on greater roles. This move toward retaining individual representation sooner could be driven by earlier targeting of individuals, the seniority of the individuals under scrutiny, and the potential for the corporation providing evidence against its own directors, officers and employees. The Memo may be interpreted as removing any level of comfort that a settlement with the corporation would include an agreement to dismiss charges against individuals.

The scope, depth, length and cost of internal investigations may also increase as corporations seek to earn cooperation credit that may help to mitigate their own exposure, and to ferret out individual wrongdoers. Insured entities may engage more lawyers, financial and accounting consultants, experts, and e-discovery vendors as they conduct broader and deeper review of electronic documents in their internal investigation. Whether these internal investigations are covered by insurance may depend, for example, on the policy's definition of claim and the scope of any pre-claim investigation coverage.

Side B coverage could also be implicated sooner than it had been in the past if increased cooperation from corporations leads to earlier scrutiny of individuals. Also, query whether this increased scrutiny will have implications for Side A D&O coverage to the extent that a corporation under increased pressure to cooperate and turn over information that could implicate its executives in wrongdoing may consider refusing to provide indemnification.

The next twelve months may be telling in light of the political climate during the current election season. There is the possibility that with a new administration, there may be new directives that either expand or retract the scope of the directive. However, it seems the DOJ has made clear that we can expect an increase in its investigation into the conduct of individual corporate actors in the near term.

Endnotes

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7 *Id.*

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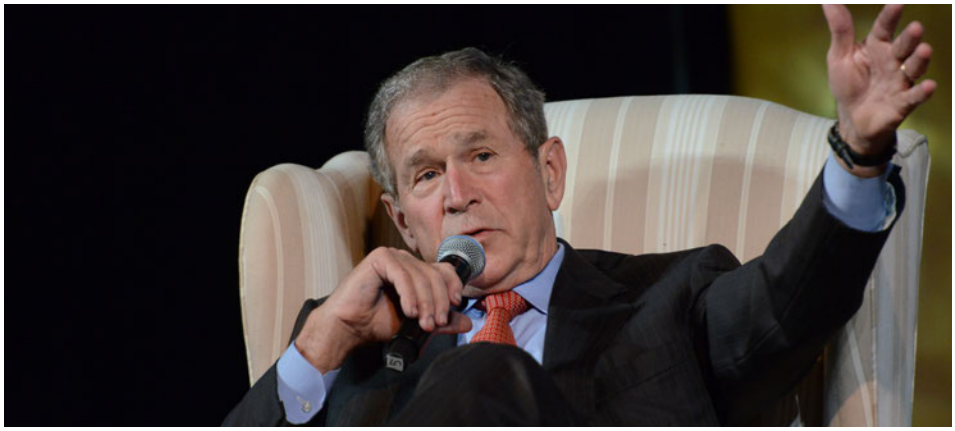
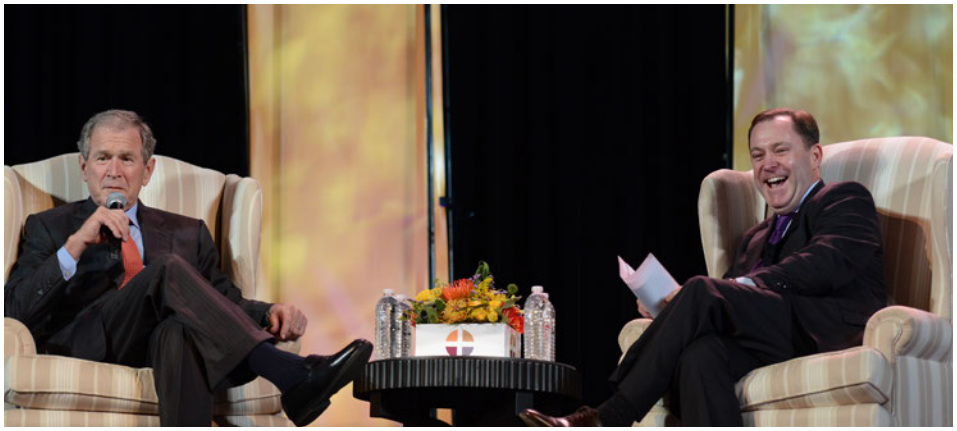
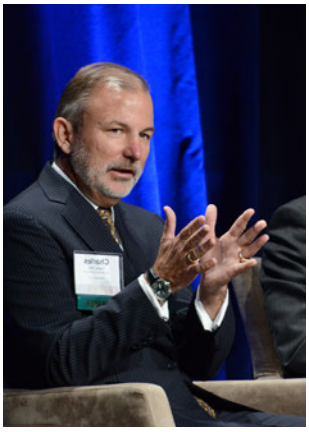
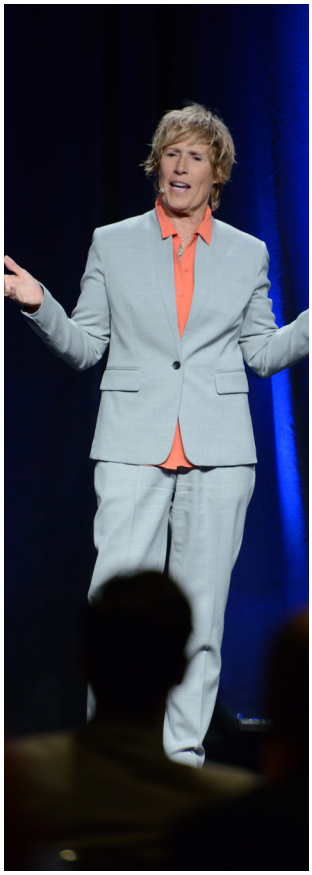
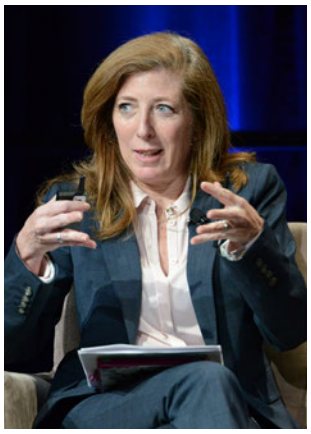
PLUS Conference 2015

