FDIC
Federal Deposit Insurance Corporation
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March 21, 2011

MEMORANDUM TO: Board of Directors

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General Counsel [redacted]

FROM: Floyd I. Robinson [redacted]
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Professional Liability and Financial Crimes Section

SUBJECT: Professional Liability Program Annual Report for 2010

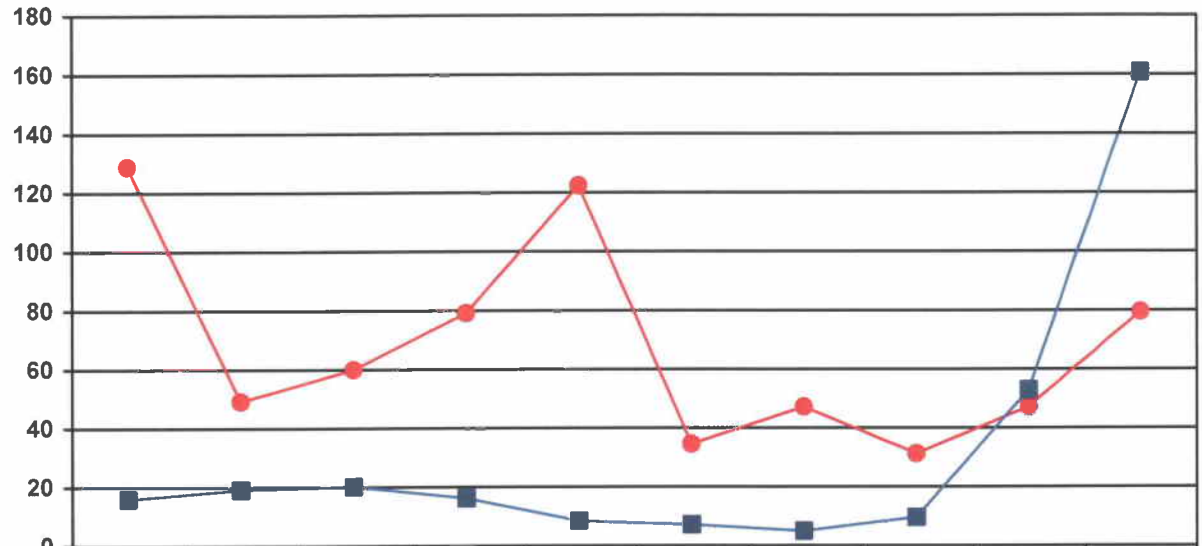
This is a report by the Professional Liability Unit ("PLU") of the Legal Division on the results of the FDIC's professional liability program for 2010. It includes a review of PLU's workload and staffing at year-end.

The purpose of the professional liability program is to hold accountable directors, officers, and professionals who cause losses to financial institutions that later fail and are placed in FDIC receivership. The program's existence also enhances industry awareness of sound corporate governance standards. On behalf of the FDIC in its receivership capacity, PLU and the Investigations Department of the Division of Resolutions and Receiverships ("DRR") conduct an investigation of every financial institution failure but only pursue professional liability claims that are both meritorious and expected to be cost-effective. If a meritorious claim exists but is not likely to be cost-effective, PLU refers it to the appropriate primary financial regulator for administrative enforcement action. PLU also assists DRR and the Legal Division's Financial Crimes Unit to obtain criminal restitution on behalf of the FDIC as receiver from defendants who have been convicted of banking crimes that caused losses to financial institutions that later fail and are placed in FDIC receivership.

