



CHAPTER 11

Professional Liability Claims

Introduction and Overview

Professional misconduct was a significant factor in the failures of financial institutions during the 1980s. The Professional Liability (PL) Program at the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) played an important role in recovering losses from those failures. This chapter describes the development of professional liability operations at the FDIC and the RTC and provides an overview of the legal standards and major areas of collection during the period of professional liability activity after the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 was enacted.¹

When an insured depository institution fails, the FDIC as receiver—like the RTC and the Federal Savings and Loan Insurance Corporation (FSLIC) before the RTC—acquires a group of legal rights, titles, and privileges that are generally known as professional liability claims. These receivership assets are claims under civil law for losses caused by the wrongful conduct of directors, officers, lawyers, accountants, brokers, appraisers, and others who have provided professional services to a failed institution. To collect on these claims, the receiver often must sue the professionals for losses resulting from their breaches of duty to the failed institution. This specialized group of receivership claims also includes contract rights inherited from the institution under any available director and officer liability insurance policy, and under the fidelity bond insurance policy that institutions purchase to cover losses resulting from dishonest or fraudulent acts by their employees.

1. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 abolished the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation and gave the FDIC initial responsibility for the Resolution Trust Corporation and permanent responsibility for operating the new Savings Association Insurance Fund. The FDIC managed the RTC's activities until November 27, 1991, when the Resolution Trust Corporation Refinancing, Restructuring and Improvement Act (RTCRRIA) separated the RTC from the FDIC. The RTC existed from August 9, 1989, to December 31, 1995.

The main objectives of the FDIC's PL Program are first to investigate all potential claims inherited from each receivership, and then to recover losses based on meritorious claims in a cost-effective manner. Although more than \$5 billion have been collected on professional liability claims, that amount is only a partial recovery of much larger losses to the deposit insurance fund (or, in the RTC's case, to the taxpayer) resulting from professional misfeasance and malfeasance. Professional liability claims are complex and contentious and often require many years and substantial investments in investigation and litigation before any actual recovery is realized.

Professional liability activities are closely related to important matters of corporate governance and public confidence. The FDIC's PL Program helps to strengthen the perception as well as the reality that directors, officers, and other professionals at financial institutions are held accountable for wrongful conduct. To this end, the complex collection process for PL claims is conducted in as consistent and fair a manner as possible. Potential claims are investigated carefully after every bank and savings and loan failure and are subjected to multi-layered review by the FDIC's attorneys and investigators before a final decision is rendered on whether and how to proceed. A lawsuit on any particular claim is filed only after attempts at resolution through settlement are made. At the FDIC, the final decision about whether to file suit typically rests with the board of directors. At the RTC, the decision to file suit typically was delegated to senior managers in the Legal Division and the Office of Investigations, and only the largest claims went to the chief executive officer (CEO).

No claim is pursued by the FDIC unless it meets both requirements of a two-part test. First, the claim must be sound on its merits, and the receiver must be more than likely to succeed in any litigation necessary to collect on the claim. Second, it must be probable that any necessary litigation will be cost-effective, considering liability insurance coverage and personal assets held by the defendants.

A number of meritorious civil cases have not been pursued because insufficient reliable sources of recovery were available to justify the cost. Wrongdoers, however, can still be held accountable. The FDIC, the RTC, and the FSLIC have referred various civil matters to the supervisory and enforcement arm of the appropriate regulatory agency. The agencies also have made thousands of criminal referrals and provided ongoing support to the Justice Department on matters involving suspected criminal activity. Since 1980, the courts have ordered more than a billion dollars in restitution against several thousand criminals formerly affiliated with failed institutions, including numerous directors, officers, and other professionals. Of the total criminal restitutions ordered, however, less than 10 percent have been paid to the FDIC.

The Professional Liability Program involved an enormous range of complex law and fact issues that were negotiated and litigated on a case-by-case basis in jurisdictions all over the country (and in some foreign countries). The program recovered a substantial amount of money and should have a beneficial effect on professional conduct at both present and future financial institutions.

Professional Misconduct as a Significant Factor in Financial Institution Failures During the 1980s

The Professional Liability Program is an important part of the effort to recover losses from insured depository institution failures. That became clear at the beginning of the emerging crisis in the early 1980s, when concerns about financial institution fraud began to surface.² Before FIRREA's enactment and throughout the years of its implementation, regulators, independent commissions, and legislative bodies have concluded that professional wrongdoing played a significant role in the depository institution crisis of the 1980s and 1990s. For example, an early systematic study by the Office of the Comptroller of the Currency (OCC) found that of the 171 national banks closed by the OCC between 1979 and 1987, more than 90 percent suffered from significant mismanagement, 35 percent suffered from insider abuse, and 11 percent were victims of fraud.³ In October 1988, the U.S. House of Representatives Government Operations Committee stated that misconduct by insiders and affiliated borrowers had contributed to the insolvency of at least one-third of failed commercial banks and more than 60 percent of all failed thrifts, resulting in tremendous costs to the federal deposit insurance funds.⁴ In addition, a 1992 report to Congress by the General Accounting Office (GAO) concluded that "a key component of these failures was wrongdoing, including negligence and fraud, on the part of directors, officers, and other professionals associated with the institutions."⁵

In July 1993, a national commission, created to study the causes of the financial institution crisis of the 1980s, reported to the president and Congress on its new research, public hearings, interviews, and review of existing work in that area.⁶ The national commission concluded that there had been "unprecedented fraud and abuse" by persons connected with failed institutions, although that was not the sole cause of the crisis, and that "fraud and misconduct were important elements in the savings and loan (S&L) debacle."^{7,8} The national commission found a "continuum of abusive practices"

2. House Committee on Government Operations, *Federal Response to Criminal Misconduct and Insider Abuse in the Nation's Financial Institutions*, H.R. Rep. No. 1137, 98th Cong., 2d Sess., 1984.

3. Office of the Comptroller of the Currency, *Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks*, June 1988, 21. See also *Report on Director and Officer Liability Insurance and Depository Institution Bond Pursuant to Section 220(b)(3) of the FIRREA*, September 13, 1991, 26 ("Regardless of whether precisely the same result would be found in a survey of current bank and thrift failures, the OCC study—and the FDIC's experience—make[s] it clear that mismanagement is very common in failed depository institutions.")

4. H.R. Rep. No. 982, 101st Cong., 2d Sess., 1990, 5.

5. "Bank and Thrift Failures: FDIC and RTC Could Do More to Pursue Professional Liability Claims," Testimony of the U.S. General Accounting Office before the Senate Committee on Banking, Housing, and Urban Affairs, June 2, 1992 (hereafter called the *1992 GAO Report*), Summary Statement & 17.

6. National Commission on Financial Institution Reform, Recovery, and Enforcement, *Origins and Causes of the S&L Debacle: A Blueprint for Reform*, July 27, 1993 (submitted pursuant to Section 2556 of FIRREA).