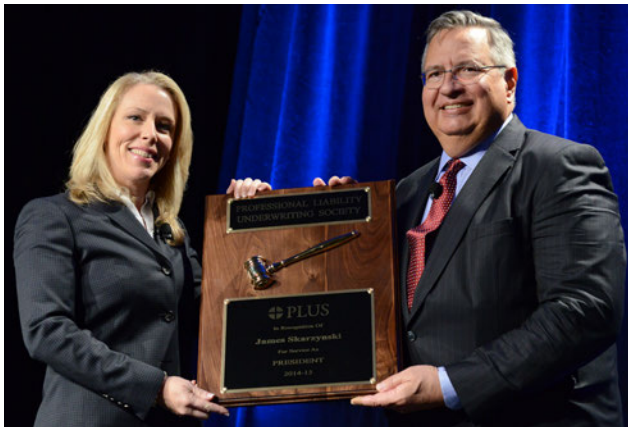
A Look Back



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PLUS FOUNDATION

Chapter Charity 2015 Recap

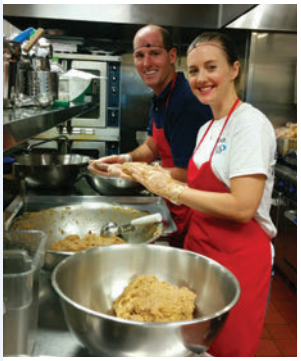
All thirteen North American Chapters participated

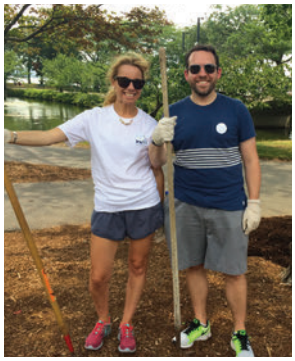
Charities Supported: **30** Grants: **$79,000**