Recoveries and Expenses

During 2010, PLU and DRR recovered $79,426,544 and incurred expenses totaling $160,773,437 for professional liability program activity. Of the recoveries, $46,174,343 (58.10 percent) was obtained from mortgage malpractice and mortgage fraud ("MMF") claims. Of the expenses, $57,333,758 (35.66 percent) was incurred by the Legal Division, $102,497,981 (63.75 percent) was incurred by DRR, and $941,698 (0.59 percent) was incurred by other FDIC Divisions and Offices. Legal Division expenses consist of $3,362,567 for ongoing operations (primarily in-house permanent PLU staff expenses) and $53,971,191 for receivership funding expenses (to handle the increased workload from recent financial institution failures). Receivership funding expenses for the Legal Division consist of $47,194,199 paid to outside counsel and consultants and $6,776,992 for other expenses (primarily salaries and travel expenses for temporary PLU employees). DRR expenses comprise $1,739,106 for ongoing operations (primarily in-house DRR Investigations staff expenses) and $100,758,875 for receivership funding expenses (primarily for outside contractors). The ratio of recoveries to total expenses is 0.49 to 1, and the ratio of recoveries to outside counsel expenses only is 1.68 to 1. These ratios are lower than they were for 2009, when the program recovered $47,148,057, the ratio of recoveries to total expenses was 0.89 to 1, and the ratio of recoveries to outside counsel expenses only was 4.18 to 1.

FDIC Professional Liability Recoveries and Expenses, 2001-2010 (in $Millions)



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Recoveries	128.6	49.1	59.9	79	122.2	34.5	47.1	31.3	47.1	79.4
Expenses	16	19.1	20.2	16.2	8.5	7.2	5	9.7	52.9	160.8

Recoveries — Expenses

The fact that expenses exceeded recoveries is attributable primarily to the substantial receivership funding expenses being incurred to handle the significant increase in new investigations arising from recently failed institutions. Professional liability program recoveries also tend to lag expenses incurred to obtain recoveries by several years. Staff typically spends substantial time and money to build a case before defendants become convinced to settle or before staff is able to obtain a judgment. Because only about one in ten individual investigations leads to a recovery, program expenses also include substantial investigation and legal analysis costs that ultimately produce no recoveries whatsoever. Investigation expenses for an individual failed institution in a given year include these sunk costs while recoveries from other more promising claims from the same institution failure may not be obtained until years later. In addition, program recoveries result not only from settlements reached and judgments obtained in the current reporting period but also from collections from structured settlements reached in previous years. As a result, much of the expenses that produced recoveries during 2010 actually were incurred in prior years. Concomitantly, most of the expenses incurred during the year will not yield recoveries until later years. For all of these reasons, the cost-effectiveness of the program is best measured by comparing recoveries and expenses over many years rather than in any individual year. Over time, the goal of the professional liability program is to achieve its historical recoveries-to-expense ratio of 4 to 1.[1]

Significant PLU Developments During 2010

During 2010, PLU obtained authority from the Board of Directors to file suit against 98 director and officer ("D&O") defendants for a total of $2.12 billion in damages. On July 2, PLU filed the first D&O liability lawsuit out of the current failed financial institution crisis. PLU filed the suit on behalf of the Receiver of IndyMac Bank, F.S.B. ("IndyMac") in the United States District Court for the Central District of California against four former officers of the Home Builder Division ("HBD") of IndyMac for $313 million in damages. IndyMac, of Pasadena, California, failed on July 11, 2008, with $30.7 billion in assets resulting in a loss to the Deposit Insurance Fund currently estimated at $12.75 billion. The lawsuit is based on $313 million in losses from negligently underwritten real estate development loans made by HBD. On November 1, PLU filed the second D&O lawsuit out of the current crisis in the United States District Court for the Northern District of Illinois against 11 former directors and officers of Heritage Community Bank ("Heritage") for $20.5 million in damages. Heritage, of Glenwood, Illinois, failed on February 27, 2009. The $20.5 million damage claim in the Heritage case comprises $9.4 million in losses on commercial real estate ("CRE") loans approved by the recommended defendants and $11.1 million in losses on unjustified dividends and unjustified incentive compensation payments.

On March 10, more than five years after the case was tried, the United States District Court for the Southern District of West Virginia issued a final order and judgment in favor of the FDIC against Grant Thornton LLP ("Grant Thornton") in the FDIC's accounting malpractice case out of The First National Bank of Keystone, *FDIC v. Grant Thornton LLP* (S.D. W. Va.). Keystone, of Keystone West Virginia, failed on September 1, 1999. The case was tried to the court (*i.e.,* without a jury) in 2004. The court entered a final judgment against Grant Thornton for $23,737,026 with post-judgment interest and with Grant Thornton to receive a credit of 8.563 percent of any future payments (which could total another $1 million to $2 million) that the FDIC receives in excess of $15.7 million from its settlement with Kutak Rock, LLP, outside general counsel to Keystone from 1993 to 1999. Grant Thornton has appealed this final order and judgment to the United States Court of Appeals for the Fourth Circuit.