7. National Commission, *Origins and Causes*, ix & 3.

8. National Commission, *Origins and Causes*, 70.

ranging from aggressive search for regulatory loopholes to outright fraud by failed institution managers, attorneys, accountants, appraisers, and others.⁹ Noting that “estimates of the actual dollar losses due to fraud and misconduct differ widely,” the national commission concluded “that taxpayer losses due to fraud were large, probably amounting to 10 to 15 percent of total net losses.”¹⁰

Thus, investigation and pursuit of PL claims were primary concerns after the enactment of FIRREA and during the subsequent receivership activities at the RTC and the FDIC.

Development of Professional Liability Operations

Before the late 1970s, neither the FDIC nor the FSLIC had receivership staff devoted to PL matters. However, expertise at both agencies quickly developed thereafter in response to notable failures such as the Penn Square Bank, N.A. (Penn Square), Oklahoma City, Oklahoma, liquidation in 1982 and the Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois, assistance transaction in 1984. Initially, in addition to the attorneys assigned to PL matters in each of those cases, and as part of the institution’s overall resolution process, teams of liquidation and examination personnel were detailed for extended periods at the location of the failed financial institution. Outside contractors, such as litigation counsel, were retained as necessary.

In 1986, as the frequency and size of failures increased, the FDIC transferred responsibility for investigating claims from Washington, D.C., headquarters to employees at the consolidated field offices then forming throughout the country. A separate unit was established in Texas, for example, to handle the large bank investigations in the Southwest. Dedicated to PL matters, those in-house personnel worked with FDIC lawyers in Washington to investigate and evaluate the claims. Investigation staff included, at various times and locations, expertise as diverse as certified public accountants, attorneys, commercial lending officers, real estate appraisers, former bank examiners, and even geologists and petroleum engineers. To meet the shifting geographic focus of receivership activity, FDIC staff and offices were relocated from the Southwest and West Coast in the early 1980s to the Northeast later in the decade.

The FDIC developed consistent procedures for managing the claims and any necessary litigation. The investigation of losses incurred by the failed institution begins at its closing, when investigation specialists enter the institution with the first group of closing personnel and conduct interviews with institution managers and other key personnel. Meanwhile, other team members retrieve important documents, searching office by office for relevant records such as loan files and minutes of board meetings. After all records have been collected, inventories are completed. For larger institutions hundreds,

9. National Commission, *Origins and Causes*, 8 & 14.

10. National Commission, *Origins and Causes*, 69-71.

or even thousands of boxes of documents might be retrieved. Keeping accurate inventories and documenting the custody of the records are especially important if litigation becomes necessary. After all documents have been retrieved and initial interviews completed, documents are removed from the failed institution to an FDIC field office. Over time these procedures have become increasingly automated and sophisticated.

The principal role of the FDIC investigator is to establish the factual basis for legal claims, and to identify losses for which the FDIC can pursue recovery in a cost-effective manner. Working with in-house attorneys and outside litigation counsel, the investigation staff compiles, analyzes, and maintains evidence and documentation to support claims. It also reviews all functions of the bank. Audits are analyzed for evidence of audit failure, operational losses are reviewed, and potential claims against professionals are identified.

Before FIRREA, the FSLIC was developing PL operations in response to thrift failures. The FSLIC relied to a much greater degree on the use of outside contractors when closing thrift institutions. It engaged private law firms at the outset of a receivership to investigate and develop PL claims. Supervised by FSLIC attorneys at the Washington office, the outside firm would be responsible for resolving all types of assets, including PL claims, from the particular receivership. The FSLIC did not develop a significant in-house capacity for investigating PL claims.

Professional Liability Operations After FIRREA

As manager of the FSLIC Resolution Fund after FIRREA, the FDIC assumed directly from the former FSLIC the responsibility for resolving claims arising from thrifts that failed before 1989. When the FSLIC PL claims transferred to the FDIC, a small group of in-house attorneys at the FDIC was suddenly managing a large caseload of claims arising from hundreds of failed thrifts as well as banks.¹¹ A Professional Liability Section (PLS) within FDIC's newly reorganized Legal Division was formed to handle all FDIC and RTC PL matters arising nationwide. Although all of RTC's PL matters involved only failed thrift institutions, most of which had been closed by the Office of Thrift Supervision (OTS), many non-RTC PL claims also arose from thrifts, most of which had been FSLIC institutions.

In late 1989, the FDIC established in Dallas its first office of professional liability attorneys outside its Washington, D.C., headquarters. The addition of those attorneys brought PLS staffing to 60 lawyers. During 1990, additional RTC teams of investigators

11. Even before FIRREA's enactment in August 1989, the FDIC had become responsible for thrifts placed in conservatorship or receivership beginning in February 1989. By the time of FIRREA's enactment, the FDIC-managed thrifts totaled 253. When that caseload was combined with an existing caseload of approximately 500 failed banks, some of the 22 FDIC professional liability attorneys each had responsibility for 50 bank and thrift failures. See *1992 GAO Report*, 8.

were established in 4 regional and 14 field offices. By the end of 1990, a national network of offices employed almost 400 investigators and staff in the RTC Office of Investigations. The FDIC assigned separate teams of PLS lawyers to oversee all investigations and litigation arising from nearly 500 RTC receiverships. In early 1991, the RTC established a separate PLS section within the independent Legal Division. The section was staffed initially by transferring attorneys from the FDIC PLS, most of whom had already been dedicated to RTC matters. Thereafter, the separate staffs at the RTC and the FDIC grew significantly through new hires; by April 1992, a total of 175 in-house lawyers at the RTC and the FDIC were assigned to PL work.

Shortly after its separation from the FDIC, when the RTC decided to decentralize its PL operations, staff in the RTC field offices began to report to their respective regional counsels and directors, rather than through the Washington, D.C., headquarters. Most lawsuits and settlement recommendations by regional staff were approved under delegated authority in their respective regions. The FDIC, in contrast, retained its reporting lines through Washington, D.C., and all suits and settlements arising nationwide were approved by the same senior management. In 1993, Congress reversed the RTC's decentralization of PL operations, mandating that an RTC assistant general counsel direct the investigation, evaluation, and prosecution of all PL claims.¹²

During its lifetime, the RTC investigated potential claims arising from more than 740 failed thrifts. The RTC brought a PL lawsuit or achieved settlement before filing suit in matters from 444 institutions, which constituted nearly 60 percent of the total institutions it handled.¹³ The RTC pursued claims against directors and officers for a third of the total number of institutions that it handled. The 559 civil professional liability actions that the RTC filed, inherited, or defended fall into a wide variety of categories, including 274 suits related to director and officer liability, 126 attorney malpractice suits, 46 fidelity bond matters, and 43 accounting malpractice matters. Some of the 274 director and officer claims brought by the RTC, however, involved insurance coverage actions out of the same institution for which a separate suit was filed.

From 1980 through 1995, the FDIC investigated all PL claims after each of the more than 1,600 depository institution failures for which it had direct responsibility for resolution. The FDIC brought claims specifically against directors and officers in less than one-fourth of the bank failures occurring between 1985 and 1992. As manager of the FSLIC Resolution Fund, the FDIC handled approximately 300 thrift institutions from 1990 to 1996, and from 1990 to 1995, the FDIC managed 361 PL cases initiated during this period. Thus, the FDIC filed, inherited, or defended more than 800 professional liability lawsuits. The figure for total non-RTC professional liability lawsuits

12. That mandate was part of a number of RTC management reforms directed by Congress under the RTC Completion Act of 1993, Pub. L. No. 103-104, codified at *U.S. Code*, volume 12, section 1441a (w)(10).