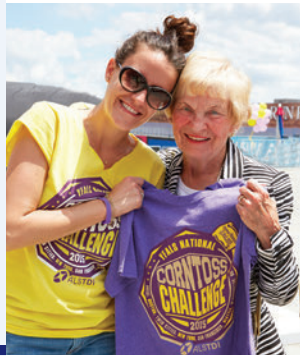
Volunteer Events (V): **15** Volunteers: **260 +**

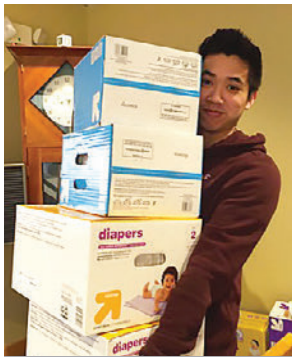
Thank you to all who participated!

•Childhood Cancer Canada Foundation	**Canada**
•Huntington Society of Canada	**Canada**
•JCCA Two Together Tutoring	**Eastern (V)**
•My Sister's Place	**Hartford (V)**
•Malta House of Care Foundation, Inc.	**Hartford**
•Hole in the Wall Gang	**Hartford (V)**
•Cradles to Crayons	**Mid-Atlantic**
•Children's Literacy Initiative	**Mid-Atlantic**
•Philabundance	**Mid-Atlantic (V)**
•Special Olympics Illinois	**Midwest (V)**
•Big Brothers Big Sisters of Metropolitan Chicago	**Midwest**
•A Prom to Remember	**New England**
•Lynne's Kids	**New England**
•Caties Closet	**New England (V)**
•The Esplanade Association	**New England (V)**
•ALS Therapy Development Institute	**North Central (V)**
•Family House, Inc.	**Northern California (V)**
•The Goodtimes Project	**Northwest (V)**
•New Beginnings	**Northwest (V)**
•Combat Wounded Veteran Challenge, LLC	**Southeast**
•HOPE Atlanta	**Southeast**
•Second Harvest Food Bank of Middle Tennessee	**Southeast (V)**
•Downtown Women's Center	**Southern California (V)**
•Helping Hand Worldwide Inc.	**Southern California**
•Arizona - Save the Family	**Southwest**
•Colorado- Wellspring Community	**Southwest**
•Brent's Place	**Southwest (V)**
•Lone Survivors Foundation	**Texas**
•Children's Medical Center Foundation	**Texas**
•Ronald McDonald House	**Texas (V)**









PLUS Foundation—Financial Aid College Scholarships for 2016

The PLUS Foundation is pleased to announce Financial Aid Scholarships, made possible by the personal donations of leaders in our industry:

- ***H. Seymour Weinstein Scholarship***
- ***Constantine "Dinos" Iordanou Scholarship***

Up to four scholarships will be awarded and scholarships will be for up to $12,000 each, payable in increments over four years.

ELIGIBILITY:

Children of any PLUS member or ***employee of a PLUS corporate sponsor company*** are eligible to apply.

Note that children of any company employee are eligible even if their parent is not a direct member of PLUS. Please share this information with your support staff that have children heading off to college that could use some support.

- Post the information in your company newsletter.
- Have your human resources department distribute to employees with children entering college next year.
- Distribute the information via company email lists or bulletin boards—though it is a PLUS Foundation program, ***you do not need to be a PLUS member to qualify***!

APPLICATION SCHOLARSHIP REQUIREMENTS:

Awarded based on family financial need and proof of average to above average high school performance.

Consistent with our mission of philanthropy and the advancement of education, the PLUS Foundation Board of Directors aims to support families and students who have greater financial needs. This step expands on our record of service to and on behalf of the professional liability community.

- The success of the PL industry relies on many employees who may be of limited financial means—the assistants, clerks and other entry level and support staff who move our business forward.
- With the cost of education rising dramatically, many deserving students struggle to attend the college of their choice…or any college at all.
- Most of the Foundation's giving goes to highly worthy charitable organizations. This new scholarship is an opportunity to direct resources to the colleagues and families of our members, creating more personal and closer connections within our PLUS community.

APPLICATIONS & DEADLINES:

Applications will be available online at on the Foundation website January 4 to March 15, 2016.