During the year, PLU also obtained approval from the Board to file three attorney malpractice lawsuits, and it obtained approval from delegated authority (all in the fourth quarter) to file three fidelity bond lawsuits. PLU filed one of these bond suits on December 10, 2010, when it filed suit out of Integrity Bank of Alpharetta, Georgia, against Cincinnati Insurance Company in the United States District Court for the Northern District of Georgia for $10 million in damages. Integrity failed on August 29, 2008.

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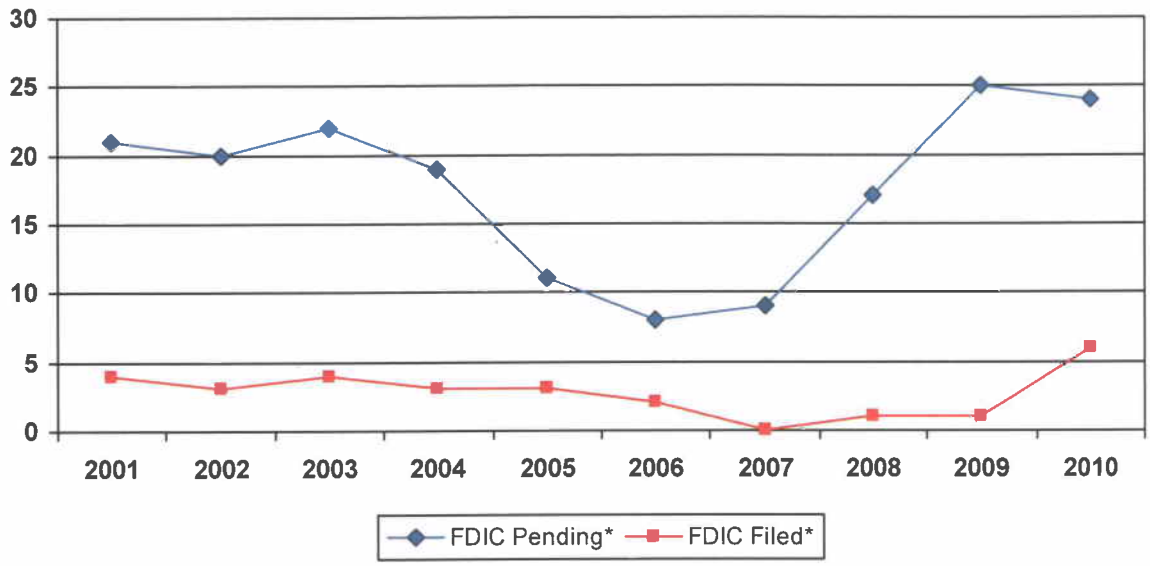
[1] DRR has indicated that the significant increase in expenses in recent years is attributed to increased use of contractor support while additional in-house staff was being hired and trained, the need for electronic file storage and forensic work to preserve evidence, and the increase in failure activity including investigations of a number of very large complex claims. Staff in PLU, DRR, and the Division of Finance continue to analyze program expenses and to look for additional efficiencies.

The following graph shows professional liability civil cases from 2001 through the end of 2010, both filed and pending. ("Pending" actions include claims filed by an institution before it failed which the FDIC inherited as Receiver.)