13. *Final Report of the Resolution Trust Corporation Professional Liability Section and Office of Investigations*, April 1996 (submitted to Congress by FDIC pursuant to the RTC Completion Act of 1993) (hereafter called the *Final RTC PLS Report*), 5.

includes all thrift claims inherited by the FDIC from the FSLIC after the enactment of FIRREA, as well as professional liability suits from commercial bank failures that occurred during the early 1980s.

The RTC PL function transferred to the FDIC upon the RTC's statutory "sunset" on December 31, 1995. As of January 1, 1996, the FDIC inherited an additional 193 RTC thrift institutions with open investigations, uncollected settlements, or litigation and 196 RTC professional liability lawsuits pending at RTC's sunset. The RTC's PL collections had peaked the previous year (1994) at \$512 million. The FDIC's PL collections had peaked earlier, with cash recoveries of \$610 million during 1992. Within a year after the RTC's consolidation back into the FDIC, professional liability staffing and workload had wound down to levels comparable to the period before FIRREA, although recoveries from continuing PL operations remained substantial.

Significant Issues and Events in Professional Liability Claims Litigation

The FDIC and the RTC investigated thousands of potential PL claims arising from the financial institution failures of the 1980s. Most of those claims were closed following investigation, either because it was already clear that they lacked strong factual and legal support on the merits, or because adequate resources from which the claim could be collected cost-effectively appeared not to be available. Of the claims that were pursued, most eventually were resolved through settlements. To reach settlement, however, the FDIC and the RTC usually had to file a lawsuit and engage in some litigation.

The duration and cost of PL litigation increased during the years after enactment of FIRREA. The FDIC and the RTC achieved a number of large, comprehensive "global" resolutions, particularly in the accounting and securities industries, but only after substantial and costly litigation. Meanwhile, success in obtaining cash recoveries from meritorious director and officer claims diminished during the years after FIRREA's enactment. Fewer claims were covered by accessible liability insurance, while the most culpable individuals at failed institutions usually had few accessible personal assets from which collections could be made. As cases proceeded through litigation, developing legal doctrines began to limit the personal liability of former depository institution professionals (especially directors).

Because of the complex and often litigious nature of PL claims, it takes a long time to settle and collect any proceeds. The "tail" on investigating and litigating professional liability claims can often run more than a decade from the time of the actual misconduct until ultimate resolution and collection by the receiver. Indeed, even in late 1997, the FDIC still had numerous pending lawsuits to recover on PL claims arising from depository institution failures during the 1980s.

The changes in the law governing liability insurance, the evolving standards of liability for director and officer claims, typical defenses raised, and the specialized areas of accounting, legal malpractice, and securities brokerage are described in the following sections.

Insurance Coverage for Director and Officer Liability Claims

Director and officer insurance contracts purchased by institutions before failure were a principal source of recovery for losses resulting from misconduct of culpable directors and officers before their institutions failed. Depository institutions purchase director and officer insurance to protect their directors and officers against liability posed by negligence, gross negligence, and breach of fiduciary duty claims. Although the insurance generally excludes coverage for losses resulting from dishonesty, fraud, and other such intentional misconduct, such losses potentially are covered by the fidelity bond insurance that all insured institutions are required to purchase pursuant to laws and regulations. Director and officer liability insurance typically covers only claims made with the carrier during the policy period, whereas fidelity bonds cover losses discovered during the period the insurance is in force. Both types of insurance contain notice provisions and various other requirements that can pose obstacles to recovery by the insured institution or its receiver.

Liability insurance and fidelity bonds had been the main recovery source for directors' and officers' misfeasance and malfeasance. Beginning in the early 1980s, however, insurers began to add new exclusionary endorsements to insurance policies sold to financial institutions. One such provision, the "regulatory exclusion," purported to preclude any government agency from recovering losses under the policy, even if the losses from wrongful acts by management would have been paid to other claimants, such as shareholders in a derivative action concerning an open institution.¹⁴

Until 1990, the agencies usually defeated regulatory exclusions by arguing that they were vague, unenforceable, and contrary to public policy. After FIRREA's enactment, however, court decisions have largely upheld regulatory exclusions. In fact, six U.S. Circuit Courts of Appeals cases eventually upheld regulatory exclusions as sufficiently clear clauses negotiated as part of a contract between two parties.¹⁵ In reaching their determinations, the courts relied in part on their finding that Congress had expressed no public policy, in FIRREA or elsewhere, against enforcing regulatory exclusion clauses.

When enacting FIRREA, Congress categorically determined not to address the regulatory exclusion issue directly and, instead, allowed the courts to continue addressing

14. Insurance carriers included other exclusions to bar recoveries by the government, such as an exclusion for classified loans and a variety of coverage termination provisions. Insurance carriers also routinely contested the adequacy of notice when the FDIC and the RTC sought to recover as receivers for the insured depository institution. The primary subject of coverage disputes between the agencies and the insurance carriers, however, was the regulatory exclusion.

15. The Sixth Circuit Court, in *FDIC v. Aetna Casualty & Co.*, 903 F.2d 1073 (6th Cir. 1990), was the first Circuit Court of Appeals to address the issue after FIRREA's enactment. Two trial courts after FIRREA, however, found in favor of coverage in particular circumstances. The Colorado Supreme Court, in *FDIC v. American Casualty Co.*, 843 P.2d 1285 (Colo.1992), held that the regulatory exclusion violated state public policy as evidenced by Colorado's banking code. A federal district court in Florida held that the regulatory exclusion did not apply to a derivative action filed by a shareholder before the failure of the bank in which the FDIC was later substituted as a party plaintiff in *ACC v. Frogel*, Case No. 91-0786 (S.D. Fla. 1993).

those contract clauses on a case-by-case basis under existing law.¹⁶ Congress also directed the FDIC, Justice Department, and Treasury Department to issue a joint study of provisions that prevented government agencies from recovering under insurance policies purchased by financial institutions such as the regulatory exclusion. The study ultimately recommended amending FIRREA to assert a federal policy against enforcement of regulatory exclusions and similar clauses.¹⁷ However, because Congress took no action on this recommendation, some courts found that there was no longer any public policy against enforcing these clauses.

That change in the law greatly hindered the agencies' efforts to recover losses caused by culpable officers and directors. Recovering losses from the personal assets of such individuals is typically more difficult and less cost-effective than obtaining indemnification from carriers under a failed institution's insurance policies. Moreover, liability insurance indemnifies losses caused by wrongful conduct of any and all former bank professionals, whose liability for loss typically was "joint and several." Resolution of claims with insurance carriers thus does not require allocation of portions of fault to each individual director and officer. As regulatory exclusions vitiated liability insurance coverage, however, collection efforts shifted to focus more on the particular liability of culpable individuals with accessible personal assets. Those persons usually were outside directors, rather than former loan officers. Not surprisingly, the specific standard of care applied to former directors increasingly became the focus of professional liability litigation.

