FDIC

Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, VA 22226-3500 Legal Division

February 19, 2019

MEMORANDUM TO: Board of Directors

THROUGH: Charles Yi [redacted]
General Counsel

FROM: Melanie D. Coates [redacted]
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Professional Liability and Financial Crimes Section

SUBJECT: Professional Liability Program Annual Report for 2018

This is a report by the Professional Liability Unit ("PLU") of the Legal Division on the results of the professional liability program of the Federal Deposit Insurance Corporation ("FDIC") for 2018. It includes a review of PLU's workload and staffing at year-end.

The purpose of the professional liability program is to recover funds for FDIC receiverships and to hold accountable directors, officers, and professionals who caused losses to insured financial institutions that later failed and were 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") investigate potential professional liability claims arising from every financial institution failure but pursue claims only if they are both meritorious and expected to be cost-effective. Where appropriate, PLU refers cases to the FDIC's Enforcement Section for administrative enforcement action by the failed institution's primary financial regulator. In addition, PLU assists DRR and the Legal Division's Financial Crimes Unit to obtain criminal restitution from defendants convicted of banking crimes that caused losses to financial institutions that later failed and were placed in FDIC receivership.

Recoveries and Expenses

During 2018 PLU and DRR recovered $116,270,528 and incurred expenses totaling $47,312,418 for professional liability program activity. The recoveries were obtained from the following types of claims:

Type of Claim	Recoveries – 2018	
Accountant Malpractice	$60,000,000	(51.60%)
Fidelity Bond	$17,750,000	(15.27%)
Securities		
Residential Mortgage-Backed Securities ("RMBS")	$13,034,655	(11.21%)
Other	$1,235,499	(1.06%)
Insurance	$10,115,001	(8.70%)
Mortgage Malpractice or Mortgage Fraud ("MMF")	$7,034,651	(6.05%)
Director and Officer ("D&O") Liability	$6,975,722	(6.00%)
Attorney Malpractice	$125,000	(0.11%)
TOTAL	**$116,270,528**	**(100.00%)**

The $60 million in accountant malpractice recoveries all came from the settlement of claims out of Colonial Bank ("Colonial"), Montgomery, Alabama, against Crowe Horwath LLP ("Crowe"), the former outsourced internal auditor of Colonial. The claims were based on Crowe's breach of its professional duties, which contributed to Crowe's failure to detect a fraud against Colonial by Colonial's biggest customer, Taylor Bean & Whitaker Mortgage Corporation ("TBW"). As discussed following, PriceWaterhouseCoopers ("PwC"), Colonial's independent outside auditor, was a co-plaintiff in the same case filed against Crowe related to the TBW fraud, and, as of year-end, the claims against PwC were still being litigated. Colonial failed on August 14, 2009, with $25.5 billion in assets.

The $17.75 million in fidelity bond recoveries resulted from the settlement of a lawsuit against Arch Insurance Company, National Union Fire Insurance Company of Pittsburgh, Pa., and Certain Underwriters at Lloyd's of London out of Washington Mutual Bank ("WaMu"), Henderson, Nevada. The FDIC's lawsuit was based on the insurance companies' breaches of contract in failing to pay $24.36 million in losses resulting from the fraud and dishonesty of loan originators that had sold fraudulent loans to WaMu. WaMu failed on September 25, 2008, with $307 billion in assets.