FDIC Professional Liability Civil Actions, 2001-2010
(Excludes MMF and Other PL-Related Matters Such as Individual Bankruptcy Cases)



PLU also obtained approval during 2010 from delegated authority to file 46 MMF lawsuits. The largest of these arose out of Downey Savings and Loan Association, F.A. ("Downey"), of Newport Beach, California, which failed on November 21, 2008. The defendants in this suit were involved in originating ten residential mortgage loans sold to Downey through a common broker, American Prime Funding, Inc. ("American"). Downey lost $2.474 million on these loans, which is the amount of the damage claim in the case. The defendants include the American qualifying broker, American loan officers who signed the loan applications, the appraiser, and borrowers who knowingly participated in the fraud on Downey. The American employees conspired with the borrowers to submit fraudulent information in the loan applications and employed straw buyers with secret second mortgages, which had they been disclosed would have disqualified the borrowers from obtaining the loans from Downey. PLU filed this lawsuit on September 15, 2010, in the United States District Court for the Central District of California.

The other 45 MMF lawsuits approved by delegated authority arose primarily out of AmTrust Bank ("AmTrust") of Cleveland, Ohio, which failed on December 4, 2009; IndyMac Bank F.S.B. of Pasadena, California, which failed on July 11, 2008; NetBank of Alpharetta, Georgia, which failed on September 28, 2007; and Washington Mutual Bank ("WaMu") of Henderson, Nevada, which failed on September 25, 2008. These other cases have claims ranging from $218,376 for a case arising out of NetBank to $2.02 million for another case out of NetBank. The approved defendants in these cases are primarily mortgage brokers, qualifying brokers, appraisers, title insurance companies, closing agents, settlement agents, and (to the extent that they personally aided and abetted the mortgage fraud at issue) borrowers. Recovery sources primarily are errors and omissions ("E&O") insurance policies and title insurance company closing protection letters.

Staff also obtained approval from delegated authority during the year to settle 42 MMF cases. During the year, PLU collected a total of $46,174,343 from residential MMF claims.

PLU Workload and Staffing as of Year-end

During 2010, 157 insured financial institutions failed, 89 of which were headquartered in five states, Florida (29), Georgia (21), Illinois (16), California (12), and Washington (11). The largest institution to fail was WesternBank Puerto Rico, of Mayaguez, Puerto Rico, which failed on April 30, 2010, with $10.80 billion in assets. These 157 failures brought total institution failures since the beginning of 2007 to 325.

These 325 failures also were relatively large in size, since their assets at failure totaled $636.35 billion. While these 325 failed institutions constitute only 13.88 percent of the total number of 2,341 institutions that failed during the previous failing bank and thrift crisis spanning 13 years from 1982-1994, the total assets of $636.35 billion associated with these 325 failed institutions equals 96.85 percent of the $657.08 billion in total assets associated with the 2,341 failures from the prior crisis.[2]

Given their large average size, these 325 failures in the past three years have resulted in a substantial increase in PLU's workload, an increase that is expected to continue during 2011. For each institution that fails, PLU opens 11 different types of investigations, although most are soon closed once it becomes clear that no viable claims exist.[3] As of September 1, 2007, PLU had 49 open institutions[4] in its inventory (39 of which were open solely for the limited purpose of monitoring collections from judgments and structured settlements), 8 professional liability lawsuits, 3 related lawsuits, 0 MMF lawsuits, 12 open investigations, and 95 active collection matters. As of year-end 2010, PLU had 355 open institutions, 24 pending professional liability

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[2] The average asset size of these 325 failed institutions is $1.96 billion. Even excluding WaMu, which failed on September 25, 2008, with $307 billion in assets, the average asset size of the 324 remaining failed institutions is $968.8 million – still more than three times the average $281 million asset size of the institutions that failed during the 1982-1994 crisis.

