FAILED BANK LEGAL ACTION

by Steve Brown

The other day, in a rare free block of time, we turned on the nightly news on TV. We hadn't done that in years and what we saw floored us. The newscasters were still talking like it was 1982. They took themselves so seriously when they said, "We are going to bring you all the news of the day first, in order to keep you up to date." First? Really? Their top story happened 10 hours ago. We had already received 27 Tweets, 12 Diggs, 6 Facebook postings, a CNN Breaking News alert and 5 stories on the Drudge Report since then. Unless the story broke at 6:59, the TV nightly news was not "first" at anything. We went on to watch out of curiosity, only to see a story on the back-end of the broadcast about how the FDIC was coming after bank management in cases where banks had failed. The way the story went, if you didn't know better, you would have thought every bank manager of a problem bank should prepare for a lawsuit.

While the investigation and timing of FDIC lawsuits can extend out for years and we admit we don't yet know what this cycle will bring, given it is so early, the reality is probably something less. It is true that catching evil bankers is a top priority of the media, FDIC and the US Department of Justice; as well as a moral imperative of Congress, this effort needs to be put in perspective. For starters, what the newscast was really trying to report was the fact that almost every director, executive and professional (counsel, accountants, etc.) at a failed bank does receive what is called a "Demand for Civil Money Damages." This official looking notice is not public and is sent to executive managers and directors in order to preserve any claim under the Directors and Officers Insurance. It is also true that almost every failed bank has probably had an investigation launched surrounding its demise, in order to ascertain what happened and if what occurred was either nefarious or a series of malfeasance - type events. If the investigation finds that management or the board was flagrantly violating regulations/bank policy or if self-dealing was found, then the investigation asks the question whether there is enough evidence to try the case. In short, the FDIC matches the action of the bank against its famous 1992 Statement Concerning the Responsibilities of Bank Directors and Officers and asks were rules violated and if so by how much.

Believe it or not, the FDIC is rational in its analysis if history is any guide and is driven by investigation results of each bank. Statistically speaking and based on the S&L crisis of the 1980's, only 24% of banks received a lawsuit. In comparison, as of the end of May, 344 banks had failed and as of May 10, the Professional Liability Litigation page on the FDIC's website shows that the agency has authorized lawsuits against 208 individuals (most of the legal activity so far has been around the residential mortgage arena, as the FDIC has actions pending against 135 parties).

So far, about 2Ys into the crisis, the run rate is below the 80's experience. Investigations normally take about 18 months and the statute of limitations are 3Ys for tort claims and 6Ys for breach-of-contract claims (or longer if state law permits) once the bank is closed.

We surmise that there are probably many reasons for this that could include: not enough legal staffing at the FDIC; limited investigation staff availability from other agencies due to the prior failure of Lehman, etc.; more regulation and better oversight than the 1980's; higher litigation costs; D&O insurance isn't what it used to be and policies are generally more limited from the 80's (most have lower average dollar amounts per claim of $1mm to $3mm; while simple negligence can be the bar (thanks to the Supreme Court decision of Atherton v FDIC), it is only in cases where state law permits it and is not preempted by Federal law.

Before going too far and sounding the all clear, however, it bears mentioning that the FDIC has filed lawsuits against management teams and directors for reasons including: poor risk management; violating loan policies; failing to properly supervise; routinely financing CRE projects without meaningful analysis of economic viability; making loans with excessive LTV ratios; failing to properly evaluate the creditworthiness of CRE borrowers and guarantors; and failing to structure the lending area to rigorously and objectively review proposed loans to guard against the risk of loss - to name a few.

We will cover more of this another time, but hope that the below historical trend holds and lawsuits remain focused on gross negligence. Let's hope the nightly news hype decreases.

BANK NEWS

Housing

A report by CoreLogic finds 38% of homeowners who took out second mortgages are underwater on their loans, a rate that is more than double owners who didn't take out these loans (who are at 18%).

Loan Growth

Research by JPMorgan finds GDP for Q2 is tracking just north of 2%, so community banks should be updating loan growth projections to take that lower level into account for planning purposes.

FL Muni Stress

Meredith Whitney reportedly points out in a research piece that 90% of FL municipal bonds are in revenue bonds and most of those are tied to real estate.