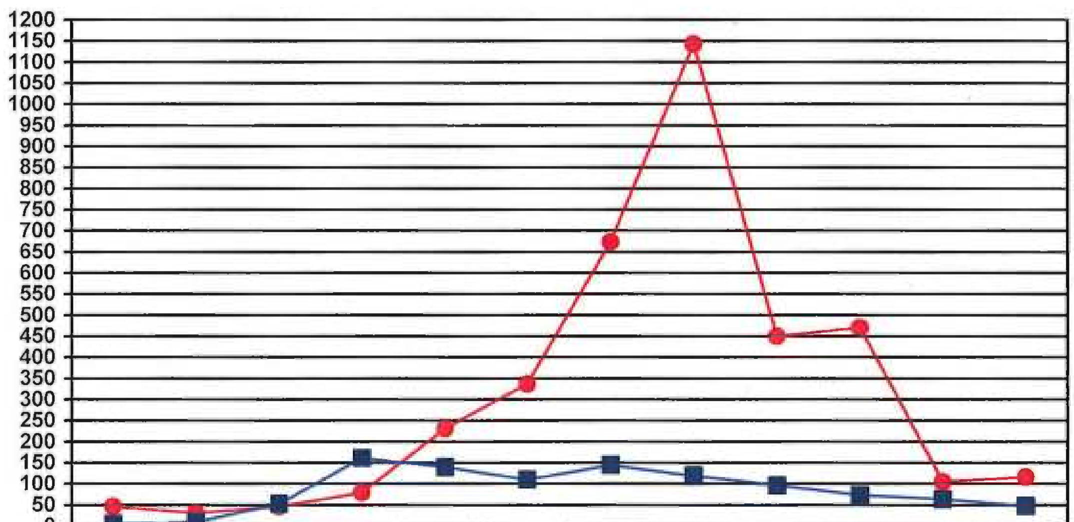
The $13 million in RMBS recoveries resulted from claims out of ten receiverships, including eight receiverships that participated as claimants in a class action settlement. The largest of these recoveries was a $9.5 million settlement of RMBS claims out of Colonial against RBS Securities, Inc. ("RBS"). The FDIC sued RBS for violations of federal and state securities laws in connection with two RMBS that Colonial had purchased prior to failure.

Of the remaining four categories of recoveries (insurance, MMF, D&O, and attorney malpractice), the single largest recovery was $10.115 million from a D&O liability insurance coverage case out of Omni National Bank ("Omni"), Atlanta, Georgia. On January 23 the U.S. Court of Appeals for the Eleventh Circuit affirmed a $10 million judgment in favor of the FDIC against Certain Underwriters at Lloyd's of London ("Lloyd's"). After the FDIC sued Omni's former directors and officers, Lloyd's filed a separate declaratory judgment action arguing that two exclusions in the applicable D&O liability insurance policy barred coverage for the FDIC's D&O claims. The separate insurance coverage litigation, which continued even after the FDIC obtained stipulated judgments against Omni's directors and officers, was finally resolved when the U.S. Supreme Court denied Lloyd's petition for *certiorari* on May 29. On July 27 Lloyd's paid the FDIC $10.115 million comprising the entire $10 million policy proceeds plus $115,000 in post-judgment interest, but refused to pay prejudgment interest. The FDIC is continuing to pursue its right to prejudgment interest against Lloyd's.

Of the total program expenses of $47,312,418 in 2018, the Legal Division incurred $45,194,918 (95.52 percent), DRR incurred $2,107,072 (4.45 percent), and other FDIC Divisions and Offices incurred $10,429 (0.02 percent). Legal Division expenses comprise $35,833,359 paid to outside counsel and consultants and $9,361,559 for other expenses (primarily salaries and travel expenses for in-house PLU employees). DRR expenses comprise $91,096 paid to outside contractors and $2,015,976 for in-house staff. The ratio of total recoveries to total expenses is 2.5 to 1, and the ratio of recoveries to outside counsel and consultant expenses only is 3.2 to 1.

Professional liability program expenses during 2018 are attributable primarily to the receivership funding expenses that the Legal Division and DRR continue to incur to conduct professional liability investigations and litigation arising from the large number of insured financial institutions that failed since the beginning of 2007. Typically, program expenses are incurred several years before associated recoveries are received, because in most instances staff spends substantial time and money to investigate and develop a claim before a settlement or judgment is obtained. Program expenses also include substantial investigation and legal analysis costs for investigations that do not ultimately identify meritorious and cost-effective claims and that, as a result, produce no recoveries. Investigation expenses for a failed institution include these sunk costs while recoveries from more cost-effective claims from the same institution may not be obtained until many 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 reporting periods. For all of these reasons, the cost-effectiveness of the program is best assessed by comparing recoveries and expenses over many years rather than in any single reporting period.