Standard of Liability for Director and Officer Claims

Long before the 1980s crisis, the legal obligations of directors and officers had been established in common law (judicial) decisions and in federal and state statutes. Directors and officers of a financial institution owe duties to their institution, its shareholders, and its creditors, as do directors and officers of corporations in general. The most important of those legal obligations are the duties of care and of loyalty. As the U.S. Supreme Court stated more than a century ago, the duty of care requires directors and officers, when conducting an institution's affairs, to use the degree of care that ordinarily prudent and diligent persons would exercise under similar circumstances.¹⁸ The duty of loyalty requires directors and officers to administer the institution's affairs and to protect the interests of depositors and shareholders with personal honesty and integrity, and

16. *U.S. Code*, volume 12, section 1821(e)(12). See also H.R. Rep. No. 54(I), 101st Cong., 1st Sess. 416-17 (1989), reprinted in 1989 *U.S. Code Cong. & Admin. News* 86, 212-13.

17. "Report on Directors and Officers' Liability Insurance and Depository Institution Bonds Pursuant to Section 220(b)(3) of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989" (September 13, 1991), reprinted in *Regulatory Exclusions Pertaining to Financial Institution D&O Professional Liability Insurance Policies*. Before the House Committee on Banking, Finance, and Urban Affairs, 103rd Cong., 1st Sess. 158 (1993).

18. *Briggs v. Spaulding*, 141 U.S. 132, 152 (1891).

prohibits them from advancing their own personal interests or those of others over the interests of the institution.¹⁹

Directors are responsible for selecting and supervising competent officers; establishing business strategies and policies; monitoring the progress of business operations; and monitoring adherence to policies and procedures required by statutes, regulations, and principles of safety and soundness. Directors must make business decisions based on fully informed and meaningful deliberation. Directors need timely, ample information from officers to discharge board responsibilities and must require officers to respond promptly to supervisory criticism. Open and honest communication among directors, officers, and regulators is therefore vital.

Corporate directors and officers are potentially liable for damages resulting from the breach of their duties. Such liability can flow from breaches of duty that are unintended but negligent, as well as from misconduct that is either intentional or so reckless or wanton as to imply deliberate intent. Before the 1980s, most state laws imposed the so-called “simple” or “ordinary” negligence standard of liability of corporate directors and officers in general.²⁰

During the 1980s and early 1990s, however, several states relaxed the simple negligence standards for director and officer liability, instead requiring that liability be based only on culpable conduct that was grossly negligent or worse. Those states, and many others that did not amend their general standard of care, also acted to protect directors and officers with some form of insulating statute.²¹ State insulating statutes typically stipulate that a corporation, by amending its bylaws or articles of incorporation, may limit the civil liability of its directors so that their liability for negligent breach of the duty of care is eliminated completely.²² Typically, state insulating statutes usually do not apply to officers, however, and do not limit liability for breach of the duty of loyalty.

When enacting FIRREA in 1989, Congress was concerned about state efforts to insulate directors and officers of federally insured depository institutions from liability for losses inflicted on the public. Congress therefore preempted state statutes so that they did not insulate directors and officers from liability for culpable conduct that is

19. *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939).

20. In at least two states, the liability standard is even stricter for managing financial institutions. The standard imposes on those directors and officers a duty of care higher than the simple negligence standard applicable to directors and officers of *nonfinancial* institutions. The standard is stricter because of the fiduciary relationship of institutions that are responsible for handling other people's money.

21. To date, 46 states have adopted a form of insulating statute. Some of the statutes apply specifically to financial institutions, and others apply to corporations in general.

22. Beginning in 1987, for example, corporations in Arkansas could specify that directors are not liable for civil damages except for breach of the duty of loyalty, acts or omissions not in good faith, intentional misconduct, knowing violations of law, or acts giving rise to liability to entities other than the corporation and its stockholders. *Arkansas Code*, Section 4-27-202B(3), made applicable to banks by Section 4-26-103(b) and to thrifts by Section 23-37-105.

grossly negligent or worse. In a new section 11(k) added to the Federal Deposit Insurance Act, Congress provided the following:

(k) Liability of directors and officers

A director or officer of an insured depository institution may be held personally liable for monetary damages in any civil action by, on behalf of, or at the request or direction of the Corporation [FDIC], which action is prosecuted wholly or partially for the benefit of the Corporation—

- (1) acting as conservator or receiver of such institution,
- (2) acting based upon a suit, claim, or cause of action purchased from, assigned by, or otherwise conveyed by such receiver or conservator, or
- (3) acting based upon a suit, claim, or cause of action purchased from, assigned by, or otherwise conveyed in whole or in part by an insured depository institution or its affiliate in connection with assistance provided under section 1823 of this title,

for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, as such terms are defined and determined under applicable State law. Nothing in this paragraph shall impair or affect any right of the Corporation under other applicable law.

The federal courts soon agreed that, for claims filed by the FDIC and the RTC on behalf of state chartered institutions, section 11(k) preempted only state insulating statutes, not other state laws like standards of care.²³ However, the courts disagreed over whether section 11(k) preempted federal common law and whether, for *federally* chartered institutions, it also preempted state simple negligence standards of care. The U.S. Supreme Court resolved this basic issue when it held that state law, not federal common law, provides the liability standard for directors and officers, and that section 11(k) provided a gross negligence floor for the FDIC claims in states with insulating statutes.²⁴ In other words, a state statute allowing directors to insulate themselves from all liability for breaches of their duty of care does not bar FDIC claims based on gross negligence. The ruling is consistent with the FDIC's long-standing internal policy of pursuing only "outside" director claims for which the facts show that the culpable conduct rises to the level of gross negligence or worse.²⁵

Although most state law definitions of gross negligence are consistent, some definitions vary. A few states have attempted to redefine gross negligence as willful or intentional

23. See, for example, *FDIC v. Canfield*, 967 F.2d 443 (10th Cir. 1992) (*en banc*), cert. denied, 506 U.S. 993 (1992).

24. *Atherton v. FDIC*, 117 S. Ct. 666 (1997).

misconduct, at least for FDIC professional liability cases. Not enough cases have been litigated under these statutes to clearly indicate what effect they actually will have. Directors and officers are generally protected from liability, however, if they have acted in good faith and with due care, and if they have made fully informed business decisions within the scope of their authority and without personal interest or self-dealing.

During the 1980s and early 1990s, the OCC, the OTS, and the FDIC developed several guides for directors: *The Director's Book*, first published by the OCC in 1987 and revised in March 1997; the *Director Information Guidelines*, published by the OTS in 1989; the FDIC General Counsel's statement titled "New FDIC Guidelines Issued to Clarify the Responsibilities of Bank Directors and Officers," dated December 17, 1992, and the *FDIC Pocket Guide For Directors*, reprinted November 1997. The FDIC guidelines clarify FDIC policies concerning professional liability suits. They describe the duties and responsibilities expected of depository institution directors and officers, discuss the differences in the way the FDIC analyzes claims against inside directors as opposed to those against outside directors, describe factors considered in filing suits, and note procedures used by the FDIC in authorizing civil lawsuits.