2016 GILMARTIN SCHOLARSHIPS

Eligibility: Children of any PLUS member or any employee of a PLUS corporate sponsor company

Applications & Deadlines: Applications will be available online starting January 4, 2016. Applications are due March 15. PLUS members will receive an email notice with a link to register. Complete information is available at www.plusfoundation.org.

Leo Gilmartin Scholarship: Scholarships are awarded for scholastic merit and extracurricular activity. Application requirements include, but are not limited to:

- College entrance exam scores
- G.P.A. and class rank
- Essay and letters of recommendation
- Extracurricular and community service activities
- Recipients must be full time students and meet GPA requirements to be eligible for subsequent years

General Details & Requirements:

- Up to four scholarships will be awarded
- Scholarships will be for up to $12,000 each, payable in increments over four years
- Applicants must be a child of a current PLUS member or employee of a PLUS corporate member
- An applicant is required to be in his/her senior year of high school
- A recipient must successfully complete high school and enroll in an accredited school in the fall

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loan underwriting, and industry practices. Further, the FDIC alleged that in approving these 86 loans, the managers of the bank specifically ignored or acted counter to prior warnings from regulators regarding improper loan underwriting. The FDIC sought between $4.4 million and $33 million from each named defendant officer or director.

The FDIC, in an examination, questioned the above loan practices. The bank's (third-generation) CEO stated that all of these loans would have at least 10% equity (90% LTV) and would not be no-interest. The trick, from a banking point of view, is that Cooperative typically lent 80% of the purchase price and received a 20% down payment. The real estate developer had lent the down payment money to the buyer and promised to make the interest payments to Cooperative for the first two years. The developer profited because it would purchase the lot ***only after*** it had found a buyer who was willing to pay twice what the developer had paid. The developer was not selling property out of his 'inventory,' so much as he was acting as a broker or intermediary. By selling the lots at a substantial premium (after obtaining an appraisal based on other inflated lots), the developer could make the down payment, make two years of interest payments, and still profit on the transaction. Certain directors and officers of Cooperative also believed that by participating in these transactions, the bank would be able to gain lucrative construction lending business once these lots were developed.

The FDIC's claims and the business judgment rule

Rippy is significant because, among other things, it was the first case in this wave of recent FDIC litigation where the bank's directors and officers obtained summary judgment at the trial level on all claims of negligence and breach of fiduciary duty against them.

Judge Boyle entered summary judgment in favor of the directors and officers on the basis of the business judgment rule.[6] Judge Boyle flatly rejected the FDIC's notion that the officers and directors of this community bank could have foreseen the real estate bubble when other economic leaders in the nation did not.

The business judgment rule has historically provided a robust protection for claims against officers and directors who act in the best interests of the company, in good faith and with due care. Analogizing to the law of trusts, courts have long reasoned that corporate directors owe fiduciary duties to the corporation and its shareholders which they serve. The rule's adoption by courts ensures that officers and directors will be protected from liability for good faith decisions, even if those decisions were glaringly wrong in hindsight. The rule thus limits a court (or a plaintiff's) ability to Monday-morning quarterback business decisions which meet the hallmarks of good faith decision making. Without the broad deference to director and officer decision making afforded by the business judgment rule, corporations would take far less risks and innovation would be stifled. Decisions which are made by a loyal and informed board, for a rational business purpose, will not create liability for the directors. In other words, decisions made in the board room will typically not be second-guessed in the courtroom.

Under North Carolina statutory corporate law:

(a) A director shall discharge his duties as a director, including his duties as a member of a committee:

(1) In good faith;

(2) With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(3) In a manner he reasonably believes to be in the best interests of the corporation.

N.C.G.S. § 55–8–30(a); *see also id*. § 55–8–42(a) (providing identical standard for corporate officers). North Carolina corporate law also permits the corporation to limit the personal liability of a director for any breaches of the duty of care, as long as the director did not know (or believe) that his actions were "clearly in conflict with the best interests of the corporation." N.C.G.S. § 55–2–02(b)(3). Corporations are not allowed to provide their officers with this same protection.