FDIC Professional Liability Recoveries and Expenses, 2007-2018 (in $millions)



	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Recoveries	47.1	31.3	47.1	79.4	231.9	337.3	674.2	1,142.7	450.3	470.9	105.4	116.3
Expenses	5	9.7	52.9	160.8	139.5	110.1	144.6	119.8	96.5	73.5	63.5	47.3

Recoveries — Expenses

As shown in the historical table attached to this report, from 1986 through 2018 the professional liability program has achieved an overall recoveries-to-expenses ratio of 4.02 to 1.

Report on Total Recoveries and Expenses From 2007 Through 2018

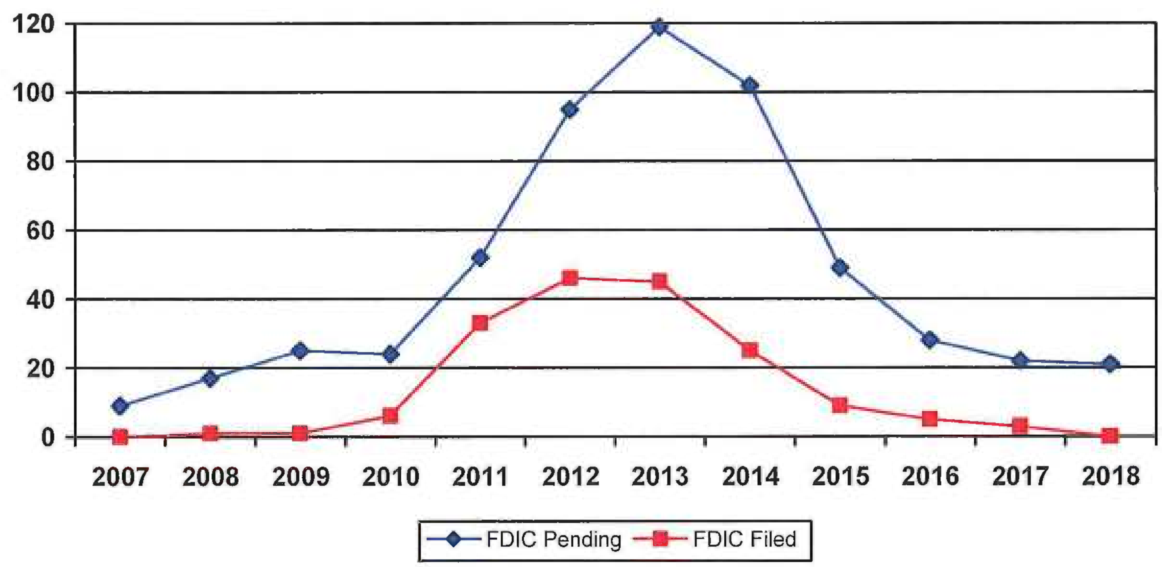
To show the relative significance of different types of recoveries to the program's more recent overall results, the following table shows recoveries from 2007 to date. Since the beginning of 2007, PLU and DRR have recovered $3.734 billion and incurred expenses totaling $1.023 billion for all professional liability program activity.

Type of Claim	Total Recoveries – 2007-2018	
Securities		
RMBS	$1,709,168,044	(45.77%)
Other	$62,417,540	(1.67%)
D&O Liability	$1,274,554,703	(34.13%)
MMF	$235,702,619	(6.31%)
Fidelity Bond	$194,261,558	(5.20%)
Accountant Malpractice	$112,884,317	(3.02%)
Appraiser Malpractice	$45,738,132	(1.22%)
Attorney Malpractice	$42,424,157	(1.14%)
Other	$34,400,065	(0.92%)
Insurance	$22,478,837	(0.60%)
TOTAL	**$3,734,029,972**	**(100.00%)**

Pending Lawsuits Year-End 2018

The following graph shows pending professional liability civil cases (excluding MMF) from 2007 through year-end 2018. ("Pending" actions include claims that PLU itself filed as well as claims that institutions filed before they failed and that the FDIC inherited as Receiver.)

FDIC Professional Liability Civil Actions, 2007-2018
(Excludes MMF)



No new lawsuits were authorized during 2018, but PLU filed one U.S. Dollar London Interbank Offered Rate ("LIBOR") lawsuit in 2018 based on earlier authority obtained from the FDIC Board of Directors. As of year-end, 21 professional liability lawsuits were pending (excluding MMF), and 9 MMF lawsuits were pending.