Defenses to Liability

After the FDIC has demonstrated that the defendants acted wrongfully under the applicable legal standard, it must then show that the conduct caused a reasonably certain measure of damages. Defendants to professional liability claims invariably raise a number of defenses, which fall into such predictable categories as the following:²⁶

- The defendant's obligation for any losses was discharged in bankruptcy;
- Other people bear a portion of the responsibility (the "comparative fault" defense);
- The regulators are at fault and should have stopped the defendant (the "contributory fault" defense);

25. An "inside" director is a person such as a member of a shareholder control group or an officer responsible for running some part of the daily operations of the institution. Insiders have more knowledge of the institution's operations, and they are responsible for ensuring that the institution complies with laws and regulations and for implementing the policies and business objectives promulgated by the board of directors. Because outside directors are neither officers nor control group members, they do not know as much about the institution's daily operations as do insiders.

26. The simplest defense is a general denial of liability. That defense is also the most powerful because if the FDIC is persuaded that it has mistaken the facts, it will voluntarily dismiss its claims. For example, the FDIC dropped some claims after the sunset of the RTC after it determined that the claims were not meritorious or no longer cost-effective. That situation rarely occurs, however, because each claim is extensively investigated before the FDIC decides to pursue it.

- The FDIC cannot sue the defendant because the officers of the failed institution knew what the defendant was doing (the “imputation” defense);
- It is too late to sue (the “statute of limitations” defense); or
- The FDIC’s conduct after failure made things worse rather than better (the “failure to mitigate” or “mitigation” defense).

Before a judge or jury can decide whether any of these defenses are applicable, a preliminary question has to be decided: What law governs? More specifically: Is the right to assert a particular defense determined by state law or by federal law? That issue was extensively litigated for several years following FIRREA’s enactment. After decisions made by many federal district courts and several federal courts of appeals, the issue eventually rose to the U.S. Supreme Court. In 1994, that court held that state, not federal, law governs the issue of whether a defendant can assert an “imputation” defense against the FDIC.²⁷

O’Melveny & Myers v. FDIC settled the question of “what law governs” the assertion of the “imputation” defense. It left undecided, however, the question of “what law governs” the assertion of other defenses to professional liability claims. Later, the Supreme Court also addressed the governing law issue in the standard of care context in *Atherton v. FDIC* when it held that state law sets the standard of conduct as long as the state standard (such as simple negligence) is at least as strict as the federal statute.^{28,29}

One defense frequently raised is the expiration of the “statute of limitations.” When wrongdoers have dominated the board of a failed institution, the FDIC has argued that the statute of limitations did not expire because of the doctrine of “adverse domination.” According to this doctrine, the clock stops running for the statute of limitations on a lawsuit against corporate wrongdoers as long as those same people control the board of directors. The theory behind the doctrine is that the wrongdoers would not have sued themselves, and that no one else could sue them until they were out of power. Not every state accepts this theory, and the states that do accept it impose different conditions on the right to invoke it. So far, three federal courts of appeals (*RTC v. Artley*, *FDIC v. Cocke*, and *FDIC v. Dawson*) have agreed that state, rather than federal, law governs concerning the operation of any “adverse domination” doctrine.³⁰ Those decisions have in practice established rules that are usually very difficult to meet, unless one can show intentional—as opposed to grossly negligent—misconduct. However,

27. *O’Melveny & Myers v. FDIC*, 114 S.Ct. 2048 (1994).

28. *Atherton v. FDIC*, 117 S.Ct. 666 (1996).

29. See *U.S. Code*, volume 12, section 1821(k). This federal statute sets a “gross negligence” floor, which applies as a substitute for state law standards that are less stringent.

30. *RTC v. Artley*, 28 F.3d 1099 (11th Cir. 1994); *FDIC v. Cocke*, 7 F.3d 396 (4th Cir. 1993), cert. denied, 115 S.Ct. 53 (1994); and *FDIC v. Dawson*, 4 F.3d 1303 (5th Cir. 1993), cert. denied, 112 S.Ct 2673 (1994).

because the Supreme Court has declined to review those decisions, they remain the governing laws in the states within their circuits.³¹

Defendants in professional liability suits also have argued that the FDIC, while acting as receiver for a failed financial institution, did not take all the reasonable measures it could have to seek out or take advantage of business opportunities to minimize the losses on the transactions for which damages are claimed. The argument is typically raised as the affirmative failure to mitigate defense, and sometimes also as part of the comparative and contributory fault defenses. To date, three federal courts of appeals (*FDIC v. Bierman*, *FDIC v. Mijalis*, and *FDIC v. Oldenburg*) have held, as a matter of federal common law, that such defenses are not available to defendants in professional liability cases, regardless of what a state's law may provide.³² Those courts found that Supreme Court decisions and other long-standing federal precedents establish the need to protect from "second-guessing" in litigation the discretionary conduct undertaken by federal officials in the course of liquidating failed financial institutions and implementing FIRREA's complex statutory scheme of policy mandates. Most courts considering such defenses after *O'Melveny* and *Atherton* have found that this federal rule precluding such defenses continues to be appropriate because of the potential for significant conflict between a federal interest and state law, if a state law were allowed to permit courts or juries to second-guess the discretionary judgments made by federal officials in the course of liquidating the assets of federally insured depository institutions.

Recoveries From Accountants

From the 1980s through the early 1990s, federal regulations required all thrifts to hire independent outside accountants to audit the institutions annually, to verify the institutions' annual financial statements, and to review management's internal control mechanisms. Many banks also contracted for outside audits. Accountants agreed to conduct their audits in accordance with generally accepted accounting principles (GAAP). Those principles include standards for planning and executing the audit, including guidelines for testing evidence supporting entries or disclosures. GAAP is a complex body of accounting literature and decisions that is frequently subject to more than one interpretation.

31. Of the various state law defenses asserted by defendants, the statute of limitations arguments were the most detrimental to FDIC efforts to collect on professional liability claims. As a result, otherwise meritorious claims, for many hundreds of million dollars in losses, were eliminated outright. The FDIC therefore proposed to Congress that it amend FIRREA to make it clear that lawsuits could be brought unless the state limitations statute had expired five or more years before the failure of the financial institution. The amendment would have eliminated the "adverse domination" issue in most cases. Ultimately, Congress amended the FDIC's proposal and enacted a five-year rule that applied only to cases of fraud and intentional misconduct and not to cases of gross negligence. Thus, except for situations involving fraud and intentional misconduct, state law continues to govern, in at least three circuits, when and how the doctrine of "adverse domination" will be applied to stop the running of the clock for bringing suits.

32. *FDIC v. Bierman*, 2 F.3d 1424 (7th Cir. 1993); *FDIC v. Mijalis*, 15 F.3d 1314 (5th Cir. 1994); and *FDIC v. Oldenburg*, 38 F.3d 1119 (10th Cir. 1994).

In most cases, auditors issue “unqualified” opinions that an institution’s financial statements are presented fairly in all material respects. The auditor may qualify the opinion, however, noting any observed deviations from GAAP. In some instances, an institution’s finances may be so shaky that the accountant issues a “going concern” letter questioning whether the institution will survive. When an accounting firm does not give an institution an unqualified opinion, the institution sometimes tries to replace it with another firm.