Last year, at the trial court level, Judge Boyle reiterated the well-known business judgment rule in entering summary judgment in favor of the managers:

> The business judgment rule involves two presumptions. First, it establishes "an initial evidentiary presumption that in making a decision the directors [and officers] acted with due care (i.e., on an informed basis) and in good faith in the honest belief that their action was in the best interest of the corporation." Second, the business judgment rule establishes, absent rebuttal of the first presumption, a "powerful substantive presumption that a decision by a loyal and informed board will not be overturned by a court unless it cannot be attributed to any rational business purpose."
>
> *FDIC v. Willetts, 48 F.Supp.3d 844, 850-51 (E.D.N.C. 2014).*

In other words, under the business judgment rule, there is a presumption that corporate directors and officers are acting in good faith and with due care. This presumption puts the burden on the plaintiff (here, the FDIC) to come forward with evidence that the officers

"(1) did not avail themselves of all material and reasonable available information (i.e., they did not act on an informed basis);

(2) acted in bad faith, with a conflict of interest, or disloyalty; or

(3) did not honestly believe that they were acting in the best interest of [the bank]."

Rippy, 799 F.3d at 313.

The bank officers and managers prevailed at the trial court level on all claims

Rippy was clearly not a case where the bank managers were accused of giving themselves loans on sweetheart terms; the FDIC produced no evidence of fraud or old-fashioned self-dealing. In light of no evidence of bad faith conduct, Judge Boyle determined that on the record before him, the managers had employed a rational—if wrong—process in approving these 86 lot loans and 9 commercial loans which varied from the normal underwriting guidelines and had acted with a rational business purpose (even if, in retrospect, that business purpose was imprudent and flawed).

In a prior examination of the bank, the FDIC had reviewed the policies and procedures in place and gave the bank a satisfactory CAMELs score of "2" in 2006 (1 is the highest CAMEL score, and 5 is the lowest). Judge Boyle construed this prior stamp of regulatory approval as demonstrating, as a matter of law, that the procedures were clearly not "irrational" and could serve a valid business purpose.[7]

Judge Boyle was also critical of the FDIC's view of history and imposition of clairvoyance on the bank's managers:

> Although there were clearly risks involved in Cooperative's approach, the mere existence of risks cannot be said, in hindsight, to constitute irrationality. Further, corporations are expected to take risks and their directors and officers are entitled to protection from the business judgment rule when those risks turn out poorly. Where, as here, defendants do not display a conscious indifference to risks and where there is no evidence to suggest that they did not have an honest belief that their decisions were made in the company's best interests, then the business judgment rule applies even if those judgments ultimately turned out to be poor.[8]

Similarly, the FDIC's claim for gross negligence failed as a matter of law because there was no evidence that the managers had ignored the well-being of the bank or engaged in any willful or wanton conduct.[9]

Judge Boyle closed his opinion in a sharp passage which did not mince words and clearly establishes his view:

> It appears that the only factor between defendants being sued for millions of dollars [compared to] receiving millions of dollars in assistance from the government is that Cooperative was not considered to be "too big to fail." Taking the position that a big bank's directors and officers should be forgiven for failure due to its size and an unpredictable economic catastrophe while aggressively pursuing monetary compensation from a small bank's directors and officers is unfortunate if not outright unjust.

The FDIC appealed.

Judgment in favor of the directors is affirmed

On appeal to the Fourth Circuit, a panel of judges agreed that all directors and officers were entitled to summary judgment in their favor on the claims for gross negligence and bad faith. The panel also agreed that all the bank's directors were entitled to summary judgment on all claims against them. However, the panel reversed Judge Boyle and remanded the case for trial as to whether the bank's officers exercised bad faith in approving the 86 lot loans and certain commercial loans which ultimately failed.

Beginning with director liability, the Court noted that Cooperative's articles of incorporation include the statutorily-permitted exculpatory clause. N.C.G.S. 55-2-02(b)(3) (corporate articles may include a "provision limiting or eliminating the personal liability of any director arising out of an action whether by or in the right of the corporation or otherwise for monetary damages for breach of any duty as a director.[10] No such provision shall be effective with respect to (i) acts or omissions that the director at the time of such breach knew or believed were clearly in conflict with the best interests of the corporation..."). Note, however, that the statute does not permit limitations on the duty of loyalty and the duty of good faith. Thus, the directors were in the clear unless the FDIC could show a breach of the duty of loyalty or the duty of good faith.