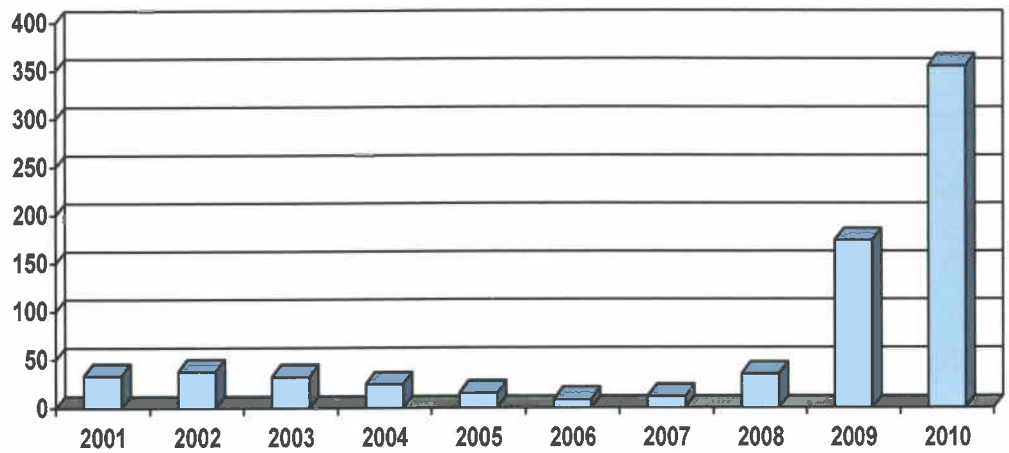
The data in this memorandum on numbers of failed institutions and associated assets have been reviewed and approved by the FDIC's Division of Insurance and Research.

[3] The 11 types of investigations are: (1) D&O liability, (2) fidelity bond, (3) attorney malpractice, (4) accountant malpractice, (5) appraiser malpractice, (6) MMF, (7) securities broker malpractice, (8) commodities broker malpractice, (9) insurance, (10) insurance issuer, and (11) other. Some institutions have multiple matters open. For example, a single bank may have an open D&O lawsuit, an accounting malpractice investigation, and an attorney malpractice lawsuit.

[4] All institutions in PLU's inventory are failed institutions. However, for PLU management purposes a failed institution is "open" in PLU's inventory while PLU is working on an investigation or active litigation relating to that failed institution.

lawsuits, 2 related lawsuits, 197 MMF lawsuits, 2,313 open investigations,[5] and 101 active collection matters.

Institutions With Open Investigations or Lawsuits at Year-end



Institutions open only for collections are not included

The 197 MMF lawsuits in PLU's inventory at year-end 2010 arise out of 15 failed institutions but primarily out of IndyMac (82 cases); Downey (36 cases); WaMu (32 cases); FNB Nevada, of Reno, Nevada, which failed on July 25, 2008 (18 cases); AmTrust (12 cases); and NetBank (7 cases). The remaining 10 cases are associated with 9 other failed institutions around the country. PLU also has more than 3,000 additional residential MMF loss loans in investigation.

To handle its substantially increasing workload, PLU began increasing its staff significantly starting in the second half of 2008. From a single office in Virginia Square in Arlington, Virginia, that had five staff attorneys and one first-line supervisor in mid-2008, PLU as of year-end 2010 had 40 attorneys and 9 managers and supervisors in five offices – Virginia Square; the East Coast Temporary Satellite Office ("ECTSO") in Jacksonville, Florida; the Midwest Temporary Satellite Office ("MWTSO") in Schaumburg, Illinois; the West Coast Temporary Satellite Office ("WCTSO") in Irvine, California; and the Dallas Regional Office in Dallas, Texas.[6] During this same time, PLU also increased its paralegal and support staff from 7 all in Virginia Square to a total of 19 paralegals, litigation support technicians, legal information

[5] An "open investigation" in PLU's inventory refers to the fact that PLU routinely opens 11 investigations for each failed institution but then "closes" each investigation as it either determines that there is no claim worth pursuing or settles the associated claim. An "open investigation," therefore, is an investigation in PLU's inventory that has not yet been settled or otherwise terminated.

[6] The increase in attorney staff in headquarters was achieved by hiring 4 "rehired annuitant" attorneys, 5 permanent "overhire" attorneys, and 14 term attorneys. PLU also lost 6 staff attorneys during 2009 and 2010 through two retirements, one reassignment within the FDIC Legal Division, and three promotions of attorneys who became temporary Supervisory Counsels (first-line supervisors) in headquarters. All staff in the TSOs are temporary employees.

technicians, and secretaries based in four of these five offices (all but the Dallas Regional Office).