For most banks and thrifts, the most important issue in the audit report is the loan loss review. Banks and thrifts are required to write down the value of loans that are substantially and permanently impaired. However, write-downs may decrease stock prices, may threaten jobs, and even more seriously, may cause an institution’s capital to fall below the minimum percentage of total institution assets that is required under federal regulation. Institutions with less than the minimum required capital are subject to more stringent supervision and restrictions and possibly to receivership. Regulators frequently require such institutions to either raise more capital or close. The amount of an institution’s capital also determines the extent to which an institution can make further loans to generate income.

The audit of internal controls is a review of management’s procedures for detecting problems, such as faulty underwriting, fraud, and noncompliance with regulations. Regulations require, in addition to the annual audit opinion, that the independent accountant issue an annual management letter identifying internal control problems. This letter must be submitted to the regulators, and management is required to respond to criticisms in the management letter.

The basic elements of an accounting malpractice claim are as follows:

- A clear and unambiguous breach of the duty to perform a competent audit in compliance with GAAP. Examples of such breaches include failing to perform an adequate sample of delinquent loans, failing to require a write-off of loans that have been “permanently impaired,” allowing securities that are readily marketable to be reported at book value rather than their lower market value, or failing to include an important internal control deficiency in the management report.
- Materiality, which occurs when the mistake on the financial statement is large enough to be significant in the overall context of the institution.
- Causation and damages, which occurs when the error causes a loss to the institution.

To establish causation the FDIC must show what management or the regulators would have done had they known the truth about an institution’s financial condition. In some cases, causation is relatively straightforward. For instance, if the board knew that the institution, which reported income in a fiscal year, actually had a loss, it could not lawfully have paid a dividend. However, proof of causation is usually difficult. The

FDIC and the RTC typically claim as damages the losses on loans made after an accountant should have issued an opinion that an institution was in dire financial straits.

During the 1980s and early 1990s, accounting malpractice lawsuits proved to be immensely complex and expensive, and accounting firms mounted formidable defenses. Considerable uncertainty existed about how juries would view the huge, technical cases that featured opposing experts opining on the complexities of GAAP accounting. In the early 1980s, the FDIC lost an expensive accounting malpractice lawsuit involving the failure of Continental. Later, the FDIC spent more than \$35 million in outside counsel costs alone when it pursued claims against Ernst & Young and that firm's audit of the Butcher banks in Tennessee. After nine months of trial in 1991, but before any verdict, Ernst & Young settled the case as part of a comprehensive global resolution of all potential liability arising from banks and thrifts that had failed previously. Other global settlements were made by several other national accounting firms during the next few years.

From the 1980s to the early 1990s, the "Big Six" accounting firms had audited more than a thousand failed institutions. As a result, the FDIC and the RTC, as well as the OTS, had potential claims against the accounting firms involving numerous institutions. In some cases, the total damages that were identified dwarfed the assets of the entire accounting firm and its insurance coverage. In discussing the claims and potential settlement, some of the firms expressed an interest in settling all claims with the FDIC, the RTC, and the OTS, rather than addressing one claim at a time.

The agencies had already demonstrated a commitment to fully litigate such claims in the Butcher banks case, as well as other high-profile institutions like Lincoln Savings and Loan (Lincoln), Irvine, California, and Centrust Federal Savings Bank (Centrust), Miami, Florida. It became apparent that the cost of litigating those claims would probably consume most of the accounting firms' insurance assets, as well as hundreds of millions of dollars in agency costs. Consequently, the FDIC, the RTC, and the OTS formed an interagency task force to negotiate across-the-board settlements.

Spurred by its exposure in the expensive Butcher banks litigation, in September 1992 Ernst & Young became the first accounting firm to enter into a global resolution, including a settlement payment of \$400 million. By the end of 1993, KPMG Peat Marwick settled for \$186.5 million, and Deloitte & Touche settled for \$312 million. In 1995, Arthur Anderson settled for more than \$100 million. In addition, those firms agreed to establish an extensive training program for accountants who would be auditing federally insured depository institutions. Two other Big Six firms settled individual cases with the FDIC. All told, \$1.15 billion on accounting claims were recovered by the FDIC and RTC, with about \$1 billion of that total being recovered through the four global settlements discussed above. As a result, very few claims actually went to trial, and many potential claims were resolved without incurring further costs of collection.

Attorney Malpractice Claims

Banking is a law-intensive business. Lending, in particular, may entail a myriad of transactions, usually involving complex collateral arrangements. Insured institutions, in addition to being subject to general principles of corporate governance, are subject to special rules and regulations designed to keep them safe and sound and to protect depositors. An insured institution can be regulated by more than one governmental agency, at both the state and the federal levels.

Attorneys play an important role in advising banks about how to do business in compliance with these complex rules. Sometimes, the scope of the attorneys' employment is limited to closing a particular loan transaction. In other institutions, outside attorneys play a central role at the institution; for example, by serving as the general counsel or as a member of the board. Lawyers who serve central roles in corporate governance may be held to a higher standard than a layperson.³³

Not surprisingly, among the thousands of potential claims investigated the FDIC and the RTC found that some attorneys had made serious mistakes that damaged their client institutions. The FDIC and the RTC filed a total of 205 attorney malpractice suits arising from less than 10 percent of all failed institutions. From those cases and some prelitigation settlements, the agencies recovered more than \$500 million, averaging about \$2.5 million for each suit filed. Most of the cases were settled at an early stage in the litigation. The primary source of recovery in most of the cases was attorney malpractice insurance policies.

As is true for other professional liability claims, attorney malpractice cases require a breach by the individual or the firm of a duty to a client institution, as well as damages caused by the breach. The claims ran the gamut, from simple failure to record a lien to allegations that attorneys played a central role in aiding and abetting a criminal CEO in deceiving shareholders and regulators. Many attorney malpractice claims involved the attorney's failure to advise the client institution about violations of regulations and statutes, usually concerning imprudent loans. For example, attorneys have failed to alert a bank's board that a loan to a nominee borrower was really a loan to an insider designed to skirt credit concentration restrictions such as the "loans-to-one-borrower" regulation.

A controversial issue in those cases is what standard of knowledge the lawyer must have of the insider's conduct to be liable: actual knowledge, intentional ignorance, or "constructive" knowledge (what the attorney should have known under the circumstances). A related issue is the extent to which a lawyer has a duty to investigate suspicious representations of bank officers. If a lawyer learns of an illegal transaction, the lawyer has a duty to go to the board of directors, if necessary, to advise them of the violation or to withdraw from the representation.

33. See *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

The largest attorney malpractice recoveries involved powerful insiders at the client institution, who had little respect for the rules and pressured outside professionals to overlook violations and even to help conceal matters from the institution's directors or regulators. When the lawyers succumbed to these pressures, they were treating the CEO rather than the institution as the client. The lawyers forgot that their job was to serve the interests of the entire institution, not those of the CEO or controlling shareholder. Some particularly egregious cases included allegations that the attorney aided and abetted the CEO in breaches of fiduciary duty, such as the PL suits involving Lincoln's CEO Charles Keating and Centrust's CEO David Paul.