In the absence of any allegations that the directors breached their duty of loyalty, the FDIC argued that there was a breach of the duty of good faith. There was also no evidence of self-dealing, fraud, or bad faith conduct on the part of the directors. The FDIC argued that making decisions without adequate information rose to the level of bad faith, however these arguments were rejected. As the Court stated, "[t]he exculpatory clause protects directors from monetary liability unless the directors "knew or believed [that their acts or omissions] were clearly in conflict" with the Bank's best interests."[11] Merely because the result was harmful or "decisions could have been better made do[es] not rise to the level of bad faith..." Accordingly, summary judgment in favor of the directors on the claims of ordinary negligence and breach of fiduciary duty was affirmed.

Judgment in favor of the officers is reversed

Turning to officer liability, the officers were not covered by the same exculpatory provisions in Cooperative's articles of incorporation which shielded the directors (indeed, N.C.G.S. 55-2-02(b)(3) does not extend to officers).[12] Thus, the officer's liability was analyzed strictly through the business judgment rule. To overcome the presumptions of the business judgment rule, the FDIC had to show that the officers "(1) did not avail themselves of all material and reasonably available information (i.e., they did not act on an informed basis); (2) acted in bad faith, with a conflict of interest, or disloyalty; *or* (3) did not honestly believe that they were acting in the best interest of Cooperative."

The FDIC mainly attacked whether the officers were acting on an informed basis. The FDIC's expert witness in banking practices noted that the officers did not act in accordance with generally acceptably and prudent banking practices.[13] They approved loans over the telephone, sometimes without first reviewing documentation. Sometimes they approved loans without reviewing any documentation, and sometimes did not receive the documentation until after loans were funded. Cooperative had also failed to address some warnings and deficiencies which regulators had noted in a 2006 bank examination (related to credit administration and audit processes).

The Fourth Circuit's ruling is in harmony with the majority of cases regarding the business judgment rule

What the Fourth Circuit does not say is just as important as what it does. The Fourth Circuit does not say that the ultimate decision to make these 86 lot loans and 9 commercial loans was actionable. It did not rule that the business judgment rule prohibited making these failed loans. Instead, *Rippy* is in alignment with most other business judgment rule cases.

The FDIC had a qualified expert witness who testified that the ***process*** used to approve the loans, which ultimately soured, did not meet generally accepted sound banking practices. This was enough to rebut the presumption of the business judgment rule. The Court was not second-guessing the decision to make these loans; but it concluded that the officers had failed in the process of deliberation and consideration before funding the loans. In other words, judges "do not measure, weigh, or quantify directors' judgments. We do not even decide if [a director's judgment] is reasonable... Due care in the decision-making context is ***process*** due care only. Irrationality is the outer limit of the business judgment rule." *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) (emphasis in original) (and stating "irrationality" can equate with the waste of corporate assets test); *State v. Custard*, 2010 NCBC 6, 18 (N.C. Sup. Ct. 2010) ("North Carolina courts have frequently looked to the well-developed case law of corporate governance in Delaware for guidance.").

Under North Carolina (and Delaware) law, absent bad faith, conflict of interest, or

continued on page 14

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disloyalty, an officer or director's business decisions "will not be second-guessed if they are the product of a rational process, and the officers and directors have availed themselves of all material and reasonably available information." *State v. Custard*, 2010 NCBC 6, 18 (N.C. Sup. Ct. 2010) (citing *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 124 (Del. Ch. 2009). As quoted with approval by the North Carolina Business Court:

> [C]ompliance with a director's duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational", provides no ground for director liability, ***so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests.*** To employ a different rule-one that permitted an "objective" evaluation of the decision-would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. Thus, ***the business judgment rule is process oriented*** and informed by a deep respect for all good faith board decisions.

State v. Custard, 2010 NCBC 6, 18 (N.C. Sup. Ct. 2010) (citing *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 124 (Del. Ch. 2009) (emphasis removed in part, added in part).

