Practical Tips For Managing Bank D&O Liability Risk

By **James Vivenzio, Jonathan Hardin and David Daniels** (March 29, 2023)

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As with past banking crises, the recent failures of Silicon Valley Bank and Signature Bank will likely put the directors and officers of affected banking institutions in the proverbial crosshairs as regulators second-guess their decisions and look for potential sources of loss recovery. Such individuals may face personal liability on a variety of different fronts.

The crisis thus far appears to stem from liquidity breakdowns and a failure to manage balance sheet and interest rate risk. The affected financial institutions had close connections with startup companies, venture capital firms and the digital asset sectors. The lack of customer diversification has been alleged as a factor in the downfall of these financial institutions.

Addressing D&O liability risks in such an environment requires an interdisciplinary approach that pays close attention to announced regulatory priorities. We describe some of the risks that D&Os at affected banks may face and make some suggestions to promote sound banking practices and mitigate personal liability risk going forward.

Banking D&O Regulatory, White Collar and Litigation Risks

In addition to the liability risks that all D&Os of privately and publicly held companies may face, bank D&Os face special risks from their heavily regulated environment.

The Federal Deposit Insurance Corporation plays a leading role in holding D&Os accountable for losses at failed financial institutions.

Acting as a receiver, the FDIC can pursue civil claims against bank D&Os, seeking to hold such individuals liable for losses at their financial institutions based on alleged negligence, gross negligence and breach of fiduciary duty. In the wake of the 2008 financial crisis, for example, the FDIC sued several officers of Washington Mutual for more than $900 million in bank losses supposedly caused by their negligence and misconduct.

Acting as a regulator, the FDIC can also bring administrative enforcement cases against bank D&Os and other individuals related to an insured depository institution. The FDIC shares this power with other federal banking agencies, including the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the National Credit Union Administration.[1] Such enforcement actions can seek significant civil money penalties, restitution of unjust enrichment and prohibition of further participation in the conduct of the affairs of any insured depository institution.

The FDIC and other banking agencies have brought a variety of enforcement actions against bank D&Os, particularly for unsafe or unsound banking practices resulting in depository institution failures. Here, as part of its receivership responsibilities, the FDIC will undoubtedly be conducting investigations and developing cases that may result in liability claims and administrative enforcement.

State bank regulators may also have enforcement authority. For example, the California Department of Financial Protection and Innovation has the authority to censure, suspend or bar individuals from participating in a regulated industry. It may also obtain equitable remedies, including rescission, restitution and penalties against violators.

In addition to regulatory exposure, criminal authorities are also likely to investigate — and potentially prosecute — individuals responsible for high-profile bank failures.

Although criminal prosecutions were largely absent following the 2008 financial crisis, the U.S. Department of Justice did prosecute hundreds of individuals for banking-related crimes in the wake of the savings and loan crisis of the 1980s. The types of federal criminal charges that could, in theory, result from such investigations could include wire fraud, bank fraud and conspiracy, among other offenses.

Likewise, the U.S. Securities and Exchange Commission has also reportedly launched an investigation into these matters. Although a civil regulatory agency, SEC investigations typically closely parallel DOJ investigations, raising the risk of liability for investigatory targets significantly.

Practical Tips: Managing D&O Risk in the Current Environment

The best risk-mitigation strategy is to be proactive in light of available regulatory guidance. Here are some practical suggestions to consider.

Liquidity Risk Governance Framework

Liquidity is the lifeblood of a banking organization, and D&O attention to liquidity risks will likely be a central concern to regulators in this current crisis.

Liquidity risk management is complex. The sophistication of a bank's liquidity management process depends on its business activities and appetite for risk, as well as the overall level of liquidity risk.

Regulators expect, however, that a well-managed banking organization, regardless of size and complexity, will identify, measure, monitor and control its exposure to liquidity risk in a timely and comprehensive manner. Regulators also expect banks to devote appropriate resources to manage such risks, even at the expense of short-term earnings performance.

To maintain an effective liquidity risk management process, bank management, with appropriate board oversight, should continue to apply fundamental principles of sound liquidity risk management consistent with interagency policy statements on funding and liquidity risk management, regulatory safety and soundness standards, along with any heightened standards for large banks.

