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KD Alert: North Carolina Federal Court Protects Bank Directors & Officers' Business Decisions

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In the first summary judgment decision of its kind, the District Court for the Eastern District of North Carolina reinforced the strength of the business judgment rule in protecting the former directors and officers of failed banks from claims by the FDIC. In its September 10, 2014 decision in ***Fed. Deposit Ins. Corp. , as receiver for Cooperative Bank v. Frederick Willetts, III, the Court dismissed all the FDIC's claims against the directors and officers of Cooperative Bank holding that the business judgment rule shielded them against the FDIC's negligence and breach of fiduciary duty claims, and found no intentional misconduct to support the FDIC's gross negligence claim.***

The FDIC lawsuit in *Willets was similar to other lawsuits filed by the FDIC following the "Great Recession" that led to numerous community, regional, and national bank closures. Following Cooperative Bank's failure in 2009, the FDIC sought to hold Cooperative Bank's former directors and officers liable for policy decisions and loans which deviated from prudent lending practices established by Cooperative Bank and other regulatory guidelines. The FDIC also alleged that the directors and officers approved the loans despite prior warnings from the FDIC concerning Cooperative Bank's underwriting and credit practices.*

The Court rejected the FDIC's arguments and granted the directors and officers summary judgment motion. In granting summary judgment on the negligence and breach of fiduciary duty claims, the Court relied on North Carolina's business judgment rule and found that the FDIC could not meet its burden to rebut the strong presumptions imposed by the rule, which are: (1) that the directors and officers acted in good faith and employed a rational process in making the decisions; and (2) the decisions of the directors and officers can be attributed to a rational business purpose.

Dealing with the first presumption, the Court held that the FDIC had not produced any evidence to support bad faith conduct or that the directors and officers acted with knowledge that the practices would harm Cooperative Bank. The Court noted that, while the subject loans and lending practices may raise questions regarding the wisdom of certain decisions in retrospect, the business judgment rule precludes the Court from delving into whether such decisions were "good" decisions. Instead, the Court evaluated whether the subject decision were made in "good faith" and followed a rational process in making the challenged loans. This limitation proved fatal to the FDIC's claims. Notably, the FDIC argued that the bank engaged in the improper lending practices despite the prior Reports of Examination ("ROE") from the FDIC warning about Cooperative bank's underwriting and credit practices. However, the Court relied upon the ROE in dismissing the FDIC claims. Indeed, although the FDIC's provided the warning in the ROE, the FDIC gave a satisfactory rating for Cooperative Bank's management, asset quality, and risk in the same ROE. Thus, in its scathing decision, the Court held that it was "absurd" for the FDIC to now challenge Cooperative Bank's practices as irrational when the FDIC had previously reviewed, addressed, and graded the processes and found them to be satisfactory.

Turning to the second presumption of the business judgment rule, the Court found that Cooperative Bank's lending practices had a rational business purpose. While conceding that there were risks involved in Cooperative Banks approach and pursuit of the challenged loans, the Court held that risk does not equate to irrationality. Rather, when Cooperative Bank was making decisions and taking certain risks in making the loans, it was aligned with the bank's growth objective. In fact, the Court noted that "corporations are expected to take risks and their directors and officers are entitled to protection from the business judgment rule when those risk turn out poorly."

After granting summary judgment on the negligence and breach of fiduciary duty claims, the Court gave short shrift to the FDIC's gross negligence claim. The District Court held that the gross negligence claim failed as a matter of law because FDIC could not establish that the directors and officers engaged in wanton conduct or consciously disregarded the bank's wellbeing.

While directors and officers of failed banks in North Carolina scored a win with the Willet decision, it remains to be seen whether other jurisdictions adopt the District Court's rationale. Many other jurisdictions afford protection under a business judgment rule similar to the rule analyzed in Willet. Thus, at a minimum, Willet should serve as a framework for future reliance on the business judgment rule and fodder for directors and officers trying to prevent the FDIC from using hindsight to obtain financial recovery from them.