Courts will not second-guess the ultimate decision arrived at, so long as the procedure utilized by boards and officers is sufficient.[14] Directors and officers are reasonably informed in making corporate decisions if they have considered the material facts to a transaction which were reasonably available at the time. *Ehrenhaus v. Baker*, 2008 NCBC 20 (N.C. Sup. Ct. 2008) (citing *Smith v. Van Gorkom*, 488 A.2d 858, 874 (Del. 1985).

Without expressly stating it, *Rippy* means that procedure matters. The officers failed to comply with recognized banking practices in obtaining loan approvals. When the officers failed to "avail themselves of all material and reasonably available information" they "did not act on an informed basis" and thus were not entitled to the protection of the business judgment rule.

The Fourth Circuit also ruled that the Great Recession was not an intervening or superseding proximate cause as a matter of law

Intertwined and underlying the manager's defenses is the narrative that the real estate bubble and financial collapse of the late 2000s was the real proximate cause of the bank's failure or was an intervening or superseding cause. Indeed, the managers argued that the burden was on the FDIC to prove that the manager's conduct in approving 86 loans, and not the exogenous factors of a nationwide real estate collapse, frozen credit markets, and a bank panic, was the real (proximate) cause of the bank's failure. The Fourth Circuit took note of this argument, stating:

> Certainly, it is convenient to blame the Great Recession for the failure of Cooperative, and in turn for the losses sustained by the FDIC when it took over the Bank. However, there is evidence in the record, as outlined above, that suggests that "in the exercise of reasonable care," the Bank officers could have "foreseen that some injury would result from their acts or omissions, or that consequences of a generally injurious nature might have been expected." Even before the Recession, exam reports from both of Cooperative's regulators indicated that the Bank was utilizing unsafe practices. And while the Recession undoubtedly contributed to the failure of the Bank, it may have been only one of many contributing factors. This is a genuine issue of material fact, and thus this is a question for a jury.[15]

This paragraph has particular salience. Under the Fourth Circuit panel's opinion, the FDIC's case survives summary judgment while admitting that the Recession "undoubtedly" was a partial proximate cause of the bank's failure.

The Fourth Circuit also affirmed the entry of summary judgment on all claims of gross negligence against all directors and officers.

Takeaways and what happens next.

The panel has remanded the case back to Judge Boyle for a trial on the ordinary negligence and breach of fiduciary duty claims against the officers. However, the Bank has the option of petitioning for en banc review before the full Fourth Circuit rather than just a three-judge panel.

Corporate boards and officers, and particular bank boards and officers, should review and follow their internal procedures regarding corporate decision-making in accordance with *Rippy*. In addition, banks should always have adequate D&O insurance coverage to protect their directors and officers against these types of claims.

Bank directors and officers must also be aware of the FDIC's recent warnings regarding the increased use of exclusions in commercial market D&O policies.[16] The FDIC did not point out any particular exclusions, although it was most likely referring to the regulatory action exclusion. Post-recession litigation by the FDIC has already generated coverage litigation, some of which has upheld a broad regulatory exclusion in certain D&O policies.[17]

In that statement, the FDIC has encouraged "each board member and executive officer to fully understand the answers" to at least four specific questions regarding D&O insurance coverage:

- What protections do I want from my institution's D&O policy?
- What exclusions exist in my institution's D&O policy?
- Are any of the exclusions new, and if so, how do they change my coverage?
- What is my potential personal financial exposure arising from each policy exclusion?

The FDIC's guidance also reminds bank managers that "FDIC regulations prohibit an insured depository institution or depository institution holding company from purchasing insurance that would be used to pay or reimburse an institution-affiliated party (IAP) for the cost of any civil money penalty (CMP) assessed against such person in an administrative proceeding or civil action commenced by any federal banking agency." This prohibition prevents the purchase of insurance to indemnify

the bank for paying civil money penalties on behalf of its managers. This would include penalties imposed when an officer or director violates a law or regulation, commits an unsafe banking practice, breaches a fiduciary duty, or engages in willful misconduct. The FDIC did not give any guidance regarding whether an individual manager can purchase their own personal umbrella policy to indemnify them for civil monetary penalties.