Conclusion

During 2010, the FDIC's professional liability program recovered $79,426,544 and incurred expenses totaling $160,773,437 as PLU and DRR Investigations continued to devote substantial additional resources to professional liability investigations and inherited litigation following the 325 failures that have occurred since the beginning of 2007 through the end of 2010.

cc: All PL&FCS attorneys

FDIC PROFESSIONAL LIABILITY RECOVERIES AND EXPENSES ($ MILLIONS)

	Recoveries[7]	In-House PLU Expenses	DRR Investigation Expenses	Outside Counsel Expenses	Total Expenses[8]	Ratio of Recoveries to Outside Counsel Expenses	Ratio of Recoveries to Total Expenses
2010	$79.4	$10.1	$102.5	$47.2	$160.8	1.68 to 1	0.49 to 1
2009	$47.1	$5.2	$35.9	$11.3	$52.9	4.18 to 1	0.89 to 1
2008	$31.3	$2.0	$5.3	$2.4	$9.7	13.1 to 1	3.23 to 1
2007	$47.1	$2.0	$.7	$2.3	$5.0	20.62 to 1	9.40 to 1
2006	$34.5	$2.6	$.9	$3.7	$7.2	9.30 to 1	4.80 to 1
2005	$122.2	$3.4	$1.1	$3.9	$8.5	31.04 to 1	14.38 to 1
2004	$79.0	$4.0	$3.1	$9.0	$16.2	8.79 to 1	4.88 to 1
2003	$59.9	$3.5	$3.0	$13.7	$20.2	4.38 to 1	2.96 to 1
2002	$49.1	$3.2	$2.8	$13.1	$19.1	3.75 to 1	2.57 to 1
2001	$128.6	$3.4	$2.1	$10.5	$16.0	12.25 to 1	8.04 to 1
2000	$54.4	$4.0	$2.7	$14.0	$20.7	3.89 to 1	2.63 to 1
1999	$84.2	$5.8	$3.2	$17.4	$26.4	4.84 to 1	3.19 to 1
1998	$186.5	$5.8	$4.2	$21.9	$31.9	8.52 to 1	5.85 to 1
1997	$156.8	$7.8	$2.3	$29.1	$39.2	5.39 to 1	4.00 to 1
1996	$195.9	$15.8	$4.0	$48.1	$67.9	4.07 to 1	2.89 to 1
1995	$563.9	$14.0	$5.3	$98.1	$117.4	5.68 to 1	4.75 to 1
1994	$909.9	$17.7	$11.2	$135.5	$164.4	6.72 to 1	5.53 to 1
1993	$1,231.2	$18.4	$17.9	$187.3	$223.6	6.57 to 1	5.51 to 1
1992	$972.6	$15.7	$16.6	$179.3	$211.6	5.42 to 1	4.60 to 1
1991	$425.2	$11.7	$7.7	$183.7	$203.1	2.31 to 1	2.09 to 1
1990	$374.3	$6.1	$5.2	$94.8	$106.1	3.95 to 1	3.53 to 1
1989	$152.1	$4.5	$4.5	$32.0	$41.0	4.75 to 1	3.71 to 1
1988	$90.0	$1.4	$3.7	$20.8	$25.9	4.33 to 1	3.47 to 1
1987	$71.5	$1.1	$4.3	$15.2	$20.6	4.70 to 1	3.47 to 1
1986	$83.3	$1.0	$3.0	$10.9	$14.9	7.64 to 1	5.59 to 1
TOTAL	$6,230.00	$170.20	$253.20	$1,205.20	$1,630.30	5.17to 1	3.82to 1

7 Recoveries comprise all FDIC, RTC, and FSLIC recoveries, including RTC and FDIC Drexel-Milken recoveries of $1.143 billion.

8 Expenses include Drexel-Milken expenses of $106.1 million. The following categories of expenses are unavailable and are not included: all FSLIC fees and expenses for 1986-1988; FSLIC in-house (legal and investigation) expenses for 1989; and RTC in-house expenses (1989-1995). DRR investigation expenses (in column 4) for all years before 1998 are staff compensation only (and exclude other direct costs). In-house expenses for all years shown exclude overhead.