The largest attorney malpractice recoveries arose from the RTC receiverships of Lincoln and Centrust, two institutions dominated by strong CEOs who eventually were convicted of bank fraud. The RTC recovered a total of \$120 million from seven different firms serving as regulatory counsel for Lincoln and another \$48 million from settlements with two firms representing Centrust.

Securities Broker Claims: Drexel Burnham Lambert, Inc., and Michael Milken

The FDIC has recovered more than \$1.1 billion on securities claims against Drexel Burnham Lambert, Inc. (Drexel), and Michael Milken, the head of Drexel's "junk bond" unit. Beginning in the early 1980s, Michael Milken targeted thrift institutions as a large, federally insured pool of capital that could be used to finance his junk bond efforts. Through Drexel, Milken engineered a campaign to exert improper influence on investment decisions at thrifts, including illegal bribes and misrepresentations concerning the value, liquidity, and risk associated with the junk bonds. Drexel also performed underwriting services for several huge thrifts, such as Centrust and Columbia Savings and Loan Association, Beverly Hills, California, through which substantial proceeds from various Drexel activities were invested. In fact, the acquisition of Lincoln by Charles Keating was facilitated by proceeds derived from a Drexel underwriting.

In early 1990, the RTC and the FDIC established a joint task force to oversee a nationwide investigation into the losses suffered by failed thrifts caused by improper activities related to Drexel and junk bonds. Within the year, the joint task force identified failed financial institutions that had traded in junk bonds underwritten by Drexel, reconstructed numerous, complex trading histories, quantified losses resulting from the trading, and amassed the oral testimony and documentary evidence necessary to evaluate and prosecute possible claims. The agencies filed multiple claims and lawsuits against Drexel, Milken, and their partnerships. The claims included those filed in the Drexel bankruptcy proceedings on behalf of 45 failed financial institutions for losses exceeding \$11 billion and those for treble damages under the federal Racketeer Influenced and Corrupt Organization (RICO) statute. The FDIC and RTC were by far the largest claimant among the thousands of claims filed in federal bankruptcy court and took the lead in litigating all civil claims for securities fraud against Drexel.

In January 1991, the agencies filed a class action suit against Milken and numerous other former Drexel managers on behalf of 53 failed thrifts. The lawsuit involved more than 1,600 different issues of junk bonds and several hundred Milken partnerships that were used to implement unlawful securities schemes. The monumental litigation required production of more than 20 million pages of documents from numerous FDIC and RTC sites nationwide. In March 1992, slightly more than a year after all claims were filed, the parties negotiated global agreements to resolve all pending litigation between the claimants, including the FDIC, the RTC, and private-sector class action litigants, and all named defendants, including Drexel, Milken, and more than 500 former Drexel and Milken partnerships and employees. The Drexel and Milken claims were resolved through highly complex structured settlements entailing periodic cash payments over time, particularly as the large bankruptcy of the Drexel brokerage house itself was resolved. A comprehensive resolution of the Drexel bankruptcy litigation was established through an amended plan of reorganization that was finally approved in March 1992. The plan set aside a percentage of Drexel's bankruptcy estate to satisfy the claims of securities litigants, pooled claims related to securities fraud against Drexel, and established a pro rata distribution plan for securities claimants. In resolving all pending civil claims against him, defendant Milken agreed to pay \$950 million in cash, plus future distributions from liquidation of his other assets. The Drexel bankruptcy plan called for periodic cash distributions to all claimants totaling at least \$1.3 billion as sums were derived from the unwinding of Drexel's bankrupt operations. Under those settlement arrangements, approximately 40 percent of the total payments would be paid to the RTC and the FDIC, as opposed to the numerous other settling claimants.

As of December 1996, more than \$1.1 billion had been collected by the FDIC since the courts approved the Drexel and Milken settlements in 1992. Of the total amounts collected, approximately \$515 million are attributed to the settlement with Milken and related parties, and approximately \$606 million are attributed to the resolution of the Drexel bankruptcy proceeding. Most of the settlement payments (93.5 percent) to the agencies were paid to the RTC, thus reflecting that damages in the Drexel and Milken matter fell mostly on failed thrift institutions, rather than on commercial banks.

Criminal Restitution Activities

FDIC staff members coordinate professional liability activities with the Justice Department whenever criminal conduct by professionals is suspected at a failed institution. The underlying loss that is the basis for a PL claim, especially a fidelity bond claim, may also be the basis for a criminal proceeding. Such conduct and the resulting loss ultimately may be the basis for a criminal restitution order that is payable by the wrongdoer to the FDIC as receiver of the failed institution.

During investigations the FDIC investigators and attorneys are alert to any evidence of possible criminal wrongdoing. Whenever appropriate, they make criminal referrals to the Justice Department and the FBI. From the 1980s to the early 1990s, many thou-

sands of such referrals were made. After FIRREA's enactment, the FDIC and the RTC set up offices and criminal units dedicated specifically to facilitating the cooperative effort begun by interagency bank fraud working groups.³⁴ Staffed by agency attorneys and investigators with professional liability expertise, the criminal units were mandated to assist federal law enforcement authorities in their investigations and to help U.S. attorneys in any prosecutions. In addition to preparing criminal referrals, the criminal units also coordinated agency responses to grand jury subpoenas and, later, efforts to locate and recover assets subject to court-ordered restitution.

Under the Victim and Witness Protection Act, criminal restitution is available to the receiver of failed financial institutions that were victims of bank fraud.³⁵ An order of restitution may be mandated as part of the defendant's criminal sentence and is often made a condition of probation. The process of obtaining a restitution order begins when a defendant charged with bank fraud is found or pleads guilty in a criminal proceeding. At that time, a request for restitution is prepared for submission to the court before sentencing. Usually written in the form of a letter to the sentencing judge, the restitution request documents the losses that the criminal conduct caused the institution, sets forth an analysis of the receiver's standing to obtain restitution under the Victim and Witness Protection Act, and requests a specific amount of restitution. Under the act's provisions, the court considers a number of factors in arriving at a restitution amount, such as the amount of losses to the victim, the financial resources of the defendant, and the financial needs and earning ability of the defendant and the defendant's dependents. The assistant U.S. attorney responsible for the criminal case is provided with an advance copy of the restitution letter, which usually is sent to the court by the prosecutor shortly before sentencing.

Since 1988, when the Justice Department and the banking agencies implemented their coordinated task force approach to the problem, more than 5,500 individuals have been convicted of various major financial institution fraud crimes.³⁶ Approximately one-third of those convicted felons were former directors and officers of their institution, and the remainder includes a significant number of attorneys, accountants, and other professionals. Courts have ordered them to pay several billion dollars in restitution to the defrauded institution or, in the case of an institution's failure, to the FDIC. The FDIC continues to work actively with the Justice Department to collect outstanding criminal restitution orders. Most of the criminal defendants have very limited assets. The FDIC has therefore succeeded in collecting only approximately \$100 million to date in FDIC and

34. Begun in the mid-1980s, the groups encompassed the Treasury Department and the Securities and Exchange Commission, as well as the Justice Department and various bank and thrift regulatory agencies. In addition to the National Bank Fraud Working Group in Washington, numerous local working groups and task forces existed nationwide. The working group network facilitated the resolution of myriad interagency issues and sometimes disparate goals.