While this decision is interesting, it does not actually change the law in North Carolina regarding the legal liability of corporate directors and officers. What the opinion does is highlight the need for a bank's directors and officers to follow their own procedures and for the bank to provide D&O insurance for its directors and offices in case these procedures were not followed.

Endnotes

1 For reference, based on a report by the North Carolina Commissioner of Banks, at the close of 2002, Cooperative Bank was the 26th largest North Carolina bank. If it had obtained its goal, it would have been approximately the 10th largest bank in North Carolina.

2 http://www.nytimes.com/2014/09/19/business/in-ruling-that-favors-failed-bank-promises-meant-little.html?_r=0

3 *FDIC v. Willets*, 7:11-CV-00165, D.E. 1, 08/10/11 (E.D.N.C.)

4 http://www.nytimes.com/2014/09/19/business/in-ruling-that-favors-failed-bank-promises-meant-little.html?_r=0

5 *FDIC v. Willets*, 7:11-CV-00165, D.E. 1, 08/10/11 (E.D.N.C.)

6 *FDIC v. Willetts*, 48 F. Supp.3d 844 (E.D.N.C. 2014).

7 *Willetts*, 48 F.Supp.3d at 850-51.

8 *Id.* at 851

9 *Id.* at 851-52.

10 *Rippy*, 799 F.3d at 311.

11 *Id.* at 312.

12 N ote that defendant Fredrick Willetts, III was both CEO and Chairman of the Board of Directors. He was both an officer and a director. The exculpation statute provides no protection to Mr. Willetts for violations of the duty of care committed as an officer.

13 *Rippy*, 799 F.3d at 313.

14 In this way, the business judgment rule operates as a standard of judicial review, and not simply as a standard of board and officer conduct.

15 *Rippy,* 799 F.3d at 316.

16 Advisory Statement on Director and Officer Liability Insurance Policies, Exclusions and Indemnification for Civil Money Penalties, FDIC FINANCIAL INSTITUTIONS LETTER,FIL-47-2013 (Oct. 10, 2013).

17 *See, e.g., Reis et al. v. Federal Insurance Co.*,No. CV 11-09835 RSWL (C.D. Cal. July 12, 2013).

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Calendar of Events

December 2015 • Vol. XXVIII • Number 12

*Many Chapter event dates will be finalized and reported in future issues. You can also visit the PLUS website to view the most up-to-date information.

Chapter Events*

Eastern Chapter
- December 9, 2015 • Winter Social • New York, NY

Hartford Chapter
- January 2015 • Networking Reception • Hartford, CT

Mid-Atlantic Chapter
- December 3, 2015 • Educational Seminar and Holiday Party • Philadelphia, PA

Midwest Chapter
- December 8, 2015 • Holiday Party • Chicago, IL

New England Chapter
- December 2, 2015 • Holiday Party • Boston, MA

North Central Chapter
- December 2, 2015 • Educational Seminar • Minneapolis, MN

Northern California Chapter
- December 10, 2015 • Holiday Party • San Francisco, CA

Northwest Chapter
- December 2, 2015 • Educational Seminar w/ IIABKC • Seattle, WA

Southeast Chapter
- December 2015 • Sponsor Appreciation and Networking Reception • Birmingham, AL

Southern California Chapter
- December 10, 2015 • Holiday Party • Los Angeles, CA

Southwest Chapter
- December 10, 2015 • Networking Reception • Denver, CO

Texas Chapter
- December 2, 2015 • Sponsor Appreciation and Networking Reception • Dallas, TX

International Events

2016 D&O Symposium
- February 3-4, 2016 • Marriott Marquis • New York, NY

2016 MedPL/PRS Symposia
- April 20-21 2016 • Chicago, IL

2016 Cyber Symposium
- September 26, 2016 • New York, NY

2016 PLUS Conference
- November 9-11, 2016 • Hyatt Regency • Chicago, IL

The mission of the Professional Liability Underwriting Society is to be the global community for the professional liability insurance industry by providing essential knowledge, thought leadership and career development opportunities.

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