Bank management should also:

- Evaluate the recent liquidity events surrounding recent bank failures and integrate lessons learned into these processes, including:

  - A comprehensive enterprisewide risk management framework commensurate with size, complexity, business activities and reliance on uninsured deposits;
  - Active management of intraday liquidity and collateral; and
  - Projections and modeling of cash flows under alternative stress-testing scenarios;
- Carefully update and evaluate the effectiveness of existing liquidity risk management programs; and
- Leverage existing liquidity risk management infrastructures to prioritize risk areas unique to the bank in question that may be important, including enterprisewide and global risks.

Concentrations

Management should ensure concentration risk management processes and control considerations address all risk categories involving both on- and off-balance sheet activities, including borrowers, funds providers and counterparties.

The lack of a diversified customer base poses specific risks that should be addressed. For example, certain credit unions with membership limitations should closely monitor their member business loans from a concentration risk perspective.

Self-Disclosure

Regulators will be asking a lot of questions to better understand a bank under investigation and its various enterprisewide risk management practices, including new products and services and third-party relationships. Proactively identifying problems based upon recent issuances, taking corrective actions or developing a plan with regulators to reduce banking risks helps demonstrate good faith. Regulators consider self-disclosure and proactive, good faith communication when deciding whether to bring certain enforcement actions.

Good faith, full cooperation after notification of problems or deficiencies, and restitution, if applicable, are mitigating factors that regulators will also consider in any penalty assessments.

On the other hand, efforts to knowingly conceal violations and deficiencies will worsen the relationship and could result in criminal investigation or prosecution for false statements, obstruction of justice, wire fraud or other relevant criminal statutes. For example, a recent regulatory penalty against a banking executive was accompanied by a March plea agreement in the U.S. District Court for the Central District of California's obstruction of justice case, U.S. v. Tolstedt, with prosecutors calling for prison time of up to 16 months.[2]

D&O Liability Insurance Coverage

D&O insurance policies are one of the most important assets protecting bank D&Os from financial liability that may result from a bank failure. Banking regulations restrict the extent to which banks can indemnify D&Os, either directly or through liability insurance.

D&O policies can provide coverage directly to such individuals for legal expenses, and potentially for settlements or judgments, arising from civil suits and enforcement actions brought by the FDIC and other banking agencies. Known as Side A coverage, D&O policies typically provide first-dollar coverage for claims asserted against individual D&Os whose costs are not indemnified or advanced by the corporate entity.

Insurers may attempt to deny D&O coverage, arguing that the so-called "insured v. insured" and "regulatory" exclusions, for example, prohibit coverage for actions brought by banking agencies like the FDIC.

Whether such exclusions actually apply depends on the specific language in the D&O policy. Management and directors should undertake to verify whether the terms and conditions in the organization's D&O policies offer the maximum scope of coverage available in the market and to ensure that notice requirements are met in the event of any claim letter, subpoena or other investigative demand.

Unique Risks for Crypto Assets

Finally, any bank dealing with customers in the crypto-asset industry should pay particular attention to the liquidity risks specific to that market.

On Jan. 3, the federal banking agencies issued a joint statement, "Crypto-Asset Risks to Banking Organizations." This statement specifically noted that issuing or holding crypto assets as a principal is highly likely to be inconsistent with safe and sound banking practices. The statement advises that these regulators have significant safety and soundness concerns with business models that are concentrated in crypto asset-related activities or have concentrated exposures to the crypto-asset sector.

On Feb. 23, the federal banking agencies issued another joint statement, "Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities." This advised that sources of funding from crypto asset-related entities may pose heightened liquidity risks to banking organizations due to the unpredictability of the scale and timing of deposit inflows and outflows. Such funding can include deposits placed by entities related to crytpo assets that benefit the entities' end customers or deposits that constitute stablecoin-related reserves.

To the extent that any bank comes to hold any crypto asset as a principal — for example, through foreclosure on crypto assets securing a loan — it should closely review those assets in light of the safety and soundness concerns expressed in the January crypto risks statement and determine whether discussions should be undertaken with its regulators concerning the maintenance or disposal of assets.

As far as any bank has a business model concentrated in activities related to crypto assets or concentrated exposures, it should develop an action plan to reduce those risks and similarly consider discussions with its regulators. Board oversight of these risks is important.

Conclusion

To summarize, D&Os should proactively address enterprisewide liquidity and concentration risks, consider the recent issuances from the federal banking agencies regarding crypto-asset activities, proactively coordinate with their regulators if needed, and verify the terms and conditions of their D&O insurance policies.

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[1] 12 U.S.C. §§ 1818 and 1786.

[2] United States v. Tolstedt, No. 2:23-cr-00115-JLS, (D. Cal. Mar. 15, 2023).