Significant Developments During 2018

On July 2 the U.S. District Court for the Middle District of Alabama awarded the FDIC as Receiver for Colonial $625,309,085 in damages in its accountant malpractice lawsuit against PwC. Previously, the court had bifurcated the FDIC's claims against PwC into separate trials on liability and damages, and in 2017 after a four-week bench trial the court had held PwC liable for professional negligence for failing to detect a multi-year fraud that TBW, assisted by two Colonial employees, had committed against Colonial. In its July 2 decision, which followed a one-week bench trial on damages, the court held that PwC's negligence caused $625,309,085 of damages to Colonial. As of year-end, the liability and damages decisions were not final and appealable and several outstanding issues remained pending before the court, including whether to allow the FDIC a jury trial against PwC for two audit years not covered by the prior bench trials.

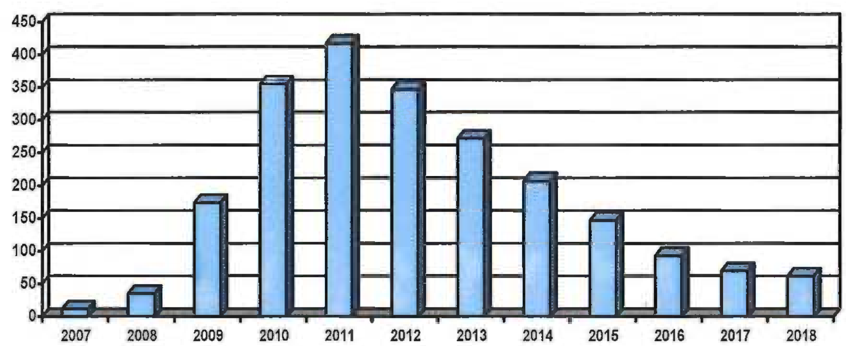
In 2018 the FDIC as Receiver for 38 failed banks and thrifts continued to litigate two large lawsuits in the U.S. District Court for the Southern District of New York and in London, England, alleging that 34 defendants wrongfully suppressed LIBOR, which resulted in substantial damages to the failed institutions. On February 20 the FDIC filed an additional complaint in the New York court asserting similar claims out of Doral Bank ("Doral"), San Juan, Puerto Rico. Both New York cases are the subject of a motion to consolidate filed by the FDIC and both are part of a multi-district litigation ("MDL") in the New York court for LIBOR suppression claims. In November the London court heard argument on a motion to strike the FDIC's claims but has not yet ruled. Neither court has yet set a discovery or trial schedule for the FDIC's claims.

The FDIC in 2018 continued to pursue state and federal securities law claims in seven RMBS cases out of five receiverships: Guaranty Bank ("Guaranty"), Austin, Texas (2 cases); Colonial (3 cases); United Western Bank ("UWB"), Denver, Colorado (1 case); and Citizens National Bank, Macomb, Illinois, and Strategic Capital Bank, Champaign, Illinois (together, "Citizens/Strategic") (1 combined case). In the two cases out of Guaranty, the parties completed discovery in 2018 and submitted summary judgment briefing on multiple issues, including briefing on a component of the damages calculation under the Texas Securities Act ("TSA"). The court ruled, among other things, that the jury must decide whether, within the meaning of the TSA, the FDIC sold the RMBS as part of a resecuritization in 2010 or, in spite of the resecuritization, is deemed to own the RMBS. Trials in the Guaranty cases are scheduled in June and August 2019. One of the three Colonial cases fully settled in 2018, and the second is scheduled for trial in April 2019 in Alabama state court. In the third Colonial case, pending in federal court in New York, the FDIC successfully amended its complaint to add state law securities claims against four of the seven defendants. Discovery in that case is partially complete, but no trial date has been set. In the UWB case, discovery is complete and summary judgment motions are pending, but the court has not yet set a trial date. In the case arising out of Citizens/Strategic, defendants' motion to dismiss remains pending and discovery is in the early stages. Damages in the RMBS cases, collectively, have been and continue to be substantial.