35. See *U.S. Code*, volume 18, section 3579.

36. The Justice Department includes as a "major" financial institution fraud any case in which the fraud or loss exceeded \$100,000; the defendant was an officer, director, or shareholder; or the scheme involved multiple borrowers at the same institution.

RTC criminal restitution. Professional liability investigators and attorneys at the FDIC and the RTC played an integral role in the coordinated law enforcement effort.³⁷

Outcomes and Results

Total professional liability collections from January 1986 to December 1996 exceeded \$5 billion. From 1990 through 1995, in particular, the FDIC and the RTC together collected a total of \$4.5 billion from all professional liability operations. Of that total, \$2 billion were collected on behalf of the FDIC receiverships, and \$2.5 billion from the RTC (including the Drexel and Milken recoveries). See table I.11-1 for a summary of the professional liability recoveries and outside counsel expenses.

Of the \$4.5 billion, the FDIC and the RTC collected more than \$1.2 billion on accounting liability claims, mostly from the global settlements with four national auditing firms. Operations at the two agencies contributed in approximately equal proportion to the \$500 million collected on attorney malpractice claims during the six years after FIRREA's enactment. The agencies recovered \$1.3 billion on director and officer claims. During this period, the agencies also collected approximately \$300 million from fidelity bond insurers for dishonest or fraudulent acts covered under those specialized insurance contracts.

From 1990 through 1995, most of the costs for professional liability operations were for outside counsel.³⁸ The RTC often retained counsel to investigate potential claims for a large number of failed thrifts, as well as to pursue any resulting litigation.³⁹ The FDIC usually retained outside counsel only after it appeared likely that a lawsuit would be approved and the assistance of outside counsel would be required to conduct the litigation. Because of the complexity and resource-intensive nature of the cases, however, both agencies used outside law firms to bring most of the lawsuits.⁴⁰

37. See the *1995 Department of Justice Financial Institution Fraud Special Report* (final report prepared by the special counsel for financial institution fraud).

38. As shown in table I.11-1, \$1 billion were spent on outside counsel, consultants, and experts from 1986 through 1996. Outside counsel expenses attracted significant public and congressional interest. See, for example, *Professional Liability and the RTC Contracting With Lawyers*, Subcommittee Hearing on General Oversight, Investigations, and the Resolution of Failed Financial Institutions Before the House Committee on Banking, Finance, and Urban Affairs, 103d Cong., 1st Sess., March 30, 1993.

39. The FDIC has conducted its PL investigations using its own staff of investigators and attorneys, and occasionally supplemented that staff with outside contractors and consultants. The RTC adopted a different practice, not only because of the heavy workload that was imposed immediately on a newly established operation, but also because the RTC, as an agency scheduled to terminate at the expiration of its mission, sought to minimize the hiring of permanent staff.

40. The use of outside counsel is the predominant practice for large receivers and other insurance company enterprises that manage liability claims. Beginning in 1993, the FDIC set up separate in-house litigation units within its PLS. Those units have handled a modest part of the professional liability caseload, but have been effective in resolving cases and reducing outside counsel costs. They also have allowed the FDIC to pursue some smaller meritorious cases that otherwise would not have been cost-effective.

Conclusion

Professional misconduct was a notable factor in the enormous losses resulting from the financial institution crisis of the 1980s and the early 1990s. The professional liability program was therefore an important part of receivership operations. Sifting through hundreds of failures, the FDIC and the RTC reviewed thousands of potential claims relating to conduct by former directors, officers, attorneys, accountants, appraisers, brokers, and other professionals formerly affiliated with failed banks and thrifts. The agencies actively pursued those claims that were both strong on the merits and likely to be cost-effective in light of accessible assets and insurance coverage. In the end, the professional liability program contributed more than \$5 billion in cash recoveries to the receivership efforts.

The professional liability program yielded benefits to the public in addition to the actual cash collections by the agencies. Those advantages are most apparent in the area of criminal restitution and law enforcement. The professional liability program also had an effect on awareness of professional standards, which directly benefits the public by enhancing discipline among professionals.

Not surprisingly, the professional liability program at the FDIC and the RTC was controversial from the start, spawning nationwide discussion and debate over basic legal and policy principles. Many of the professionals sued were respected people in their communities, and some were public figures and politicians. Although many of the claims involved outright fraud, most of the lawsuits alleged that the professionals were grossly derelict in performing their duties to the failed institution. Thus, most defendants in professional liability lawsuits are honest citizens who neither committed crimes nor specifically intended to cause the failure of the institutions. It was therefore inevitable that the professional liability program would be the subject of substantial public interest, including numerous hearings before Congress.

Defendants frequently accused the FDIC and the RTC of being too aggressive in bringing lawsuits. They charged that the agencies were seeking to impose new, stringent standards of conduct retroactively. Others criticized the agencies for bringing too few suits and for settling claims for amounts that were insufficient, considering the extent of the losses or the defendant's personal assets. Still other critics contended that sensitivity to professional liability lawsuits has made it difficult for financial institutions to obtain good professionals at banks and thrifts.

Table I.11-1

**Professional Liability Recoveries and Outside Counsel Expenses
1986 - 1996**
(*\$ in Millions*)

Year	FDIC		RTC	
	Recoveries	Outside Counsel Cost	Recoveries	Outside Counsel Cost
1996*	\$81.1	\$15.1	\$114.8	\$33.0
1995	231.7	22.1	222.7	75.7
1994	239.9	33.2	511.6	100.0
1993	266.5	43.5	364.3	134.6
1992	609.8	85.2	288.4	69.8
1991	319.3	87.0	31.7	49.8
1990	363.1	79.6	11.2	3.4
1989	147.9	32.0	4.2	N/A‡
1988	90.0	20.8		
1987	71.5	15.2		
1986	83.3	10.9		
Subtotals†	\$2,504.1	\$444.6	\$1,548.9	\$466.3
		Drexel/Milken†	1,028.8	106.0
Totals	\$2,504.1	\$444.6	\$2,577.7	\$572.3

* Although all recoveries are by the FDIC after the December 31, 1995, sunset of the RTC, collections can still be traced to thrift institutions inherited by the FDIC.

† The recoveries and costs to the RTC under the Drexel/Milken global settlements are reported separately, below this subtotal line, and as part of the line showing total recoveries and costs for the FDIC and the RTC. Approximately 6.5 percent of collections under the Drexel/Milken settlements were allocated to thrift institutions managed by the FDIC under the FSLIC Resolution Fund. Those relatively smaller Drexel/Milken collections to the FDIC are not reported separately, but are included within the annual figures for the FDIC above.

‡ Not applicable

Source: FDIC, Legal Division.

PREVIOUS CHAPTER NEXT CHAPTER TABLE OF CONTENTS



The Radisson Lord Baltimore Hotel, a registered historic landmark near the Inner Harbor in Baltimore, Maryland, was sold by the FDIC at its December 1992 auction for \$8.5 million.



During the crisis years, the FDIC and RTC acquired approximately \$410 billion in assets that were targeted for asset disposition. By the end of 1997, less than \$5 billion of those assets remained with the FDIC.