PLU Workload and Staffing at Year-End

During 2018 no FDIC-insured financial institutions failed, leaving the total number of failures since the beginning of 2007 at 531. The 531 failures since 2007 resulted in a very substantial increase in PLU's workload beginning in 2008, which peaked during 2011 and 2012 and has been declining since then. 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.[1] As of September 1, 2007, PLU had 49 open institutions in its inventory (39 of which were open solely for the limited purpose of monitoring collections from judgments and structured settlements), 8 pending professional liability lawsuits, 3 related lawsuits, 0 MMF lawsuits, 12 open investigations, and 95 collection matters.[2] As of year-end 2018, PLU had 95 open institutions (33 of which were open for collection only), 20 pending professional liability lawsuits, 1 additional related lawsuit, 9 MMF lawsuits, open investigations in 27 claim areas out of 18 institutions,[3] and 60 collection matters.

Institutions With Open Investigations or Lawsuits at Year-End
(Excludes Institutions Open Only for Collection)



To handle the increased workload, PLU's staff increased substantially starting in the second half of 2008, peaked in 2011, and has been decreasing since then. From a single office in Virginia Square that had 17 total staff in January 2008, PLU as of year-end 2011 had grown to 65 staff and managers located in two permanent and three temporary satellite offices. As of year-end 2018, PLU had 21 total staff in two permanent offices—Virginia Square and the Dallas Regional Office.

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1 The 11 types of investigations are: (1) D&O, (2) fidelity bond, (3) MMF, (4) attorney, (5) accountant, (6) appraiser, (7) RMBS and other securities, (8) commodities, (9) insurance, (10) insurance issuer, and (11) other. Some institutions have multiple matters open. For example, out of a single failed bank, the FDIC as receiver may have a pending D&O lawsuit, a pending bond lawsuit, and an active MMF investigation.

2 All institutions in PLU's inventory are failed institutions. For PLU management purposes, however, a failed institution is "open" in PLU while PLU is working on any matter relating to that failed institution.

3 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, settles or otherwise resolves the associated claim, or pursues litigation. An "open investigation," therefore, is an investigation in PLU's inventory that is still active because it has not been settled or otherwise resolved or moved to litigation.

Conclusion

During 2018 the FDIC's professional liability program continued to operate cost-effectively recovering a total of $116,270,528 and incurring total expenses of $47,312,418 as PLU and DRR continued to devote substantial resources to the professional liability investigations and litigation cases arising from the 531 failures that have occurred since the beginning of 2007 through 2018.

FDIC PROFESSIONAL LIABILITY RECOVERIES AND EXPENSES ($ MILLIONS)

	Recoveries[4]	In-House PLU Expenses	DRR Expenses	Outside Counsel Expenses	Total Expenses[5]	Ratio of Recoveries to Outside Counsel Expenses	Ratio of Recoveries to Total Expenses
2018	$116.3	$9.4	$2.1	$35.8	$47.3	3.25 to 1	2.46 to 1
2017	$105.4	$8.8	$6.4	$48.4	$63.5	2.18 to 1	1.66 to 1
2016	$470.9	$9.2	$5.5	$58.8	$73.5	8.00 to 1	6.40 to 1
2015	$450.3	$12.1	$11.2	$73.1	$96.5	6.16 to 1	4.67 to 1
2014	$1,142.7	$13.3	$16.3	$90.1	$119.8	12.68 to 1	9.54 to 1
2013	$674.2	$13.5	$36.8	$94.2	$144.6	7.16 to 1	4.66 to 1
2012	$337.3	$12.6	$29.3	$68.1	$110.1	4.96 to 1	3.06 to 1
2011	$231.9	$12.0	$62.3	$64.7	$139.5	3.58 to 1	1.66 to 1
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	$9,759.0	$261.1	$423.1	$1,738.4	$2,425.1	5.61 to 1	4.02 to 1

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

[5] Expenses include Drexel-Milken expenses of $106.1 million. The following categories of expenses are unavailable or are not included: all FSLIC fees and expenses for 1986-1988; FSLIC in-house (legal and investigation) expenses for 1989; RTC in-house expenses (1989-1995), and certain electronic data costs. DRR investigation expenses (shown 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.